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The Valuation of Minority Interests in Forced Takings

Julius Koo and Howard Rosen
FTI Consulting
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Valuation experts are often tasked with determining the value of an entire business enterprise, such as 100 per cent interest in the shares of a privately held company. While most dispute-related valuations in international arbitration involve the valuation of a 100 per cent interest or a controlling interest of less than 100 per cent, it is the valuation of minority interests that presents added complexity and requires special considerations.

Generally speaking, minority shareholders are unable to elect a majority of the board of directors, and depending on the nature of the relative shareholdings of other shareholders, may be subject to the will of majority shareholders (with some protections from various Corporations Acts depending on jurisdiction). Shareholder agreements can offer further protection to minority shareholders, but a lack of control can influence the value of the shareholding, and in some cases the effect on value can be material.

While it is the disputes involving controlling interests that garner the most attention due to the relatively higher values at stake of larger percentage ownership interests, minority interests should not be overlooked. This article examines the complexities and considerations faced by valuation experts in valuing minority interests in the context of forced takings in international arbitration.

Controlling interests v minority interests

The definitions of control and rights of shareholders will depend on the jurisdiction in which an entity is incorporated, and what corporate law statutes apply. A valuation expert should be aware of what percentage of shareholder votes are required for significant corporate actions, and the rights of majority and minority shareholders, as these considerations are relevant in determining whether a certain percentage shareholding represents a controlling interest or a minority interest.

For example, in Canada, the Canada Business Corporations Act (as well as the Provincial Corporations Acts) and income tax legislation generally define control and the rights of controlling shareholders. A controlling interest is defined as one having more than 50 per cent of the voting shares of a company. The rights and privileges of a controlling interest include:

- the ability to elect the majority of the board of directors, which allows for control through decisions that influence the strategic direction of the company;
- the ability to appoint themselves or others in senior management positions, which allows for control through operational decisions of the company;
- the ability to determine the timing and quantum of dividends, which allows for control of one's return on investment;
- the right to determine the timing of the sale of the business, and the amount and form of consideration of the sale; and
- the right to liquidate the business and distribute the proceeds.[1]

The issue of control is not as simple as having more than 50 per cent of the votes. The ability to pass special shareholder resolutions required to enact 'fundamental changes' in the business are set out in the Federal and Provincial Corporations Acts.[2] These statutes provide for specific voting requirements in order to pass special resolutions, which may be two-thirds of votes or three-quarters of votes depending on the prevailing statute. A 'fundamental change' may be a significant change in the direction of a company, or a sale or liquidation of the business. The requirements to pass special resolutions and other terms of shareholder rights and privileges may also be provided for in a company's incorporation documents, in shareholders' agreements or in financing agreements.

In the United States, companies are free to incorporate in any state no matter the location of the headquarters or where business is conducted; however, more than half of all publicly traded companies in the US are incorporated in Delaware.[3] Under the Delaware General Corporation Law, the existence of a two-thirds vote requirement essentially gives 33.4 per cent shareholder ability to block certain activities of management and in some cases allow the 33.4 per cent shareholder to maintain an effective controlling interest.

For valuation assignments in international arbitration, it is important for a valuation expert to understand the statutory definitions of control and shareholder rights, if they are provided for in the relevant jurisdiction, and any case-specific factors that influence control. The existence of a shareholder agreement or a review of the articles of incorporation will also provide information that is relevant to the determination of restrictions or protections that are afforded to various shareholders.

Minority interest shareholders are not afforded the same rights and privileges enjoyed by controlling interest shareholders, and thus a valuation expert needs to consider whether adjustments should be made to the pro rata portion of the total value of an entire business enterprise when valuing a minority interest in the context under which the dispute arose. The two most common adjustments are:

- minority discount – a discount for the inability to control the strategic and operational direction of the company; and
- illiquidity discount – a discount for the lack of an immediately ready market in which to sell minority shareholdings, especially for privately held companies and thinly traded publicly held companies.

Definition of value

The starting point of any valuation exercise is to define the concept of 'value' being determined. In international arbitration cases, the standard of value is often referred to as 'fair market value'. Fair market value has different definitions in different parts of the world.

In Canada, the definition of fair market value that has been generally accepted by Canadian courts is:

> The highest price available in an open and unrestricted market between informed and prudent parties, acting at arm's length and under no compulsion to act, expressed in terms of cash.[4]

In the United States, fair market value is defined by the American Society of Appraisers (ASA) as:

> The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.[5]

While the International Valuation Standards Council (IVSC) does not provide a definition for fair market value, it does provide a definition for 'market value' under its International Valuation Standards (IVS) Framework as:

> The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.[6]

The concepts outlined in these definitions all have common elements that are generally accepted by valuation professionals globally. These common elements are:

- a willing buyer and seller not under compulsion to transact;
- a knowledgeable buyer and seller at arm's length;
- an open and unrestricted market; and
- price expressed in terms of cash equivalents.

The other concept of value relevant to the valuation of minority interests is the term 'fair value'. In the context of valuation for dispute purposes (as opposed to financial accounting purposes), the term 'fair value' is not as clearly defined as fair market value and is subject to interpretation by courts and tribunals. Generally, courts in Canada and the United States have interpreted 'fair value' to mean fair market value without the application of discounts to reflect the fact that the shareholding being valued is a minority interest. However, the application and determination of fair value in specific cases is varied in terms of the quantum of discounts, if any, that are applied to the valuation of minority interests.

The IVSC provides a definition for fair value under its IVS Framework as:

> the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.[7]

For valuation purposes, this definition of fair value requires the assessment of special advantages or disadvantages that each party will receive from the specific transaction; these advantages and disadvantages are to be disregarded under the IVSC definition of market value since they are not generally available to market participants.

The concept of fair value is relevant in international arbitration since it allows courts and tribunals to examine the specific circumstances of the case, and to decide on a value that is just and equitable to all parties. As illustrated in the application of fair value in Canada and the United States discussed below, this concept provides courts room for broad flexibility in arriving at a value which they consider appropriate in each individual case.

Canada

In Canada, the issue of valuing minority interests and the concept of 'fair value' can arise from the following transactions or causes of action under the Canada Business Corporations Act (CBCA) (and certain Provincial Corporations Acts):

- shareholder dissent rights that may be triggered by specified corporate changes such as restricting the issue or transfer of shares, restricting businesses the corporation may carry on, amalgamating, or selling all or substantially all of the corporation's property; and
- compulsory purchase or 'squeeze-out' provisions that may be triggered by a takeover bid by the tender of 90 per cent or more of the shares of any class to which the bid relates.

The minority interests in the above circumstances are entitled to be valued and acquired at fair value (ie, pro-rata fair market value, with no deduction for minority interest or no premium for control). Under the CBCA, courts have the option to order that shares be purchased where there has been oppression of minority shareholder rights. Oppression remedies are triggered by corporate conduct that is 'oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer'.[8] Although the CBCA does not specify the standard of value for the valuation of minority interests in cases of oppression, the courts generally apply the concept of fair value, consistent with the appraisal rights noted above.

While the CBCA and Provincial Corporations Acts provide for valuations at fair value, the term 'fair value' is not specifically defined in these Acts. Generally, the fair value of a minority interest in dissent and oppression cases has been interpreted by Canadian Courts to mean fair market value without applying a discount to reflect a minority shareholding.[9] In the often cited case Domglas Inc v Jarislowsky, a case heard in the Supreme Court of Quebec relating to dissenting minority shareholders, the Court made the following comment with reference to the definition of fair value:

> Thus, a 'fair' value is one which is just and equitable. That terminology contains within itself the concept of adequate compensation (indemnity), consistent with the requirements of justice and equity.[10]

In the Domglas case, the Quebec Court of Appeal considered the question of the applicability of a minority discount and it was held that it was reasonable and correct to reject any discount.[11] In Canada, most courts have defined 'fair value' as the value that is just and equitable given the specific circumstances of each case. This provides Canadian courts with flexibility and room to judge the applicability of discounts related to the valuation of minority interests.

United States

In the United States, as in Canada, the issue of valuing minority interests commonly arises from minority shareholder oppression cases and cases triggering appraisal rights of dissenting minority shareholders. The definition and application of 'fair value' in these cases is complicated in the US, which will vary by state and the governing corporate statues adopted in each state. For example, the definition of 'fair value' provided for in the 1984 Revised Model Business Corporation Act (RMBCA), under shareholder appraisal rights, did not specifically mention the application of discounts to share valuation.[12] Revisions were made in 1999 to the RMBCA to specifically exclude minority discounts and marketability discounts in arriving at fair value.[13] However, not all states have adopted the 1999 amendments, and many states, such as New York, have statutes that reflect the 1984 RMBCA definition of 'fair value' which allow the courts to decide the appropriateness of applying specific discounts to value based on the facts of the case. Under the Delaware General Corporation Law, a minority shareholder is entitled to an appraisal of the fair value of the shareholdings by the Delaware Court of Chancery, under the appraisal rights available for merger or consolidation transactions.[14] In reference to the determination of fair value, the Delaware Court of Chancery is to exclude 'any element of value arising from the accomplishment or expectation of the merger or consolidation' and 'the Court shall take into account all relevant factors'. [15] Therefore, while the fair value concept is used in Delaware, the definition and determination of 'fair value' is left open for the court to decide if minority interest related discounts are applicable on a case-by-case basis.

A key distinction in the definition of 'fair market value' and what many courts interpret as fair value is the concept of a willing buyer and a willing seller under no compulsion to act. In cases of minority shareholder oppression where minority shareholders are 'squeezed out' by majority shareholder actions or in other cases of forcible taking, such as the expropriation of an asset or business by a government, the seller would not be considered as willing and likely are compelled to transact.

In the case McKesson Corporation et al v the Islamic Republic of Iran et al, heard in the United States District Court, District of Columbia,[16] it was found that the defendant had expropriated McKesson's 31 per cent interest in an Iranian dairy company and that Iran could be held liable in federal court for the expropriation under the Treaty of Amity and customary international law. The Court ruled that the plaintiffs were entitled to an award of damages equal to the 'full value of the property expropriated', which is 'usually "fair market value" where that can be determined'. In the determination of fair market value of this minority interest, the Court rejected the application of a minority discount and a lack of marketability discount. In arriving at this decision, the Court applied what it considered to be analogous domestic law that addressed the legal propriety of minority and marketability discounts in appraisal actions in the United States. It was noted that the overwhelming majority of courts in the United States have found that no minority or lack of marketability discount is appropriate in the valuation of minority interests in an appraisal action when being purchased by the majority shareholder or the corporation itself. In this decision, the Court also observed that:

> in a forced sale, discounts are inherently unfair to the forced-out shareholder who did not pick the timing of the transaction and thus is not in the position of a willing seller

and

> because allowing discounts create incentives for oppressive behavior, both discounts are particular disfavored where the stock trade is a result of such behavior.

While the Court acknowledged that these considerations involve interpretation of US domestic corporate law statutes, it found that the position of McKesson as a foreign shareholder facing an expropriating government was analogous to that of the oppressed or 'forced-out' minority.

International arbitration

In the ICSID case ADC Affiliate Limited et al v the Republic of Hungary,[17] one of the claimants, ADC Affiliate Limited, held a 34 per cent interest in a project company set up for a renovation and design project of Terminal 2 in the Budapest-Ferihegy International Airport. This arbitration arose from an alleged unlawful expropriation by the Republic of Hungary of the claimants' investment in and related to this airport project. The Tribunal concluded that the respondent did unlawfully expropriate the claimants' interest and awarded damages. The Tribunal accepted the discounted cash flow approach as an appropriate method to compute the fair market value of the expropriated investments of the claimants. In the valuation of the 34 per cent interest, the respondent argued that discounts for illiquidity and absence of control should have been applied. The Tribunal rejected the application of these discounts based on the following factors: the project company was a regulated entity with relatively stable cash flows, as opposed to a privately held company with erratic cash flows; and ADC Affiliate Limited, as a minority shareholder, had adequate shareholder protections in the agreements related to the project.

In the ICSID case CMS Gas Transmission Company v the Argentine Republic,[18] the claimant held a 29.42 per cent interest in a company (TGN) set up by the Argentine Republic for the transportation of natural gas. This arbitration arose from the alleged suspension by Argentina of a tariff adjustment formula for gas transmission applicable to the company in which CMS had an investment. The Tribunal concluded that the actions of the Argentine government did not constitute an indirect or 'creeping' expropriation, but resulted in the objective breach of the fair and equitable treatment standard. With respect to compensation, the Tribunal concluded that the standard of fair market value was the most appropriate in this case. In the valuation of the loss suffered by CMS on its minority interest in TGN, the Tribunal concluded that the discounted cash flow approach was the most appropriate in this case due to the following factors:

- the shares of TGN were not publicly traded;
- the market capitalisation in the Argentine stock market was illiquid and examining publicly traded natural gas transporters was not the most adequate method to value companies;
- TGN was an ongoing company with a record of profits;
- there was no significant evidence of comparable transactions and it would be speculative to determine compensation on that basis; and
- there was adequate data to make a rational discounted cash flow valuation.

In arriving at the valuation of CMS' minority interest as described in the public award decision, there was no discussion of whether a minority discount was applied. Interestingly in this case, the value of the shares was determined and awarded on the basis that CMS must transfer the ownership of its shares in TGN to the respondent upon payment of the award, and the respondent was given up to one year after the date of the award to accept the transfer.

In the ICSID case Gemplus SA et al and Talsud SA v the United Mexican States, [19] the claimants together held a 49 per cent interest (Gemplus holding 20 per cent and Talsud holding 29 per cent) in a concessionaire set up by the Mexican government to create and operate a new national motor vehicle registry in Mexico. This arbitration arose from the claimants' allegations against the respondent of:

- unlawful expropriation;
- unfair, inequitable and arbitrary treatment; and
- failure to provide full protection and security in regard to their investment in the concessionaire.

The Tribunal concluded that the claimants' investments were unlawfully expropriated by the respondent, indirectly with the requisition of the operation of registry and directly with the revocation of the concession agreement. With respect to compensation, the Tribunal concluded that the claimants' claims derive only from their status as investors with minority shareholdings in the concessionaire. The relevant exercise to the Tribunal was the valuation of the claimants' lost investments in the form of their minority shares. With respect to the definition of value, the Tribunal referred to the Argentina bilateral investment treaty, which provides for the equivalent of the 'market value' of the shares, and the France bilateral investment treaty, which provides for the equivalent of the 'fair market value' of the shares. Some of the difficult valuation issues that the Tribunal contended with in this case include the following:

- The concession was intended by the respondent and the claimants to be a profitable investment, but the project never achieved the level of profitability contemplated by the concession's business plan. The Tribunal considered that it still retained a reasonable opportunity to make significant future profits until the time of the respondent's unlawful conduct.
- The Tribunal accepted that there was no 'open, public, active or other available market' for the claimants' shares in the concessionaire and that there was no comparable business as at the valuation date.
- The Tribunal rejected the use of the discounted cash flow approach by the claimants as an appropriate methodology, and accepted the respondent's contention that the status of the concession's business prior to and up to the valuation date was 'far too uncertain and incomplete to provide any sufficient factual basis for the DCF method'.
- In expressing its reservations of the claimants' use of the DCF method in this case, the respondent submitted that a prospective buyer of the claimants' shares would be acquiring a minority interest and, as such, would normally command a discount. The respondent further submitted that a fully informed arm's length purchaser contemplating the purchase of this minority interest would demand a 'very high discount'.
- The Tribunal also rejected the respondent's use of the asset approach and the use of declared tax values since neither of these approaches takes into account the concessionaire's most valuable intangible asset as at the valuation date, being the reasonably anticipated future income stream from the concession agreement under the remaining term of 10 years.
- With respect to the underlying data, the Tribunal noted that it was a material consensus by the quantum experts that the accuracy of much of the underlying data used in the discounted cash flow approach was not in dispute, even though the use of the DCF method itself was disputed.

Having made the above considerations, the Tribunal applied a modified form of the income-based approach to value the claimants' minority shares in the concessionaire by reference to the concessionaire's 'reasonably anticipated loss of future profits' assessed at the valuation date.

Considerations in the valuation of minority interests

A valuation expert should first consider the type of business enterprise that is the subject of the valuation, whether it is a publicly traded corporation, a privately held company, a joint venture or partnership, or a government regulated enterprise. This will have an impact on the valuation methodology and the applicability of a minority interest. For example, using public stock market share prices and trading multiples to arrive at the value of a particular block of shares will in part already include an inherent minority discount since stock prices reflect the publically quoted price of one share, which is a non-controlling interest. However, shares of publicly traded companies if they are highly liquid may to some extent mitigate the perceived minority discount in stock market trading prices. As illustrated by the international expropriation cases above, the valuation of government-regulated entities set up for specific projects will have special considerations, such as whether there are any true comparable publicly traded companies or transactions, whether the entity generated stable historical positive cash flows or the reasonable expectation to generate future cash flows, and whether there are project agreements that provide protections for minority interests involved.

In addition to the ownership percentage being valued, a valuation expert should also understand the ownership structure and the rights and privileges of the shareholding interest. Documents such as articles of incorporation and shareholder agreements may provide information on restrictions or protections that affect various shareholders. The jurisdiction under which the company was incorporated will also have an impact on 'control', such as the provision of specific voting requirements to pass special resolutions that require more than 50 per cent of shareholder votes.

Understanding the cause of action and the dispute that gave rise to the valuation exercise is equally important. In cases involving shareholder dissent rights, compulsory purchase transactions, shareholder oppression and expropriation, shareholder interests are often considered forcibly taken. These transactions involve parties that would be considered unwilling 'sellers' under compulsion to transact. Depending on the jurisdiction and the cause of action, the valuation expert should clearly define the standard of value and understand the applicability of fair market value and fair value in the particular jurisdiction. The valuation of these minority interests should reflect a willing buyer and a willing seller not under any compulsion to transact.

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Notes

1. Canada Business Corporations Act, June 25, 2013.
2. Canada Business Corporations Act, June 25, 2013, Part XV. Ontario Business Corporations Act, December 31, 2011, Part XIV.
3. www.corp.delaware.gov/aboutagency.shtml
4. The Canadian Institute of Chartered Business Valuators, Introductory Business & Securities Valuation, 2009.
5. ASA Business Valuation Standards, 2009, p27.
6. IVS Framework, 2011, para 30.
7. IVS Framework, 2011, para 39.
8. Canada Business Corporations Act, June 25, 2013, para 241.
9. Canadian court cases which address fair value and the exclusion of minority discounts include: *Brant Investments Ltd v KeepRite Inc,* Court of Appeal for Ontario (CA 837/87); *Ford Motor Company of Canada v the Ontario Municipal Employees Retirement Board,* Court of Appeal for Ontario (C41312 & C41450); *Sutherland v Birks,* Court of Appeal for Ontario (C37495).
10. *Domglas Inc v Jarislowsky,* Supreme Court of Quebec (13 BLR135), as cited in *Manning v Harris Steel Group Inc,* Supreme Court of British Columbia.
11. Domglas, as cited in *Irwin v DW Coates Enterprises Ltd,* Supreme Court of British Columbia.
12. Model Business Corporation Act, American Bar Association, 1984.
13. Model Business Corporation Act, American Bar Association, 1999.
14. The Delaware Code, Title 8, Chapter 1 – General Corporation Law, section 262(a).
15. The Delaware Code, Title 8, Chapter 1 – General Corporation Law, section 262(h).
16. United States District Court, District of Columbia, No. CIV. A.82-00220(TAF).
17. ICSID Case No. ARB/03/16.
18. ICSID Case No. ARB/01/8.
19. ICSID Case No. ARB (AF)/04/3 & ARB (AF)/04/4.

TD South Tower
79 Wellington Street West
Suite 2010
Toronto, ON M5K 1G8
Canada
Fax: +1 416 649 8101

Julius Koo
julius.koo@fticonsulting.com
+1 416 649 8060

Howard Rosen
+1 416 649 8072
howard.rosen@fticonsulting.com

www.fticonsulting.com

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