Squeeze-outs, Freeze-outs, and Discounts: Why Is Illinois in the Minority in Protecting Shareholder Interests?

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I. INTRODUCTION

As contrasted with Delaware—a supposedly pro-management state[1]—Illinois generally has been considered a pro-shareholder state. Delaware's Corporation Code has been characterized as leading a "race to the bottom,"[2] whereas the Illinois Business Corporation Act ("BCA") was the model for the original Model Business Corporation Act[3] and generally is regarded as a balanced statute, containing many protections for shareholders and minority interests.[4] Similarly, as discussed below,

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1. *See William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 670 (1974).

2. *See id.* at 664–65. For a succinct summary of the "race to the bottom" argument, see MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS—CASES AND MATERIALS 102–07 (4th ed. 2000). Eisenberg suggests that Delaware may be moderating its pro-management stance because it has not been as aggressive as other states in adopting anti-takeover statutes. *Id.* at 106. However, there may be other explanations for this. Consider, for example, Delaware's failure to adopt a control share statute. The reason for this could be that Delaware could not meet the standing test upon which the Supreme Court, in *CTS Corp. v. Dynamics Corp. of America*, in part relied upon to uphold Indiana's control share statute. *See CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 91 (1987). Indiana's statute applies only to corporations that have their principal offices in Indiana and where either 10% of the corporation's shareholders reside in Indiana, 10% of the corporation's shares are owned by Indiana residents, or 10,000 shareholders of the corporation reside in Indiana. IND. CODE ANN. § 23-1-42-4(a) (West 1989). In upholding the Indiana statute, the Supreme Court stated that "the Indiana Act applies only to corporations that have a substantial number of shareholders in Indiana." *CTS Corp.*, 481 U.S. at 93. Many corporations organized in Delaware do not have their shareholder base in Delaware.

3. *See* Ray Garrett, *Model Business Corporation Act*, 4 BAYLOR L. REV. 412, 424 (1952).

4. *See* 7 CHARLES W. MURDOCK, ILLINOIS PRACTICE—BUSINESS ORGANIZATIONS § 1.12 (1996); *see also* 805 ILL. COMP. STAT. 5/7.40(a), 7.55, 7.71, 7.85, 8.35, 8.60, 11.65, 12.55, 12.56 (2002). Delaware generally has no comparable provisions or, if it does, such provisions are inferior. For example, Illinois provides dissenters' rights in both mergers and sales of

Illinois courts generally have been protective of minority shareholders' interests.[5]

Consequently, it is paradoxical that the Illinois courts, although divided on the issue, frequently have accepted the imposition of minority and marketability (liquidity) discounts in "fair value" proceedings.[6] The legislature has offered protection to minority shareholders under a "fair value" standard in two circumstances: (1) dissenters' rights under sections 11.65 and 11.70 of the BCA[7] and (2) alternative remedies, generally in oppression situations, under section 12.56 of the BCA.[8] These sections frequently are triggered when the person or persons in control of a corporation use their power to disadvantage minority shareholder interests.

This Article will first examine the types of situations that give rise to fair value proceedings—cash-out mergers, reverse stock splits, and oppressive conduct—to illustrate the conflicts of interest between those in control and minority shareholders.[9] It will then review the Illinois cases that hold those in control to a high standard of fiduciary duty and contrast this approach with the effect of discounts in fair value cases, noting that the courts did not recognize the fiduciary issues involved in any of the cases accepting discounts.[10] The Article will then summarize

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substantially all the assets of the corporation, whereas Delaware grants the rights only in mergers. *Compare* DEL. CODE ANN. tit. 8, § 262 (2002), *with* 805 ILL. COMP. STAT. 5/11.65. In another area, Delaware's conflict of interest statute, title 8, section 144 of the Delaware Code, on its face would permit an interested shareholder to insulate herself from self-dealing activity as a director. Fortunately, the Delaware Supreme Court, in *Fliegler v. Lawrence*, 361 A.2d 218, 221 (Del. 1976), in effect rewrote the Delaware statute to make it comparable to section 8.60 of the Illinois Business Corporation Act.

5. *See infra* Part III.B (discussing Illinois Supreme Court decisions that establish the existence of the majority shareholder and director's fiduciary duty to the corporation and to minority shareholders).

6. *See infra* Part III.C (discussing the evolution of Illinois case law concerning discounts). A minority discount is a reduction in the value of shares because the shares are held by a minority shareholder who does not control the corporation. A marketability discount is a reduction in the value of shares because there is not a ready market into which the shares can be sold. The impact of applying discounts in valuing shares of stock is discussed *infra* Part IV.A.1. A "fair value" proceeding is one in which the value of a shareholder's interest in a corporation is determined by a court pursuant to legislative direction. *See infra* notes 7–8 and accompanying text.

7. 805 ILL. COMP. STAT. 5/11.65, 11.70 (articulating the shareholder's right to dissent in section 11.65 and the proper procedure for dissenting in section 11.70).

8. *Id.* § 12.56 (discussing minority shareholder remedies in situations involving, inter alia, oppressive conduct by those in control of a corporation).

9. *See infra* Part II.A (discussing the mechanics of cash-out mergers and Illinois statutory provisions establishing dissenters' rights to fair value determinations of their shares).

10. *See infra* Part III.B–C (discussing Illinois cases regarding the application of a majority shareholder's or director's fiduciary duty to the minority shareholder and the corporation).

the policy arguments against discounts and demonstrate that discounts transfer value from the minority to the majority, thereby rewarding those in control who are not faithful to their fiduciary obligation not to benefit at the expense of the corporation or the other shareholders.[11] It concludes by reviewing the decisions in other jurisdictions that demonstrate conclusively that the Illinois position is inconsistent with the overall trend of these decisions.[12]

II. BACKGROUND

The transactions that give rise to "fair value" proceedings—generally cash-out mergers, reverse stock splits, and oppressive conduct—often involve complex fact situations and invariably implicate conflicts of interests. Accordingly, each of these situations will be analyzed in terms of both the applicable statutes and the conflicts of interest that are inherent in these situations.

A. Cash-out Mergers

The BCA now permits cash to be used as the consideration given to the shareholders of a merging corporation[13]—that is, a corporation that merges into another corporation and whose separate existence then ceases.[14] In such a cash-out merger, section 11.70 of the BCA gives dissenters' rights to shareholders who are squeezed out.[15]

The mechanics of a cash-out merger, using figure 1 below as an example, are as follows: Those in control set up a "vehicle" corporation ("Vehicle, Inc.") that they control and into which the operating corporation ("Business, Inc.") will merge. Cash is used as the consideration, with the result being that minority shareholder *C*'s interest in Business, Inc. is extinguished. While all former owners of Business, Inc. receive cash for their interests in Business, Inc., which will cease to exist after the merger, the shareholders who controlled

11. *See infra* Part IV.B (examining the current judicial trend rejecting both minority and liquidity discounts).

12. *See infra* Part IV.B (noting the numerous jurisdictions that have rejected minority and marketability (liquidity) discounts compared to the few jurisdictions besides Illinois that continue to apply minority and marketability discounts); *infra* app., tbls. 1–4 (listing states that have accepted or rejected discounts); *see, e.g.*, Offenbecher v. Baron Servs., Inc., No. 2000025, 2002 WL 959833, at *4 (Ala. Civ. App. May 10, 2002) ("The majority rule applied in the several United States jurisdictions with respect to the calculation of "fair value" under the [Model Business Corporation Act] does not allow *any* discounting . . . ."), *aff'd sub nom. Ex parte* Baron Servs., Inc., No. 1011635, 2003 WL 1787932 (Ala. 2003).

13. *See* 805 ILL. COMP. STAT. 5/11.05(c).

14. *See id.* § 11.50(a)(2).

15. *See id.* § 11.70.

Business, Inc., *A* and *B*, now control Vehicle, Inc., which has acquired all the assets and liabilities of Business, Inc. by operation of law.[16] Vehicle, Inc. now has the business of the initial corporation and minority shareholder *C* is out in the cold because he has no equity interest in Vehicle, Inc. In essence, Vehicle, Inc. is now Business, Inc. but *C* has no ownership interest.

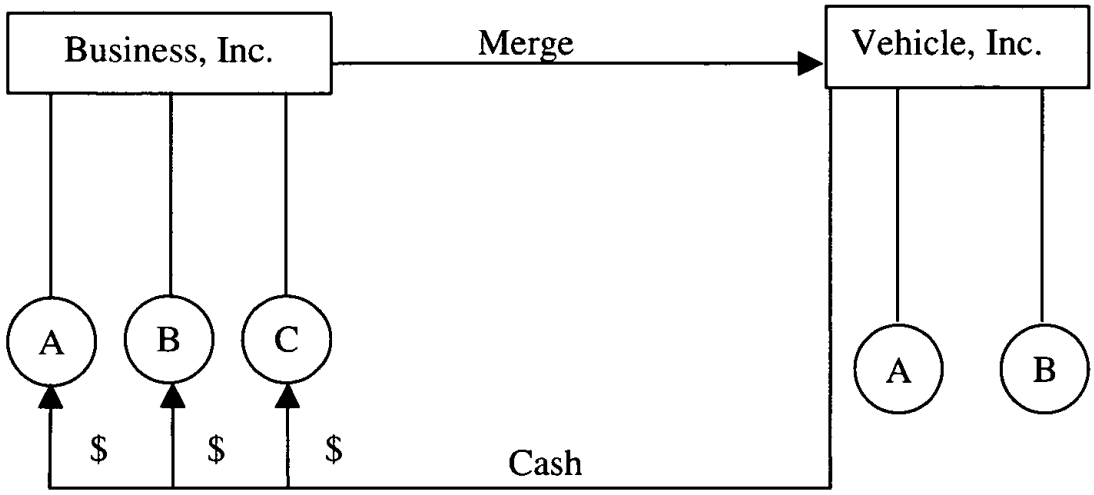

Figure 1. Diagram of a cash-out merger.

This is, in essence, a form of private eminent domain because Vehicle, Inc. has acquired *C*'s stock over his objection. All that is necessary to authorize a merger in Illinois is majority action at the board of directors level[17] and a two-thirds vote at the shareholder level.[18] Assuming *A*, *B*, and *C* comprise a three-person board of directors, and assuming each owns one-third of the shares, *A* and *B* constitute a majority of the board and, at the shareholder level, can provide the requisite two-thirds vote to accomplish the merger.

The foregoing is sometimes referred to as "cram-down." By following statutory procedures, those in control of a corporation can "cram" a transaction "down" the throat of the minority over the minority's objection. Thus, the minority is forced to accept cash for the stock previously owned, even though the minority opposes the transaction. In figure 1 above, Vehicle, Inc. is a "clone" of Business,

16. *See id.* § 11.50(a)(3)–(a)(5).

17. *Id.* § 11.05 ("The board of directors of each corporation shall, by resolution adopted by a majority vote of the members of each board, approve a plan merger . . . .").

18. *Id.* § 11.20(a). The two-thirds vote can be reduced to a majority vote through a prior amendment of the articles of incorporation. *Id.* § 11.20(b). But such amendment would itself require a two-thirds vote. *Id.* § 10.20(c)–(d).

Inc. The only difference is in ownership. All three shareholders owned Business, Inc. but only *A* and *B* own Vehicle, Inc.

In this situation, there is no "structural" assurance of fairness because *A* and *B* are on both sides of the transaction and thus have a conflict of interest. *A* and *B* could care less whether the cash given in the transaction is adequate, i.e., fair, because through their ownership of Vehicle, Inc., they end up owning the business and the assets of Business, Inc. In fact, the smaller the cash consideration Vehicle, Inc. gives in the transaction to the shareholders of Business, Inc., the less cash *A* and *B* will need to front temporarily through Vehicle, Inc., which will then give two-thirds of the cash back to *A* and *B* in their capacity as shareholders of Business, Inc. pursuant to the merger. The person who comes out on the short end is *C*, who has received inadequate consideration for his stock in Business, Inc.

Because those in control have the power to eliminate minority shareholders on the majority's terms, the Illinois legislature has provided "dissenters'" or "appraisal" rights for shareholders in *C*'s situation. Pursuant to sections 11.65 and 11.70 of the Business Corporation Act,[19] *C* can request that the court determine the "fair value" of his shares. It is important to note that the "standard of value" is not "fair market value" but rather "fair value." As will be discussed below, legislatures throughout the United States have almost uniformly used "fair value" as the standard in these statutes[20] rather than a fair market value methodology, which traditionally has employed minority and marketability discounts.[21]

To appreciate the relationship between the "private eminent domain" nature of squeeze-out transactions and the "fair value" standard, it is important to recognize that, in the early development of the corporate enterprise, squeeze-out mergers would have been impossible because organic changes required a unanimous vote.[22] This afforded protection,

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19. *Id.* §§ 11.65, 11.70.

20. Pueblo Bancorp. v. Lindoe, Inc., 63 P.3d 353, 364–65 (Colo. 2003) ("[F]orty-five states . . . currently have dissenters' rights statutes which, like Colorado, require that a dissenting shareholder be paid 'fair value' for his shares.").

21. *See* Charles Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 479–80 (1990) (analyzing why the fair market value approach, which discounts the value of stock in federal tax cases, protects the taxpayer-shareholder but disadvantages shareholders in a corporate squeeze-out, thus justifying the adoption of another standard of value, "fair value," in squeeze-out and freeze-out situations).

22. *See* Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 504 (7th Cir. 1989) ("Corporate law once had a generally-applicable unanimity rule in major transactions . . . ." (citing William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and*

but also too much power, to the minority. The Illinois Supreme Court, in *Teschner v. Chicago Title & Trust Co.*, explained the change from a unanimous vote requirement to a two-thirds vote requirement, with the concurrent creation of dissenters' rights, as follows:

> At common law the unanimous consent of the stockholders of a corporation was required to make fundamental changes in the corporation. To provide needed flexibility and to remove what was in effect a power of veto held by a dissenting minority, legislatures authorized the making of corporate changes by majority vote. To afford a measure of protection to a dissenting minority, most jurisdictions, including Illinois, enacted statutes giving dissenters the right to receive the cash value of their stock and providing for an appraisal of the stock where an agreement as to its value could not be reached.[23]

Thus, the legislative quid pro quo for minority shareholders' sacrifice of their veto power was the right to receive, in cash, the judicially determined "fair value" of their shares. As the United States Supreme Court stated, the change from a unanimous vote to a majority vote "opened the door to victimization of the minority."[24] To solve this dilemma, many state legislatures adopted statutes permitting a dissenting minority shareholder to recover the appraised value of its shares. In Iowa, for example, the state supreme court opined that an Iowa statute "allow[ed] a dissenting minority to get out of the corporation with the 'real value' of its stock. It prevented the minority from being squeezed out for a lesser price."[25] Since the purpose of the statute is to protect minority shareholders, it is inconsistent with the purpose of the statute to advantage the majority and disadvantage the minority by transferring value from the minority to the majority through the discounting process.[26]

Business Purposes, 1980 AM. B. FOUND. RES. J. 69, 77–97; Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 226–30 (1962))).

23. Teschner v. Chi. Title & Trust Co., 322 N.E.2d 54, 56 (Ill. 1975) (citations omitted).

24. Voeller v. Neilston Warehouse Co., 311 U.S. 531, 536 n.6 (1941).

25. Woodward v. Quigley, 133 N.W.2d 38, 43 (Iowa 1965). The Iowa Supreme Court later opined that minority discounts are precluded under either the "real value" or "fair value" standard. Sec. State Bank v. Zeigeldorf, 554 N.W.2d 884, 889–90 (Iowa 1996) (holding that applying marketability discounts only to minority blocks of stock undermines legislative intent to protect minority shareholders).

26. *See infra* Part IV.A.1 (examining how value is transferred from minority shareholders to the controlling shareholders as a result of discounting).

B. Reverse Stock Splits

The effect of a cash-out merger can be accomplished in a simpler fashion through a reverse stock split[27] if the minority shareholder whose removal is sought holds less than the number of shares held by those in control. For example, if *A* and *B* were each to hold thirty-four shares and *C* held thirty-two shares, *A* and *B*, through their control of the board and two-thirds shareholder voting control, could amend the articles of incorporation to provide for a one-for-thirty-four stock split—i.e., for every thirty-four shares held, a shareholder would be entitled to one share.

A normal stock split, say, for example, two-for-one, is used to *increase* the number of shares outstanding and thus lower the price of the shares. In a two-for-one split, each shareholder would receive two shares for each share previously held, but the price of the new shares would be only one-half of the pre-split share price because the value of the corporation has not changed.

In a reverse stock split, the goal is not just to *decrease* the number of shares outstanding, but to create fractional shares and *reduce* not only the number of shares outstanding but also the *number of shareholders*.[28] In the example above, *A* and *B* would each receive one share, but *C* would be entitled only to a fraction (32/34) of one share. In such a situation, the recapitalization plan would normally provide that fractional shares not be issued but rather paid for in cash. Thus, *C* would again be "cashed out" over his objection.

Illinois' fractional-share statute[29] neither uses the term "fair value" nor gives the cashed-out shareholder dissenters' rights. However, in an attempt not to run afoul of the fairness condition implicit in *Teschner*, thus enabling the shareholder to enjoin the transaction, the company, in most reverse stock split situations, utilizes the optional dissenters' rights

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27. The Illinois Supreme Court, in *Teschner v. Chicago Title & Trust Co.*, approved a reverse stock split but noted that

> [t]he plaintiff's complaint made no claim of fraud or deceptive conduct by the defendants. It did not charge that the exchange offer was unfair or that the price later offered for the shares was inadequate. . . . The plaintiff did not allege or show any improper purpose on the part of the defendants.

Teschner, 322 N.E.2d at 57–58.

28. Pursuant to Illinois law, the board of directors, in lieu of issuing fractional shares, has the option to pay cash equal to the value of each fractional share, thereby cashing out minority shareholders. 805 ILL. COMP. STAT. 5/6.15 (2002).

29. *Id.*

provision in the BCA.[30] It is through this means that "fair value" issues arise in reverse stock splits.

C. Freeze-outs and Oppression

The foregoing transactions are frequently referred to as "squeeze-outs" because the minority shareholder is squeezed out, i.e., removed from the corporation against his will. However, those in control of a corporation sometimes employ another technique, referred to as a "freeze-out," to rid themselves of minority shareholders. This technique frequently involves terminating the minority shareholder as an employee and stopping the payment of dividends. It is arguably more pernicious than a squeeze-out because the minority shareholder still has funds invested in the corporation but has no return on such investment, either through salary or dividends.

Consider the following situation: *A*, *B*, and *C* each invest $85,000 in a corporation, which, after a time, earns $500,000 annually before payment of salaries to *A*, *B*, and *C*. Assume further that the market would value the jobs done by *A*, *B*, and *C* at $100,000 each, but *A*, *B*, and *C* instead determine to pay themselves a salary of $150,000 each. Since they are the only shareholders, no one but the Internal Revenue Service would complain about the reasonableness of such salaries and, if the corporation is a Subchapter S corporation, even the IRS won't care![31]

Business valuation experts would characterize $50,000 of the $150,000 salary as "non-functional" compensation.[32] In effect, it is a

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30. *Id.* § 11.65(a)(4) (allowing minority dissent and consideration in accordance with section 11.70 or as provided in the by-laws or the articles of incorporation).

31. In a "C" corporation, the corporation is a tax paying entity. Consequently, taxpayers have sought to reduce corporate income by taking out profits in the form of compensation, which is deductible by the corporation. However, an "S" corporation is a "pass through" entity and the corporation pays no tax at the entity level, though there are, however, modest "reasonable compensation" issues in an S corporation relating to whether the shareholders are subject to self-employment tax.

32. *See, e.g.*, Hendley v. Lee, 676 F. Supp. 1317, 1327–28 (D.S.C. 1987) (treating $150,000 of a $250,000 salary as non-functional). One valuation expert explained non-functional compensation as follows:

> In closely-held companies, it is common to find that compensation and perquisites to owners and managers may be based on the personal desires of owners and on the company's ability to pay rather than on the value of services performed for the company. How much the earning power base should be adjusted to reflect discrepancies between compensation paid and value of service performed depends on the purpose of the valuation.
>
> Owners of successful closely-held businesses tend to take out what normally would be considered profits in the form of compensation and discretionary expenses. This may be an effort to avoid the double taxation that arises from paying a corporate

dividend or a return on the capital invested in the corporation.[33] Yet, what if *A* and *B*, as two of the three directors, voted to terminate *C*? *C* is now without a job and has no return on the capital he invested in the corporation. In other words, *A* and *B* have "frozen out" *C*.

Frequently, *A* and *B*, after freezing out *C* by terminating his employment, will then raise their own salaries. In the above example, *A* and *B* could raise their salaries by $75,000 each without affecting the "after salary" profits of the corporation. In effect, they are dividing *C*'s former salary between themselves.[34] Even if they do not do this, they are, in effect, giving themselves a $50,000 dividend (the non-functional portion of their $150,000 salary), but denying any return to *C*. This is a conflict of interest situation because *A* and *B* are distributing corporate funds to themselves but not to *C*.[35]

Courts, in reviewing the foregoing situation, frequently have concluded that C's "reasonable expectations" have been frustrated and that the conduct of *A* and *B* is "oppressive" toward *C*.[36] The Illinois legislature, in situations involving oppressive conduct, has provided *C*

> income tax and then paying a personal income tax on what is left from that paid in the form of dividends. It is not uncommon to find an owner/manager of a successful company drawing $150,000 annual compensation, even though his services to the company could be replaced for $60,000 per year. The extreme cases go much, much farther.
>
> If the owner/manager described in the previous paragraph wants to sell his business and retire, the difference between his compensation and what it will cost to replace him will become available as a part of pretax profits, and the earning power base should be adjusted accordingly in establishing the selling price of the business.

SHANNON P. PRATT, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 172–73 (1981).

33. One of the first courts to recognize the plight of the minority shareholder was the court in Donahue v. Rodd Electrotype Co. of New Eng., 328 N.E.2d 505, 513 (Mass. 1975). "[The majority] may drain off the corporation's earnings in the form of exorbitant salaries and bonuses to the majority shareholder officers and perhaps to their relatives . . . ." *Donahue*, 328 N.E.2d at 513 (citing F.H. O'NEAL & J. DENSEN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATE 42 (1961)); *see also In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1180 (N.Y. 1984) (noting that Kemp & Beatley had a long-standing policy of awarding de facto dividends based in stock ownership in the form of extra compensation bonuses).

34. The net effect is that *A* and *B* each receive $225,000 (their initial salary of $150,000 plus $75,000—one half of what *C* formerly received). Since the value of each of their jobs is only $100,000, each receives a disguised dividend of $125,000 while *C* receives nothing.

35. *See In re Kemp & Beatley*, 473 N.E.2d at 1180.

36. *Id.* at 1179; *see also* Ferdinand S. Tinio, Annotation, *What Amounts to Oppressive Conduct Under Statute Authorizing Dissolution of Corporation at Suit of Minority Stockholder*, 56 A.L.R. 3d 358 (1974). *See generally* 8 MURDOCK, *supra* note 4, at §§ 18.19–18.20 (reviewing the development and application of the reasonable expectations test in situations involving oppressive conduct).

with a panoply of remedies, including the right to be bought out at "fair value."[37]

III. THE CURRENT STATUS OF ILLINOIS LAW

A. "Fair Value"—A Question of Fact or a Matter of Law

The foregoing discussion illustrates the types of situations that can give rise to "fair value" determinations. The balance of this Article focuses upon the appropriate approach for Illinois courts to take when confronting the issue of whether to accept minority or liquidity discounts in determining the value of minority shares in fair value proceedings. The overwhelming majority of courts throughout the country have held that neither liquidity nor minority discounts are permissible in fair value proceedings.[38]

Generally, courts have held that the inappropriateness of discounts is a question of law and not of fact.[39] By contrast, Illinois courts have treated the issue as one of fact, in which the trial court defers to the valuation expert and the appellate court defers to the trial court.[40]

This is indeed a paradoxical situation since most valuation experts with whom the author has worked acknowledge that they rely upon the advice of the attorney who engaged them as to whether to incorporate minority and liquidity discounts into their valuation approach. The author's experience is confirmed by the advice offered by three of the leading valuation experts in their current treatise: "[T]he appraiser should solicit the view of counsel as to interpretation of fair value and, in most cases, should not assume that there is a definition that is clear and concise."[41]

The purpose of this Article is to demonstrate that there is a clear and concise definition of "fair value" of a shareholder's interest, namely, the proportionate interest of the minority shareholder in the enterprise as a

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37. 805 ILL. COMP. STAT. 5/12.56(b)(11), 12.56(e)–(f) (2002) (governing the purchase of all of a petitioning shareholder's shares by the corporation or by other shareholders).

38. *See infra* notes 132–48 and accompanying text (revealing that most states that confront the issue of minority and marketability discounts reject the use of those discounts); *infra* app., tbls. 1–2 (listing jurisdictions where courts have rejected minority and liquidity discounts).

39. Note the language quoted from the cases listed in tables 1 and 2 of the appendix: when a court holds that discounts are impermissible, the court treats the issue as one of law.

40. *See, e.g.*, Stanton v. Republic Bank of S. Chi., 581 N.E.2d 678, 681 (Ill. 1991). The lower court stated that the case was "essentially an 'expert witness . . . type of case,'" and the Illinois Supreme Court stated that it, "as the reviewing court, will not substitute the judgment as to credibility of witnesses for that of the trial court." *Id.*

41. SHANNON P. PRATT ET AL., VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 32 (4th ed. 2000).

whole, valued on a going-concern basis, without applying either a minority or a marketability discount.[42] Unfortunately, in Illinois, we have the nonsensical situation with respect to discounts in which the appellate courts defer to the trial courts; the trial courts, in effect, defer to the valuation expert; and the valuation expert defers to the opinion of the attorney who engaged the expert. Contrariwise, most other jurisdictions[43] regard minority and liquidity discounts as prohibited as a matter of law.

B. The Illinois Supreme Court and Fiduciary Duties

Before analyzing the economics of discounts, the rationale for not utilizing them in fair value proceedings, and the opinions from other jurisdictions, it is important to review the teaching of the Illinois Supreme Court with respect to fiduciary duties and minority shareholder rights. As stated at the outset of this Article, Illinois is sometimes viewed as pro-shareholder, as opposed to pro-management.[44] A better characterization of Illinois jurisprudence is that it is balanced and in tune with reality, as opposed to the pro-management bias that sometimes characterizes Delaware decisions.

Several decisions of the Illinois Supreme Court establish that directors and controlling shareholders owe fiduciary duties to the corporation and its shareholders and reflect a concern that those in control do not advantage themselves at the expense of other shareholders. In *Winger v. Chicago City Bank & Trust Co.*,[45] which was an early and rudimentary version of a management leveraged buy-out, the supreme court stated:

> The question is one when, as between the parties, influence is implied in the very conception of the relation, in which the position of one is superior to that of the other. It does not involve intentional concealment or misrepresentation, and while equity does not deny the possibility of valid transactions between the two parties, yet, because *every fiduciary relation implies a condition of superiority held by one of the parties over the other,* in every transaction between them by which the superior party obtains a possible benefit, equity raises a presumption against its validity, and casts upon that party the *burden*

42. *See* Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989); *see also infra* app., tbls. 1–2 (listing the cases that have endorsed this definition).

43. *See infra* app., tbls.1–4 (summarizing the cases that have addressed this issue).

44. *See supra* notes 1–5 and accompanying text.

45. Winger v. Chi. City Bank & Trust Co., 67 N.E.2d 265 (Ill. 1946). A substantial portion of the following discussion of *Winger* is excerpted from the author's treatise on business organizations. *See* 8 MURDOCK, *supra* note 4, § 14.2, at 5–6.

> of proving affirmatively its compliance with equitable requisites to overcome the presumption.[46]

The foregoing statement catches the essence of the basis upon which a fiduciary relationship depends: the imbalance of power between the fiduciary and the one to whom a duty is owed. In the corporate form, while the shareholders ostensibly control the directors through the electoral process, once the directors are in place, they control not only the operations of the corporation but also the flow of information back to the shareholders. As the *Winger* court observed, "if the directors act in their own interests there was no one to represent the corporation"[47] or, of course, its shareholders—or at least those shareholders who are not coextensive with the directors. Thus, it is the power and control that directors have vis-à-vis the corporation and its shareholders that gives rise to the fiduciary duties imposed upon a director.

Likewise, a review of Illinois decisions illustrates that Illinois courts also have been vigilant in protecting the interests of minority shareholders. Consider the decision in *Tilley v. Shippee*,[48] which is significant not only for its holding but also for its economic analysis of the situation. In *Tilley*, the plaintiff and the defendant entered into a contract to purchase a business, including its real estate, name, and other property for $60,000.[49] The property, aside from real estate, was worth about $3000.[50]

The transaction was closed at a bank that loaned the defendant $30,000 secured by the real estate.[51] These funds were paid to the sellers; in addition, the plaintiff paid the sellers $10,000, and the defendant paid them $20,000.[52] The business was incorporated, and the plaintiff received one-third of the shares and the defendant, two-thirds.[53] The corporate minutes indicated that the defendant leased the real estate to the corporation, which had an option to buy after six months.[54] However, the business failed, and the defendant canceled the lease for non-payment of rent.[55] When the plaintiff learned that the defendant

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46. *Id.* at 276 (emphasis added).

47. *Id.*

48. Tilley v. Shippee, 147 N.E.2d 347 (Ill. 1958). A substantial portion of the following discussion of *Tilley* is excerpted from the author's treatise on business organizations. *See* 7 MURDOCK, *supra* note 4, § 10.4, at 572.

49. *Id.* at 349.

50. *Id.* at 348.

51. *Id.* at 349.

52. *Id.*

53. *Id.* at 349–50.

54. *Id.* at 350.

55. *Id.*

claimed outright ownership of the real estate, he filed suit to declare a constructive trust on the real estate.[56]

In analyzing the parties' business relationship, the court found it improbable that the plaintiff would have paid $10,000 for a one-third interest in the non-real estate assets worth $3000.[57] On the other hand, viewing the transaction as a whole, the plaintiff paid one-third of the cash, the defendant paid two-thirds, and the rental payments by the corporation, which was owned in a one-third to two-thirds ratio, were intended to pay off the debt on the real estate.[58] This data indicated that the plaintiff had a one-third interest in all the purchased property.[59] The court held:

> In this particular transaction the parties were joint adventurers in the acquisition of a business which was being purchased for operation by them. Their decision to form and operate as a corporation rather than a partnership does not change the fact that they were embarking on a joint enterprise, and their mutual duties and obligations were similar to those of partners.[60]

Accordingly, the court imposed a constructive trust upon the real estate and required the plaintiff to assume one-third of the mortgage liability.

Two years later, the Illinois Supreme Court in *Shlensky v. South Parkway Building Corp.*[61] clarified that *Winger* did not hold that directors could never deal with their corporation, but rather that "the rule of the *Winger* case, insofar as it provides that directors shall have the burden of establishing the fairness and propriety of the transactions, not only protects shareholders from exploitation, but permits flexibility in corporate dealings."[62] This would not be the case if directors were absolutely barred from engaging in transactions with their corporations. On the other hand, placing the burden of proof on the persons challenging the actions of a fiduciary "would put a premium on sharp practices by directors by putting the onus of proof on their victims, and would also tend to further separate corporate management from

56. *Id.*

57. *Id.* at 352.

58. *Id.*

59. *Id.*

60. *Id.*

61. Shlensky v. S. Parkway Bldg. Corp., 166 N.E.2d 793 (Ill. 1960). A substantial portion of the following discussion of *Shlensky* is excerpted from the author's treatise on business organizations. *See* 8 MURDOCK, *supra* note 4, § 14.2, at 6.

62. *Id.* at 801.

ownership."[63] Accordingly, the court placed the burden of proof on the defendant directors.

Consequently, it is clear under Illinois case law that, in conflict of interest situations, the defendant directors, or the controlling shareholders, as the case may be, have the burden of proving the fairness of the transaction. In conflict of interest situations, the immediate harm is to the corporation, but minority shareholders also are affected adversely. For example, in the merger situation discussed earlier, all shareholders are affected adversely by the inadequate consideration in the merger.[64] Yet, the real loss only falls on the minority shareholder because the majority shareholders receive a more than offsetting benefit from their position on the other side of the transaction.

Later, in *Kerrigan v. Unity Savings Ass'n*, five individuals, three of whom were also directors, controlled a savings and loan association; these individuals then organized an insurance agency to sell insurance to mortgage customers of the association.[65] On the basis of the pleadings, the court determined that the formation of the insurance agency was a corporate opportunity that the defendants appropriated without first offering it to the association.[66] The court remanded the case to the trial court, which had granted summary judgment for the defendants and stated strongly that "in the view that we take of this case, the question of defendants' liability is established on the basis of the pleadings and *no trial is required.*"[67] According to the supreme court, "[s]ince the individual defendants, as directors, admittedly controlled Unity [Savings], the requisite disclosure and tender would necessarily have had to be made to Unity's shareholders."[68] Thus, those in control owed a duty to the minority shareholders.

These cases, and the numerous appellate court decisions that have followed them,[69] demonstrate that Illinois jurisprudence requires those in control of a corporation to act in the best interests of the corporation and all of its shareholders. In addition, when those in control deal with

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63. *Id.*

64. *See supra* fig. 1 (diagramming the mechanics of a cash-out merger).

65. Kerrigan v. Unity Sav. Ass'n, 317 N.E.2d 39, 41 (Ill. 1974). A substantial portion of the following discussion of *Kerrigan* is excerpted from the author's treatise on business organizations. *See* 8 MURDOCK, *supra* note 4, § 14.2, at 7.

66. *Id.* at 44.

67. *Id.* at 45 (emphasis added).

68. *Id.* at 43.

69. *See* 7 MURDOCK, *supra* note 4, §10.4 (examining cases addressing shareholder fiduciary duties); 8 *id.* ch. 14 (collecting cases involving duty of loyalty issues).

the corporation, they have the burden of establishing the fairness of the transaction.

C. The Current Illinois Position on Minority Discounts

There are four appellate decisions and one Illinois Supreme Court decision dealing explicitly with the issue of whether minority or liquidity discounts are appropriate in fair value determinations. While the supreme court decision represents the controlling law, its decision in *Stanton v. Republic Bank of South Chicago*[70] can be understood best by first reviewing the earlier appellate court decisions.

The first case, *Independence Tube Corp. v. Levine*,[71] is unsound precedent for several reasons, the most substantial of which is the fact that it was predicated upon an erroneous view of the approach taken in other jurisdictions regarding discounts. In support of either minority or liquidity discounts, the court in *Independence Tube* cited decisions from Georgia[72] (which now has been overruled by the Georgia Supreme Court), Kentucky,[73] and New York.[74] What the court did not recognize was that, at that point in time, courts in five jurisdictions had rejected discounts—California,[75] Delaware,[76] Indiana,[77] Iowa,[78] and

70. Stanton v. Republic Bank of S. Chi., 581 N.E.2d 678 (Ill. 1991).

71. Independence Tube Corp. v. Levine, 535 N.E.2d 927 (Ill. App. Ct. 1st. Dist. 1988) (finding that in a closely held corporation, the "minority interest factor" and the "lack of marketability" are intrinsic factors to use for evaluation purposes even when the real buyer is the corporation). *See generally infra* notes 72–89 and accompanying text (discussing *Independence Tube*).

72. Atl. States Constr., Inc. v. Beavers, 314 S.E.2d 245, 251 (Ga. Ct. App. 1984) (stating that minority discounts are allowable but must be applied with "caution"). The *Beavers* case, however, has been overruled by Blitch v. Peoples Bank, 540 S.E.2d 667, 670 (Ga. Ct. App. 2000) (rejecting both minority and liquidity discounts).

73. Ford v. Courier-Journal Job Printing Co., 639 S.W.2d 553, 556 (Ky. Ct. App. 1982) (noting that a marketability discount "merely indicates that the appraisers gave some weight to the market value of the stock").

74. Blake v. Blake Agency, Inc., 486 N.Y.S.2d 341 (App. Div. 1985). While *Blake* accepted marketability discounts, it rejected minority discounts. *Id.* at 349.

75. Brown v. Allied Corrugated Box Co., 154 Cal. Rptr. 170, 176 (Ct. App. 1979). In rejecting discounted minority share valuation, *Brown* also held that majority shareholders have a fiduciary duty to the corporation not to undervalue stock. *Id.* at 177.

76. Cavalier Oil Corp. v. Harnett, Civ. A. Nos. 7959-60, 7967-68, 1988 WL 15816, at *8–*9 (Del. Ch. Feb. 22, 1988) (rejecting discounted share valuation as contrary to statutory policy because it calculates the overall value of shares as a function of specific shares), *aff'd*, 564 A.2d 1137 (Del. 1989).

77. Eyler v. Eyler, 492 N.E.2d 1071, 1074 (Ind. 1986) (rejecting, as part of a divorce proceeding, the application of a minority discount to shares of a business attributable to a spouse).

78. Woodward v. Quigley, 133 N.W.2d 38, 43 (Iowa 1965) (finding that the statute allowed "dissenting minority to get out . . . with the 'real value' of its stock" and "prevented the minority from being squeezed out for a lesser price").

Missouri[79]—while a sixth jurisdiction—Kansas—noted that a "minority" discount already was impounded in the valuation process when it was predicated upon a capitalized earnings approach.[80] This is because price-earnings ratios are derived from publicly traded stocks that represent minority interests. It is for this reason that some Delaware courts add a control *premium*,[81] as opposed to a minority *discount*, in determining fair value.

Consequently, the decision in *Independence Tube*, rather than reflecting the position taken in other jurisdictions, actually adopted a minority position. As will be discussed below, today this minority position is further dwarfed by the overwhelming number of jurisdictions that have rejected discounts since *Independence Tube* was decided.[82]

Independence Tube is also of dubious precedential value because the minority shareholder in the case arguably was attempting to extort the company. The purpose of the transaction in this case was to enable the company to elect Subchapter S status.[83] The company offered $500 per share to its shareholders, and the plaintiff shareholder voluntarily sold 400 shares[84] but refused to sell 100 shares held in trust.[85] Because a trust generally cannot be a shareholder of a Subchapter S corporation,[86] it was critical that the corporation acquire the 100 shares held in trust. The shareholder claimed that these shares were worth between $774 and $1405 per share.[87] The court found the value to be $550 per share, which approximated what the company had offered per share and what

79. Dreiseszun v. FLM Indus., 577 S.W.2d 902, 910 (Mo. Ct. App. 1979) (finding that the value of the plaintiff's shares must be computed "pro rata").

80. Moore v. New Ammest, Inc., 630 P.2d 167, 177 (Kan. Ct. App. 1981) (stating that minority discounts were not appropriate when valuing a company on market value but acceptable when the valuation was based on assets), *overruled by* Arnaud v. Stockgrowers State Bank, 992 P.2d 216 (Kan. 1999). The Kansas Supreme Court subsequently held that "fair value" precludes either a minority or marketability discount. *Arnaud*, 992 P.2d at 220. A capitalized earnings value is the product of the earnings of a company and a price-earnings ratio. The price-earnings ratio is derived from the trading prices of publicly held companies.

81. Rapid-Am. Corp. v. Harris, 603 A.2d 796, 806–07 (Del. 1992) (discussing the valuation of a subsidiary). A control premium is determined by comparing the market price of a company with the price paid in a takeover. Acquiring companies typically pay a premium of 30-40% over trading market prices.

82. *See infra* Part IV.B (discussing the jurisdictions that have rejected discounts); *infra* app., tbls. 1–2 (listing states where discounts have been rejected).

83. Independence Tube Corp. v. Levine, 535 N.E.2d 927, 928–29 (Ill. App. Ct. 1st. Dist. 1988).

84. *Id.* at 929.

85. *Id.*

86. I.R.C. § 1361 (2000 & West Supp. 2003).

87. *Independence Tube*, 535 N.E.2d at 929–30.

the shareholder had accepted for 400 shares.[88] Thus, the court in effect refused to let the plaintiff use his trustee status to extort more value than he was willing to accept for the 400 shares he tendered to the corporation.

While *Independence Tube* was the first "fair value" case to deal with discounts, shortly before it was decided *Johnston v. Hickory Creek Nursery, Inc.* rejected a minority discount where the interest was purchased by the remaining shareholders, because the purchase, instead of putting the buyers in a minority position, resulted in "a substantial pro rata increase in their share and control of the corporation."[89] This same logic also dictates rejection of minority discounts in "fair value" cases.

Two years after *Independence Tube*, the appellate court in *Institutional Equipment and Interiors, Inc. v. Hughes* recognized that "fair value" is a different standard of value than "fair market value," stating that "the trial court properly refused to use the fair-market value approach, [which] did not apply in a situation where a dissenting minority shareholder in a closely held corporation was being bought out by a majority stockholder." [90] Consequently, the appellate court held that it was not error for the trial court to refuse to apply either minority or liquidity discounts.[91]

The *Institutional Equipment* court defined the fair market value standard as "based on the price that would be agreed upon in an arms-length transaction between a willing buyer and a willing seller on the open market, neither under a compulsion to act, and both parties possessed of all relevant facts."[92] This is the standard used in estate and gift tax valuation.[93] As the author has discussed extensively in an earlier article, the fair market value standard in tax cases typically involves the use of both minority and liquidity discounts because the "imposition of the tax mandates a cash out-flow—with the concomitant requirement that at least some of the assets be converted into liquid form."[94] Thus, in the tax area, the valuation approach should be conservative; otherwise, the taxing process could become confiscatory

88. *Id.* at 931.

89. Johnston v. Hickory Creek Nursery, Inc., 521 N.E.2d 236, 239–40 (Ill. App. Ct. 3d Dist. 1988).

90. Inst'l Equip. & Interiors, Inc. v. Hughes, 562 N.E.2d 662, 667–68 (Ill. App. Ct. 2d Dist. 1990).

91. *Id.* at 668.

92. *Id.* at 667.

93. Treas. Reg. § 20.2031-1(b) (as amended in 1965).

94. Murdock, *supra* note 21, at 480.

if the stock were sold at a lower price than that assessed by the Internal Revenue Service.

It is with this background that the supreme court decision in *Stanton v. Republic Bank of South Chicago*[95] must be viewed. In *Republic Bank*, appraisers for both parties employed discounts and the court noted that "both discounts fell within the range proposed by the Bank's experts and plaintiffs' experts."[96] This would not be surprising since, at the time, fair value litigation had not exploded as it has during the past decade.[97] Consequently, a very substantial portion of a business valuator's work was in connection with valuations for tax purposes, where discounts are routine.[98]

Notwithstanding the fact that the appraisers and the trial court had both employed discounts, the Illinois Supreme Court twice volunteered that there was no requirement to use discounts in fair value proceedings, stating that "the trial court acted within its discretion to apply such discounts, *even though not required to do so*."[99] After noting that the minority and liquidity discounts only totaled 10% and were within the range proposed by the experts, the court concluded that "the trial court was not even required to apply any discounts."[100] Thus, the supreme court actually discouraged the use of discounts while, at the same time, treating the issue as one of fact within the discretion of the trial court.

In 1997, in *Weigel Broadcasting Company v. Smith*, the appellate court, while recognizing that "fair value" is not synonymous with "fair market value,"[101] declined to follow *Institutional Equipment* and *Hickory Creek* because the cases were distinguishable factually from the *Weigel* situation.[102] In *Weigel*, Shapiro, the president of the company, and his family owned 83% of the company before a reverse stock split, and thus, according to the court, the shares the dissenting shareholders

95. Stanton v. Republic Bank of S. Chi., 581 N.E.2d 678 (Ill. 1991).

96. *Id.* at 682.

97. *See infra* app., tbls. 1–4. The overwhelming majority of cases are within the last ten years.

98. *See, e.g.*, JEFF A. SCHNEPPER, THE PROFESSIONAL HANDBOOK OF BUSINESS VALUATION (1982). In his 1982 treatise, Schnepper devotes only fourteen out of 227 pages to valuation in dissenters' rights cases and does not consider oppression cases at all, nor does he discuss the "fair value" standard. *See id.* at 195–209. His focus is almost entirely on valuation for tax purposes. By way of contrast, Shannon Pratt devoted two chapters to these issues in the 2000 edition of her work. *See* PRATT ET AL., *supra* note 41, at 789–815.

99. *Republic Bank,* 581 N.E.2d at 682 (emphasis added).

100. *Id.*

101. Weigel Broad. Co. v. Smith, 682 N.E.2d 745, 749 (Ill. App. Ct. 1st Dist. 1996).

102. *Id.* at 751.

lost "did not materially increase Shapiro's control over, or position within, the company."[103]

In doing so, the court missed three fundamental points. First, the primary rationale for minority and liquidity discounts is that a buyer would not want to step into the shoes of the seller, a minority shareholder, who is powerless to direct the operations of the company. Thus, minority shares are worth less—the minority aspect—and are not as saleable as control shares—the liquidity aspect. Yet, when the corporation or a controlling shareholder is the buyer, the buyer is not subject to the minority disability.

Second, eliminating minority shares is always to the advantage of majority shareholders, assuming the majority can afford the buy-out. A 51% position is better than a 50% position,[104] a 67% position is better than a 51% position,[105] and a 100% position is better than an 83% position. The main reason for this latter proposition is that a 100% position frees the majority of conflict of interest issues and the attendant possibility of a derivative suit, and it gives the majority shareholders unfettered control of the corporation and access to corporate assets.[106] The cases are legion where those in control advantage themselves with exorbitant salaries and loans, and by hiring family members and using corporate funds for personal purposes.[107]

The third fundamental point missed by the *Weigel* court is that the imposition of discounts in valuing minority shares results in a transfer of value from the minority shareholders to the majority shareholders.

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103. *Id.*

104. A 50/50 split gives each shareholder veto power and can lead to deadlock.

105. For example, the BCA generally requires a two-thirds vote for organic changes. 805 ILL. COMP. STAT. 5/10.20(c), 11.20(a), 11.60(c), 12.15(c) (2002).

106. *See, e.g.*, Weinberger v. U.O.P., Inc., 457 A.2d 701, 708 (Del. 1983) (listing factors in favor of a parent corporation merging a subsidiary into the parent, including "[f]acilitat[ing] the flow of resources between Signal [parent] and its subsidiaries" and "[e]liminat[ing] potential conflicts of interest").

107. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 508 (Mass. 1975) (involving a corporation which had agreed to buy out the controlling shareholder but not a minority shareholder); *see also* Hager-Freeman v. Spircoff, 593 N.E.2d 821, 829 (Ill. App. Ct. 1st Dist. 1992) (discussing how the defendant hired his son as a director, apparently replacing the plaintiff, and paid the son $10,000 per year even though the son was a full-time student downstate at Southern Illinois University); Conduti v. Hellwig, 469 N.E.2d 220, 228 (Ill. App. Ct. 1st Dist. 1984) (discussing how bonuses were paid to the shareholder's children and family members when they charged gasoline to the corporation), *overruled by* Schrimer v. Bear, 672 N.E.2d 1171 (1996); Miller v. Magline, 256 N.W.2d 761, 764 (Mich. Ct. App. 1977) (detailing how, in six years, the defendant-president raised his salary from $10,016 to $120,183, an increase of over 1000%).

This is essentially a conflict of interest situation that will be analyzed in Part IV.A.1 of this Article.

The *Weigel* court also cited *Republic Bank* for the proposition that the imposition of discounts is within the discretion of the trial court,[108] and cited this author for a dissenting point of view.[109] It is the opinion of this author, which is supported in judicial decisions across the country, that discounts are not a question of fact for the trial court but are barred as a matter of law by the legislature's use of the standard "fair value."

The error that the supreme court made in *Republic Bank* was that it did not recognize "fair value" as a standard of value but rather treated this term as part of the factual valuation process. This is understandable since judges themselves are not valuation experts. Moreover, at the time *Republic Bank* was decided, more than a decade ago, most business valuators did not understand that "fair value" is a different standard than "fair market value." This is understandable because legislative terms are for the legislatures and courts to define, not laymen—and regarding legislative interpretation, business valuators are laymen. As discussed earlier, business valuators generally rely upon the attorney who engaged them to define what is meant by fair value.[110]

As discussed below, courts around the country, and particularly in the last decade or so, almost uniformly have held that, with respect to minority and liquidity discounts, the "fair value" standard, as a matter of law, prohibits such discounts.[111] Moreover, the business valuation profession now is coming to appreciate the significance of the "fair value" standard. In one of the most recent treatises on business valuation, the significance of the fair value standard is addressed:

> A clear and concise understanding of the appropriate standard of value is a key to any credible business appraisal. Indeed, as Pratt, Reilly, and Schweihs have indicated, the failure to adhere to the appropriate standard of value can be a primary reason for the wide variances between two business valuations. Nowhere is this principle more significant than in the application of the fair value standard in connection with oppressed and dissenting shareholder matters.[112]

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108. Weigel Broad. Co. v. Smith, 682 N.E.2d 745, 750 (Ill. App. Ct. 1st Dist. 1996).

109. *Id.* at 751.

110. *See* PRATT ET AL., *supra* note 41, at 32.

111. *See infra* Part IV.B (explaining judicial trends rejecting the use of discounts in calculating fair value).

112. Anne C. Singer & Jay E. Fishman, *Fair Value for Oppressed and Dissenting Shareholders*, *in* HANDBOOK OF ADVANCED BUSINESS VALUATION 301 (Robert F. Reilly & Robert P. Schweihs eds., 2000).

The authors of this treatise acknowledge that, as legislatures rarely define fair value, "the definition of fair value is left to judicial interpretation."[113] It is noteworthy that these experts do not assert that it is the role of business valuation experts to define fair value.

Before reviewing the case law and legislative developments, it may be helpful first to analyze the economic impact of minority and liquidity discounts, and the policy reasons for rejecting them in determining the meaning of "fair value."

IV. ANALYSIS AS TO WHY DISCOUNTS SHOULD BE REJECTED IN ILLINOIS

A. *The Policy Behind Rejecting Minority and Liquidity Discounts*

1. Conflicts of Interest Transfer Value from the Minority to the Majority

The transactions that give rise to "fair value" proceedings typically involve direct or indirect conflicts of interest in which those in control benefit at the expense of minority shareholders. Consider figure 1 at the beginning of this Article, in which *A* and *B* organized Vehicle, Inc. and caused the operating corporation, Business, Inc., to be merged into Vehicle, Inc. This involves a clear conflict of interest since *A* and *B*, through their control of both corporations, are on both sides of the deal. In this situation, the payment of inadequate consideration by Vehicle, Inc. to the shareholders of Business, Inc. injures *C* but benefits *A* and *B* through their ownership of Vehicle, Inc. Accordingly, both the Illinois Supreme Court decision in *Shlensky*[114] and section 8.60 of the BCA[115] impose upon *A* and *B* the burden of proving that the transaction was fair. Thus, *A* and *B* must establish that "fair value" was given. Because of the conflict of interest, however, it is impossible for *A* and *B* to establish "fair value" when discounts are used in the valuation process.

Consider the following example, illustrated below, in which the value of Business, Inc. before discounts is 100 units,[116] and such value is reduced by a 30% minority discount and a 30% liquidity discount.[117] Since *A* and *B* each have 34% of the shares, their interest in the business is sixty-eight units, while *C*'s interest in the business is thirty-two units.

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113. *Id.*

114. Shlensky v. S. Parkway Bldg. Corp., 166 N.E.2d 793, 806 (Ill. 1960).

115. 805 ILL. COMP. STAT. 5/8.60(a) (2002).

116. A unit could be either $1000 or $1 million. The percentage impact will be the same.

117. The combined effect of two 30% discounts is a 51% discount: 100 – 30% = 70; 70 – 30% = 49. Thus, the two discounts reduce C's value by 51%.

Applying a 30% minority discount reduces this interest to 22.4;[118] applying a liquidity discount of another 30% reduces the value of *C*'s interest to slightly less than sixteen units.[119]

Thus, the imposition of these discounts has reduced *C*'s interest by about 50%, or sixteen units. But where has this value gone? Obviously, to *A* and *B*, because the "underlying" value of the business is not affected by the change in ownership. Thus, the interest of *A* and *B* has risen from sixty-eight units to eighty-four units, or about 25%. When *C* is paid off, the value of Business, Inc. shrinks to eighty-four units, of which *A* and *B* now own 100%, so their interest still has risen from sixty-eight units to eighty-four units. Figure 2 below illustrates what has happened.

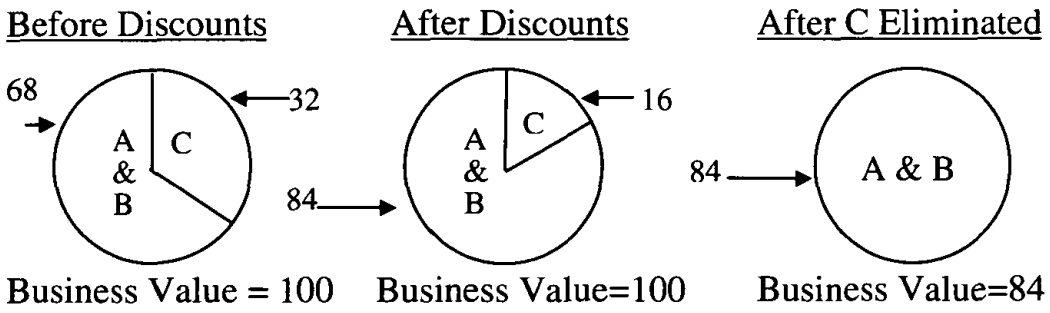

Figure 2. The effect of discounts on the interests of the minority and majority shareholders in a transaction to eliminate the minority shareholder.

Instead of using cash-out mergers, there is some tendency today to use reverse stock splits to obfuscate the conflict of interest. In the foregoing situation, since *A* and *B* each have more shares than *C*—thirty-four, thirty-four, and thirty-two respectively—a one-for-thirty-four reverse stock split, coupled with a decision not to issue fractional shares, will eliminate *C* and give *A* and *B* each one share, or 50% of Business, Inc.[120]

Unlike a cash-out merger, the reverse stock split does not involve two entities, each controlled by *A* and *B*, engaging in the transaction. A cash-out merger is a two-step process: (1) organize Vehicle, Inc. and (2) merge Business, Inc. into Vehicle, Inc. In contrast, a reverse stock split

118. 32.0 – 30% = 22.4

119. 22.4 – 30% = 15.68.

120. *A* and *B* will each receive one share and *C* will receive 32/34 of a share. Since fractional shares will not be issued, *C* will be paid in cash. *See* 805 ILL. COMP. STAT. 5/6.15; *see also supra* Part II.B (discussing reverse stock splits).

is a one-step approach: amend the articles of incorporation to reflect the split and opt not to issue fractional shares. The essence is the same, however, as *A* and *B* have used corporate machinery to eliminate *C* and appropriate the remaining value of the business to themselves. Using discounts to value *C*'s interest results in a transfer of part of the value *C* holds to *A* and *B*.

The oppression situation is slightly different. A review of the cases on oppression illustrate that the conduct deemed oppressive also constitutes a breach of fiduciary duty—for example, firing an employee-shareholder without legitimate cause.[121] Oppressive conduct by those in control invariably involves benefiting the majority at the expense of the minority. When this conduct leads to a buy-out, discounting the value of minority shares leads to a double benefit to the wrongdoer: the oppressive conduct in the first place and second, the acquisition of the minority's interest cheaply.

2. Structural Reasons Why Discounts Are Inappropriate

From a structural standpoint, there are three reasons why discounts are inappropriate in fair value cases.[122] As discussed above, both the *Hickory Creek* and *Institutional Equipment* cases recognized that, when the buyer is either a controlling shareholder or the corporation, the logic that a minority interest is worth less because the buyer would assume the impotent position of the seller simply is not true.[123] Contrariwise, the minority shares acquired by either the corporation or the controlling shareholder enhance the control of the controlling shareholder.[124] This rebuts a major argument for a minority discount. Further, with respect to a marketability or liquidity discount, it is paradoxical to argue liquidity when the legislature has created an exit opportunity. As the Illinois Supreme Court stated in *Republic Bank*:

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121. *See, e.g., In re* Weidy's Furniture Clearance Ctr. Co., 487 N.Y.S.2d 901, 903–04 (N.Y. App. Div. 1985) (detailing the termination of an employee-shareholder without legitimate cause); *cf.* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 662 (Mass. 1976) (holding that the majority owners owed good faith and loyalty in their dealings with the minority owners).

122. For a more in depth exploration of these policy by the author, see Murdock, *supra* note 21, at 482–88.

123. *See supra* notes 89–92 and accompanying text (discussing the rejection of the application of minority discounts by the courts in *Hickory Creek* and *Institutional Equipment*).

124. For example, assume the shares of a 20% holder are acquired by the corporation. If there were two 20% holders and one 60% holder, after the acquisition, only 80% of the formerly outstanding shares remain outstanding, and the 60% holder now has 75% of the stock. Obviously, if the 60% holder is the purchaser rather than the corporation, she now holds 80%. In either event, the majority has increased its control.

> In conclusion, we note that the Bank and its majority shareholders are the moving parties who caused the "merger" and brought themselves within the statute. It was their choice. The minority and dissenting shareholders then exercised their statutory right to have the court decide fair value. Fair value does not necessarily mean that price which the majority shareholders are willing to pay the minority shareholders.[125]

This same logic holds true for a reverse stock split or oppressive conduct case. It is those in control whose conduct has triggered the "fair value" proceeding that gives the minority shareholder the right to sell his or her shares. In effect, the wrongful conduct creates a market that previously did not exist.

The third policy reason against discounts from a structural perspective is the pro-rata nature of the transactions that give rise to fair value proceedings. In a merger, for example, all shares of the same class are treated alike. A 51% holder does not receive a greater consideration per share than a 1% holder. In the oppression situation, the remedy initially provided by the legislature was dissolution.[126] Once again, in a corporate dissolution, a 51% holder does not receive proportionately more per share than a 1% holder. The pro-rata nature of the underlying transaction influenced the drafters of the Model Business Corporation Act to amend the act in 1999 to reject discounts in fair value proceedings.[127] As discussed in the following section, this accelerated both statutory and case law developments rejecting minority and liquidity discounts.

B. The Overwhelming Trend Since Independence Tube*: Rejection of Both Minority and Liquidity Discounts*

As previously discussed, when *Independence Tube* accepted discounts in fair value valuations, it was adopting a minority position.[128] Moreover, of the three cases it relied upon, the Georgia case has been overruled, with the Georgia Supreme Court now holding that neither minority nor liquidity discounts are allowable in fair value

125. Stanton v. Republic Bank of S. Chi., 581 N.E.2d 678, 682–83 (Ill. 1991).

126. 1933 Business Corporation Act §86, 1933 Ill. Laws 308, 351; *see also* Gidwitz v. Lanzit Corrugated Box Co., 170 N.E.2d 131, 134 (Ill. 1960) (finding that a court may liquidate a corporation when those in control act oppressively).

127. *See infra* notes 155–58 and accompanying text.

128. *See supra* notes 71–83 and accompanying text (explaining that the court in *Independence Tube* adopted a minority position as regards minority discounts).

proceedings,[129] while the New York case accepted liquidity discounts but explicitly rejected minority discounts.[130]

In the decade and a half that has followed *Independence Tube*, the case has become even more of a minority position. It appears that every jurisdiction that has considered whether minority discounts are allowable in fair value proceedings after *Independence Tube* in 1988, twenty-five in all, have rejected minority discounts, generally as a matter of law.[131] Accordingly there is no question but that the Illinois cases, to the extent that they permit discounts based on the minority status of the shareholder, in fair value proceedings, are an anomaly when viewed from the perspective of judicial decisions across the country.

With regard to marketability or illiquidity discounts, the Colorado Supreme Court, in rejecting marketability discounts as a matter of law earlier this year, surveyed all of the decisions relating to this issue that had been brought to its attention and concluded that the "clear majority trend" is not to apply such discounts.[132] According to the Colorado court, the leading case is the Delaware case of *Cavalier Oil Corp. v. Harnett*,[133] which fifteen other jurisdictions have followed.[134] Table 2 also lists four other jurisdictions, not addressed by the Colorado court, that also have rejected marketability discounts: Arizona, Indiana, Iowa, and North Carolina.[135] However, table 2 does not include Oklahoma because a minority discount rather than a marketability discount was at issue.[136] Nevertheless, the Oklahoma court did explicitly state that it

129. Blitch v. Peoples Bank, 540 S.E.2d 667, 670 (Ga. Ct. App. 2000).

130. Blake v. Blake Agency, Inc., 486 N.Y.S.2d 341, 349 (N.Y. App. Div. 1985).

131. The states and years of rejection are as follows: Maine (1989); Rhode Island (1991); Massachusetts, Minnesota, Oklahoma, Washington (1992); Nebraska (1994); South Carolina (1995); North Dakota, Vermont (1997); Montana (1998); Kansas, New Jersey, North Carolina (1999); Georgia, Virginia, Wisconsin (2000); Arizona, Colorado, Connecticut, Missouri, South Dakota (2001); Alabama, Indiana, Utah (2002); *see also infra* app., tbl. 1.

132. *See* Pueblo Bancorp. v. Lindoe, Inc., 63 P.3d 353, 367 (Colo. 2003) (deciding a dispute in which this author testified as an expert witness during the trial court proceedings).

133. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144–45 (Del. 1989) (affirming a chancery court decision that found that the application of marketability or minority discounts in the valuation of minority stock was inappropriate). The corporation only appealed the refusal to apply the minority discount. *Id.* at 1139, 1144.

134. *Pueblo Bancorp.*, 63 P.3d at 365–66 (listing Alabama, Connecticut, Georgia, Maine, Minnesota, Missouri, Nebraska, New Jersey, Oklahoma, Rhode Island, South Carolina, South Dakota, Utah, Virginia, and Washington).

135. *See infra* app., tbl. 2.

136. *See infra* app., tbl. 2.

would follow Delaware law,[137] and Delaware does reject marketability discounts.[138]

The Colorado court also listed five states, in addition to Illinois, that accepted marketability discounts.[139] However, table 4 lists only four states[140] because the Virginia case[141] that interpreted Maryland law as allowing discounts was decided before a later Virginia decision in which the court rejected discounts.[142]

Subsequent to *Independence Tube*, twenty jurisdictions have rejected marketability discounts.[143] Only two jurisdictions, Florida in 1999 and Nevada in 1998, have accepted them.[144] The court in the Florida decision stated that it was simply following New York,[145] and the Nevada case was decided by a federal court that cited no authority for its decision.[146]

What has led to the overwhelming rejection of both minority and liquidity discounts over the past ten years? Courts generally have come to appreciate the policy reasons set forth in the previous section,[147] particularly the conflict of interest that characterizes squeeze-outs and freeze-outs. As the Delaware Supreme Court stated in *Harnett*, a case relied upon by many of the decisions this past decade:

> More important, to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result.[148]

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137. Woolf v. Universal Fid. Life Ins. Co., 849 P.2d 1093, 1095 (Okla. Ct. App. 1992).

138. *Cavalier Oil Corp.*, 564 A.2d at 1144–45.

139. *Pueblo Bancorp.*, 63 P.3d at 367 (listing Florida, Illinois, Kentucky, Virginia, New York, and Oregon).

140. *See infra* app., tbl. 4.

141. McDonough v. Alpha Constr. Eng'g Corp., No. 12757, 1994 WL 1031191, at *3 (Va. Cir. Ct. May 19, 1994).

142. *See* U.S. Inspect, Inc. v. McGreevy, No. 160966, 2000 WL 33232337, at *10 (Va. Cir. Ct. Nov. 27, 2000).

143. The states and years of rejection are as follows: Maine, Missouri (1989); Rhode Island (1991); Nebraska (1994); South Carolina (1995); Iowa (1996); Kansas, New Jersey, North Carolina (1999); Georgia, Minnesota, Virginia (2000); Arizona, Connecticut, South Dakota (2001); Alabama, Indiana, Utah, Washington (2002); Colorado (2003). *See infra* app., tbl. 2.

144. *See infra* app., tbl. 4.

145. Munshower v. Kolbenheyer, 732 So. 2d 385, 386 (Fla. Dist. Ct. App. 1999).

146. Steiner Corp. v. Benninghoff, 5 F. Supp. 2d 1117, 1129 (D. Nev. 1998). The court did reduce the discount from 60% to 25% and suggested that discounts were inequitable. *Id.*

147. *See supra* Part IV.A (explaining the reasons for rejecting minority and marketability discounts).

148. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989).

The supreme court decision in *Harnett* was handed down subsequent to *Independence Tube* and thus Illinois courts did not have the benefit of its reasoning. Nor did the *Independence Tube* court have the benefit of the numerous decisions that now recognize that "discounts defeat legislation enacted to protect the minority's right to dissent."[149] As previously discussed, once minority shareholders lost their veto power over cash-out mergers, for example, they were at the mercy of the majority.[150] Dissenters' rights were conferred to protect the minority from overreaching by the majority.[151]

Two other developments are also significant. In 1992, the American Law Institute approved the following standard for determining "fair value":

> The fair value of shares . . . should be the value of the eligible holder's proportionate interest in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability.[152]

The introductory note to the appraisal chapter embodying the above standard of fair value recognized that the appraisal or dissenters' rights process is critical to corporate governance since majoritarian control creates the risk that the majority may abuse the power it has, for example, by voting for a transaction "that eliminates the minority's interest in the corporation at an unfairly low price."[153] Section 7.22(a) is now incorporated in the final draft of the Principles of Corporate Governance approved in 1994 ("ALI Principles of Corporate Governance").

Four years after the official promulgation of the ALI Principles of Corporate Governance, the American Bar Association proposed amending the Model Act to define fair value substantially in accordance with the ALI language.[154] The proposal sought to amend section 13.01(4)(iii) of the Model Act[155] to state, in part, that "fair value" meant

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149. Hansen v. 75 Ranch Co., 957 P.2d 32, 42 (Mont. 1998) (referencing decisions in Delaware, Rhode Island, Iowa, Missouri, Maine, California, Colorado, and Oregon.)

150. *See supra* text accompanying notes 22–24 (explaining consequences of eliminating unanimous vote requirements for corporate transactions).

151. *See supra* text preceding and accompanying note 19 (noting the need for the Illinois dissenters' rights statute); *supra* notes 23–25 and accompanying text (discussing the reasons behind dissenters' rights statutes).

152. AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §7.22(a) (Proposed Final Draft 1992).

153. *Id.* at pt. VII, ch. 4, introductory note.

154. Comm. on Corporate Laws, ABA, *Proposed Changes in the Model Business Corporation Act—Appraisal Rights*, 54 BUS. LAW. 209, 210, 215–16 (1998).

155. MODEL BUS. CORP. ACT 3D §13.01(4)(iii) (1984) (amended 1999).

the value of the shares "without discounting for lack of marketability or minority status."[156] The proposal was adopted the following year.[157]

The rationale for the Model Act change was substantially similar to that set forth in the ALI Principles of Corporate Governance: marketability and minority discounts are generally inappropriate "because most transactions that trigger appraisal rights affect the corporation as a whole and because such discounts give the majority the opportunity to take advantage of minority shareholders who have been forced against their will to accept the appraisal—triggering transaction."[158]

Thus, both the American Law Institute and the American Bar Association, in rejecting discounts, were concerned about the potential abuse of power by those in control. As discussed throughout this article, the conflicts of interest that inhere in squeeze-out and freeze-outs, with the attendant transfer of value from the minority to the majority in control of the corporation, require courts to protect the interests of minority shareholders.

Undoubtedly, the endorsement of these two organizations has influenced courts in rejecting minority and marketability discounts.

V. CONCLUSION

As court after court has recognized, discounts, whether minority or marketability, transfer value from the minority shareholder, for whose benefit the statutes were enacted, to the majority shareholder. While there are numerous other arguments against discounting minority shares in dissenters' rights or oppression cases, this is the key concept to appreciate.

Illinois' acceptance of discounts is inconsistent with the historic role of Illinois courts in protecting minority shareholders. Today, it is also contrary to the approach taken by an overwhelming number of courts around the country, which have rejected discounts. While the Illinois Supreme Court accepted discounts in *Republic Bank*, it did so on the basis of deference to the lower courts. In doing so, however, it clearly emphasized that lower courts need not apply discounts.

In view of the overwhelming weight of authority against discounts, it is time for the Illinois courts to join the majority, recognize that the

156. Comm. on Corporate Laws, ABA, *supra* note 154, at 210.

157. Comm. on Corporate Laws, ABA, *Changes in the Model Business Corporation Act Pertaining to Appraisal Rights and to Fundamental Changes—Final Adoption*, 55 BUS. LAW. 405 (1999).

158. Comm. on Corporate Laws, *supra* note 154, at 256.

issue is one of law in defining fair value, and reject both minority and marketability discounts. Otherwise, the trial courts will continue to defer to valuators who in turn defer to the attorneys, thus leaving us in the paradoxical situation where the opinion of a trial attorney trumps the view of the supreme court.

APPENDIX

TABLE 1
JURISDICTIONS REJECTING MINORITY DISCOUNTS

Alabama (implicitly)	Offenbecher v. Baron Servs., Inc., No. 2000025, 2002 WL 959833, at *6 (Ala. Civ. App. May 10, 2002) (rejecting marketability discounts even though such discounts "can claim more theoretical support than the minority discount" (quoting 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 5.32 (2d ed. 1999))), *aff'd sub nom. Ex parte* Baron Servs., Inc., No. 1011635, 2003 WL 1787932 (Ala. 2003).
Arizona	Pro Finish USA, Ltd. v. Johnson, 63 P.3d 288, 293 (Ariz. Ct. App. 2003) (relying upon the majority rule). "The value of the dissenters' proportionate interest is to be determined 'without any discount for minority status or, absent extraordinary circumstances, lack of marketability.'" *Id.* (quoting AM. LAW. INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.22(a) (1994)).
California	Brown v. Allied Corrugated Box Co., 154 Cal. Rptr. 170, 176 (Ct. App. 1979) (stating that if minority shares could be discounted, "the very misconduct and unfairness which provoked the minority shareholders [to sue could] be used further to oppress them").
Colorado	M Life Ins. Co. v. Sapers & Wallack Ins. Agency, 40 P.3d 6, 13 (Colo. Ct. App. 2001) ("[M]inority discount was not applicable as a matter of law.").
Connecticut	Devivo v. Devivo, No. CV 980581020, 2001 WL 577072 (Conn. Super. Ct. May 8, 2001). The court found that fair value is "the value of the corporation as a whole . . . allocate[d] to the shares of the petitioning shareholder in proportion to [his] percentage interest." *Id.* at *5. In addition, relying upon the majority rule and the ALI, and confirmed by the provisions of the agreement in question, the court stated that "discounts for lack of control or marketability should not be allowed in determining fair value." *Id.* at *9.

Delaware	Cavalier Oil Corp. v. Harnett, Civ. A Nos. 7959–60, 7967–68, 1988 WL 15816, at *8 (Del. Ch. Feb. 22, 1988) (finding that "'minority' and 'nonmarketability' discounts . . . are improper under Delaware law"), *aff'd*, 564 A.2d 1137 (Del. 1989).
Georgia	Blitch v. Peoples Bank, 457, 540 S.E.2d 667, 670 (Ga. Ct. App. 2000) (relying upon the majority view and the 1999 Model Act, and, in effect, overruling *Atl. States Constr. v. Beavers*, 314 S.E.2d 245 (Ga. Ct. App. 1984)). "[A] court should not apply minority or marketability discounts in determining the fair value of dissenters' shares. Rather, . . . a shareholder should generally be awarded his or her proportional interest in the corporation after valuing the corporation as a whole." *Id.* (citation omitted).
Indiana	Wenzel v. Hopper & Galliher, P.C., 779 N.E.2d 30, 39–40 (Ind. Ct. App. 2002) (relying upon the reasoning of the majority cases). "Accordingly, we hold as a matter of law that the trial court erred in applying minority and marketability discounts . . . ."[159] *Id.*
Iowa	Sec. State Bank v. Ziegeldorf, 554 N.W.2d 884, 889 (Iowa 1996) ("[W]e have refused to allow the value of the dissenter's shares to be discounted because they represent a minority interest in the corporation. Such a discount 'in effect would let the majority force the minority out without paying it its fair share of the value of the corporation.'" (quoting Woodward v. Quigley, 133 N.W.2d 38, 43 (Iowa 1965))).

159. The court recognized the ALI "extraordinary circumstances" test may make marketability discounts a mixed question of law and fact.

Kansas	Arnaud v. Stockgrowers State Bank, 992 P.2d 216, 220 (Kan. 1999) (overruling *Moore v. New Ammest, Inc.*, 630 P.2d 167, 177 (Kan. Ct. App. 1981)). The court stated that because discounts "enable the majority shareholders to seize the minority shareholders' interest in the corporation to the extent a minority or marketability is allowed . . . [w]e hold that minority and marketability discounts are not appropriate when the purchaser of the stock is either the majority shareholder or the corporation itself." *Id.*
Maine	*In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1004–05 (Me. 1989) ("Our view of the appraisal remedy is obviously inconsistent with the application of minority and nonmarketability discounts. . . . Any rule of law that gave the shareholders less than their proportionate share of the whole firm's fair value would produce a transfer of wealth from the minority shareholders to the shareholders in control.").
Massachusetts	BNE Mass. Corp. v. Sims, 588 N.E.2d 14, 19 (Mass. App. Ct. 1992) ("The task assigned to the court . . . is not to reconstruct an 'intrinsic value' of each share of the enterprise but, rather, to determine what a willing buyer realistically would pay for the enterprise as a whole . . . . Only in this fashion can minority stockholders be assured that insiders in control of a company, burdened by conflicting interests, may not purchase the enterprise at a price less than that obtainable in the marketplace of qualified buyers and avoid paying a full and fair price to the minority.").
Minnesota	MT Props., Inc. v. CMC Real Estate Corp., 481 N.W.2d 383, 388 (Minn. Ct. App. 1992) ("[B]ecause the legislature has enacted the statute with the evident aim to protect the dissenting shareholder, we must prohibit application of minority discounts when determining 'fair value' in statutory dissenter's rights cases in Minnesota. This result is also in accord with the approach of the majority of states . . . .").
Missouri (implicitly)	*Compare* Dreiseszun v. FLM Indus., 577 S.W.2d 902, 909–10 (Mo. Ct. App. 1979) (stating that "this court refuses to ascribe to the Legislature any intention to permit the majority stockholders . . . to . . . fritter away

	any right of the minority shareholders" and accordingly entitling plaintiffs to the 'pro rata value' of their stock), *with* King v. F.T.J., Inc., 765 S.W.2d 301, 305 (Mo. Ct. App. 1989) ("The application of a 7% minority discount was supported by the evidence . . . ."). For a more recent decision, see *Swope v. Siegel-Robert, Inc.*, 243 F.3d 486, 496-497 (8th Cir. 2001) ("[W]e are not bound by Missouri's intermediate appellate court . . . [because] we conclude that if deciding the issue today, the Missouri Supreme Court would follow the compelling logic of the current trend toward disallowing minority and marketability discounts [as a matter of law] in dissenting shareholders' fair value appraisal determinations.").
Montana	Hansen v. 75 Ranch Co., 957 P.2d 32, 42 (Mont. 1998) (overruling *McCann Ranch, Inc. v. Quigley-McCann*, 915 P.2d 239 (Mont. 1996), and stating, "We further conclude that application of a minority discount is inappropriate when minority shareholders in a close corporation sell their shares to the corporation or majority shareholders in a situation controlled by the dissenters' rights statute.").
Nebraska	Rigel Corp. v. Cutchall, 511 N.W.2d 519, 526 (Neb. 1994) ("[I]n the event of a merger, neither a minority discount nor a deduction for lack of marketability is to be given in determining the fair value of a dissenter's shares . . . . Only by not doing so can the statutory policy of fully compensating a dissenting minority shareholder be achieved.").
New Jersey (implicitly)	Lawson Mardon Wheaton, Inc. v. Smith, 734 A.2d 738, 749 (N.J. 1999). Citing the ALI Principles, the court stated that fair value should be determined pro rata "without any discount for minority status." *Id.* However, a minority discount was not in issue. *See id.*
New York	Blake v. Blake Agency, Inc., 486 N.Y.S.2d 341, 349 (N.Y. App. Div. 1985) ("[A] minority interest in closely held corporate stock should not be discounted solely because it is a minority interest."); *see also* Friedman v. Beway Realty Corp., 661 N.E.2d 972, 977 (N.Y. 1995) (rejecting minority discounts).

	Royals v. Piedmont Elec. Repair Co., No. 97 CVS 7201999, WL 33545516, at *13 (N.C. Super. Ct. Mar. 3, 1999) ("The Court believes that North Carolina law does not favor application of discounts for lack of control or lack of marketability under these circumstances . . . ."), *aff'd*, 529 S.E.2d 515 (N.C. Ct. App. 2000).
North Dakota	Fisher v. Fisher, 568 N.W.2d 728, 732 (N.D. 1997) (stating, upon review of other jurisdictions, "We agree a trial court ascertaining 'fair value' of minority shares under the [BCA] should not automatically discount their value.").[160]
Oklahoma	Woolf v. Universal Fid. Life Ins. Co., 849 P.2d 1093, 1095 (Okla. Ct. App. 1992) ("We hold that the trial court erred in applying a [minority] discount to the value of Shareholders' stock." (relying on Cavalier Oil Corp. v. Harnett, 564 A.2d 1137 (Del. 1989))).
Oregon	Columbia Mgmt. Co. v. Wyss, 765 P.2d 207, 214 (Or. Ct. App. 1988) ("To include a minority discount would simply penalize him while allowing the corporation to buy his shares cheaply. That is not the protection that the legislature had in mind or that other courts have provided.").
Rhode Island	Charland v. Country View Golf Club, Inc., 588 A.2d 609, 612 (R.I. 1991) ("We agree with the rationale of *Brown* and hereby adopt the rule that [in a buy-out alternative remedy] we shall not discount the shares solely because of their minority status.").
South Carolina	Morrow v. Martschink III, 922 F. Supp. 1093, 1105 (D.S.C. 1995) ("This court concludes that no minority discount or marketability discount should be applied to reduce the fair value of Plaintiff's shares. These discounts have not been recognized in South Carolina in the context of corporate dissolution actions and have been rejected by many courts.").

160. *Fisher v. Fisher* is a divorce case but the court applied a "fair value" standard under an alternative remedy buy-out statute.

	First W. Bank Wall v. Olsen, 621 N.W.2d 611, 618 (S.D. 2001) (agreeing "with the reasoning of *Cavalier Oil* [Del.] and its progeny" and holding as "inappropriate" the application of "a minority discount when determining the fair value of dissenter's shares").
Utah	Hogle v. Zinetics Med., Inc., 63 P.3d 80, 91 (Utah 2002) (after discussing minority and marketability discounts, the supreme court stated that the trial court "should not employ discounts in its valuation of the Minority's shares").
Vermont	Waller v. Am. Int'l Distribution Corp., 706 A.2d 460, 463 (Vt. 1997) ("[T]he 'minority discount' is inappropriate where the court has found oppression of the minority."); *In re* 75,629 Shares of Common Stock, 725 A.2d 927, 935 (Vt. 1999) ("[T]here was no legal error in applying a [30%] control premium to adjust a valuation that reflected publicly traded minority interests.").
Virginia	U.S. Inspect, Inc. v. McGreevy, No. 160966, 2000 WL 33232337, at *10–11 (Va. Cir. Ct. Nov. 27, 2000) (relying upon the substantial majority of jurisdictions and the ALI, and stating that "this court . . . finds that no minority discount should be applied in determining the fair value of shares").
Washington	Robblee v. Robblee, 841 P.2d 1289, 1295 (Wash. Ct. App. 1992) ("'Dave's ownership will go to almost 80% and he will be ridding himself of a minority shareholder who had become, and would continue to be, extremely difficult.' This, though, is one of the very reasons a minority shareholder's stock should not be discounted to fair market value, because the value to Dave is different from what it would be in the market. Where no market was involved in valuing Neil's shares, and Dave had strong incentive to buy them, we find no justification in these facts for the application of a fair market value minority discount.").
Wisconsin	HMO-W Inc. v. SSM Health Care Sys., 611 N.W.2d 250, 258 (Wis. 2000) ("We conclude that [the dissenters' rights statute] does not permit the application of a minority discount in determining the fair value of a

	dissenter's shares. A minority discount runs contrary to the protective purpose of the dissenters' rights statute . . . .'').

TABLE 2
JURISDICTIONS REJECTING MARKETABILITY (LIQUIDITY) DISCOUNTS

Alabama	Offenbecher v. Baron Servs., Inc., No. 2000025, 2002 WL 959833, at *4–*6 (Ala. Civ. App. May 10, 2002) (relying in part on the 1999 Model Act in calculating value "as a matter of law . . . without regard to the 50 percent 'marketability' discount espoused by [the valuation expert]"), *aff'd sub nom. Ex parte* Baron Servs., Inc., No. 1011635, 2003 WL 1787932 (Ala. 2003).
Arizona	Pro Finish USA, Ltd. v. Johnson, 63 P.3d 288, 293 (Ariz. Ct. App. 2003) (relying upon the majority rule). "The value of the dissenters' proportionate interest is to be determined 'without any reference for minority status or, absent extraordinary circumstances, lack of marketability.'" *Id.* (citation omitted).
Colorado	Pueblo Bancorp. v. Lindoe, Inc., 63 P.3d 353, 368–69 (Colo. 2003) (relying upon the 1999 Model Act, the ALI, and the national trend in other jurisdictions).[161] "The trial court must determine the value of the corporate entity and allocate the dissenting shareholder his proportionate ownership interest of that value, without applying a marketability discount at the shareholder level." *Id.*
Connecticut	Devivo v. Devivo, No. CV980581020, 2001 WL 577072 (Conn. Super. Ct. May 8, 2001). The court stated that fair value is "the value of the corporation as a whole . . . allocate[d] . . . to the shares of the petitioning shareholder in proportion to [his] percentage interest." *Id.* at *5. In addition, relying upon the majority rule and the ALI, and confirmed by the provisions of the agreement in question, the court stated that "discounts for

161. With respect to the ALI Model Act exception for marketability discounts in extraordinary circumstances, such issue was not before the court but the court recognized that such exception is very limited.

	lack of control or marketability should not be allowed in determining fair value." *Id.* at *9.
Delaware	Cavalier Oil Corp. v. Harnett, Civ. A Nos. 7959–60, 7967–68, 1988 WL 15816, at *10 (Del. Ch. Feb. 22, 1988) (rejecting minority and nonmarketability discounts).
Georgia	Blitch v. Peoples Bank, 540 S.E.2d 667, 670 (Ga. Ct. App. 2000) (relying upon the majority view and the 1999 Model Act, and, in effect, overruling *Atl. States Constr. v. Beavers*, 314 S.E.2d 245 (Ga. Ct. App. 1984)). "[A] court should not apply minority or marketability discounts in determining the fair value of dissenters' shares. Rather, . . . a shareholder should generally be awarded his or her proportional interest in the corporation after valuing the corporation as a whole." *Id.* (citation omitted).
Indiana	Wenzel v. Hopper & Galliher, P.C., 779 N.E.2d 30, 39-4 (Ind. Ct. App. 2002) (relying upon the reasoning of the majority cases). "Accordingly, we hold as a matter of law that the trial court erred in applying minority and marketability discounts . . . ." *Id.*
Iowa	Sec. State Bank v. Ziegeldorf, 554 N.W.2d 884, 890 (Iowa 1996) ("To allow a marketability discount under this record would undermine the legislature's intent to protect minority shareholders from being forced out at a price below the fair value of their pro-rata share of the corporation.").
Kansas	Arnaud v. Stockgrowers State Bank, 992 P.2d 216, 220 (Kan. 1999) (stating that discounts "enable the majority shareholders to seize the minority shareholder's interest in the corporation to the extent a minority or marketability discount is allowed" and holding that "minority and marketability discounts are not appropriate when the purchaser of the stock is either the majority shareholder or the corporation itself").
Maine	*In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1004–05 (Me. 1989) ("Our view of the appraisal remedy is obviously inconsistent with the application of minority and nonmarketability discounts. . . . Any rule of law that gave the shareholders less than their proportionate share of the whole firm's fair

	value would produce a transfer of wealth from the minority shareholders to the shareholders in control.").
Minnesota	Advanced Communication Design, Inc. v. Follett, 615 N.W.2d 285, 292 (Minn. 2000). "[F]air value in a court-ordered buy-out . . . means a pro rata share of the value of the corporation as a going concern without discount for lack of marketability." *Id.* (relying upon ALI's no discount "except in extraordinary circumstances" standard). Note that in this case, the court held that where the appraised value of the shares of a minority shareholder in a court-ordered buyout (pursuant to the MBCA) results in an unfair wealth transfer from remaining shareholders to the minority shareholder, an extraordinary circumstance is presented warranting the application of a marketability discount. *Id.* at 293. This is an extraordinarily rare situation.
Missouri	King v. F.T.J., Inc., 765 S.W.2d 301, 305 (Mo. Ct. App. 1989) ("[I]t cannot be said the trial judge erred by failing to apply a lack of marketability discount . . . ."); *see also* Swope v. Siegel-Robert, Inc. 243 F.3d 486, 494, 496–97 (8th Cir. 2001). "[N]o Missouri court has ever applied a discount for lack of marketability." *Id.* at 494. "[W]e are not bound by Missouri's intermediate appellate court . . . [because] we conclude that if deciding the issue today, the Missouri Supreme Court would follow the compelling logic of the current trend toward disallowing minority and marketability discounts [as a matter of law] in dissenting shareholders' fair value appraisal determinations." *Id.* at 496–97.
Nebraska	Rigel Corp. v. Cutchall, 511 N.W.2d 519, 526 (Neb. 1994) ("[I]n the event of a merger, neither a minority discount nor a deduction for lack of marketability is to be given in determining the fair value of a dissenter's shares . . . . Only by not doing so can the statutory policy of fully compensating a dissenting minority shareholder be achieved.").
New Jersey	Lawson Mardon Wheaton, Inc. v. Smith, 734 A.2d 738, 749 (N.J. 1999). Although the lower courts had "found that the present case falls within the 'extraordinary circumstances' exception to the general prohibition against applying a marketability discount," the court

	disagreed. *Id.* However, in *Balsamides v. Protameen Chemicals*, 734 A.2d 721, 733–35 (N.J. 1999), the court applied the "extraordinary circumstances" exception to no discount when the court permitted the plaintiff *oppressed* shareholder to buy out the other shareholder who had breached his fiduciary duties to plaintiff and the company.
North Carolina	Royals v. Piedmont Electric Repair Co., No. 97 CVS 7201999, WL 33545516, at *13 (N.C. Super. Ct. Mar. 3, 1999) ("The Court believes that North Carolina law does not favor application of discounts for lack of control or lack of marketability under these circumstances . . . ."), *aff'd*, 529 S.E.2d 515 (N.C. Ct. App. 2000).
Rhode Island	Charland v. Country View Golf Club, Inc., 588 A.2d 609, 613 (R.I. 1991) ("We therefore today adopt the rule of not applying a discount for lack of marketability in [buy-out alternative remedy] proceedings.").
South Carolina	Morrow v. Martschink III, 922 F. Supp. 1093, 1105 (D.S.C. 1995) ("This court concludes that no minority discount or marketability discount should be applied to reduce the fair value of Plaintiff's shares. These discounts have not been recognized in South Carolina in the context of corporate dissolution actions and have been rejected by many courts.").
South Dakota	First W. Bank Wall v. Olsen, 621 N.W.2d 611, 619 (S.D. 2001) ("This [marketability] discount is especially inapplicable in a dissenters' rights context, as a ready market does exist for the dissenters' shares, namely the majority shareholder or the corporation itself. To apply a non-marketability discount to the dissenters' shares would 'unfairly enrich[] the majority shareholders who may [attempt to] reap a windfall from the appraisal process . . . .'" (quoting Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989))).
Utah	Hogle v. Zinetics Med., Inc., 63 P.3d 80, 91 (Utah 2002) (noting, after discussing minority and marketability discounts, that the trial court "should not employ discounts in its valuation of the Minority's shares").
Virginia	U.S. Inspect, Inc. v. McGreevy, No. 160966, 2000 WL 33232337, *12. (Va. Cir. Ct. Nov. 27, 2000) ("[T]his court adopts the reasoning of the Delaware, New Jersey

	and Maine Supreme Courts that the policies underlying dissenting shareholder statutory schemes are inconsistent with the imposition of marketability discounts, absent extraordinary circumstances.").
Washington	Matthew G. Norton Co. v. Smyth, 51 P.3d 159, 167 (Wash. Ct. App. 2002) ("[T]o the extent that the trial court's order was intended to declare that, absent extraordinary circumstances, no such [marketability] discount can be applied at the shareholder level, we affirm.").

TABLE 3
JURISDICTIONS ACCEPTING MINORITY DISCOUNTS

Mississippi (federal court)	Hernando Bank v. Huff, 609 F. Supp. 1124, 1126 (N.D. Miss. 1985) ("[T]he court concludes that in the present case a minority discount is proper in determining the fair value of the stock of the dissenters.").
New Mexico	McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232, 243–45 (N.M. Ct. App. 1986) (upholding, in an oppression case, a minority discount under a "fair and reasonable price" standard articulated by the trial court in framing an alternative remedy to dissolution, and relying on tax cases to support the minority discount).

TABLE 4
JURISDICTIONS ACCEPTING MARKETABILITY (LIQUIDITY) DISCOUNTS

Florida	Munshower v. Kolbenhayer, 732 So. 2d 385, 386 (Fla. Dist. Ct. App. 1999) ("[W]e rely on New York case law as persuasive . . . .").
Kentucky	Ford v. Courier-Journal Job Printing Co., 639 S.W.2d 553, 556–57 (Ky. Ct. App. 1982).
Nevada (federal court)	Steiner Corp. v. Benninghoff, 5 F. Supp. 2d 1117, 1129 (D. Nev. 1998) (rejecting a 60% marketability discount and instead applying a 25% discount on the basis that "[i]t would be inconsistent to allow a company to force minority shareholders to sell their shares back to the corporation, but to reduce the price the corporation had to

	pay for those shares because no one would ever want to buy them," but without citing any case authority to justify any discount).
New York	Blake v. Blake Agency, Inc., 486 N.Y.S.2d 341, 349 (N.Y. App. Div. 1985) ("A discount for lack of marketability is properly factored into the equation because the shares of a closely held corporation cannot be readily sold on a public market.").
Oregon	Columbia Mgmt. Co. v. Wyss, 765 P.2d 207, 213 (Or. Ct. App. 1988) (upholding the applicability of a marketability discount "to reflect the potential volatility in Columbia's enterprise value . . . as well as the marketability problems that affect the shares of all closely held corporations").

TABLE 5
ILLINOIS CASES

Independence Tube Corp. v. Levine, 179 Ill. App. 3d 911, 918, 535 N.E.2d 927, 931 (1988) ("[W]e find persuasive the fact that other [s]tates which have similar provisions do use such discounts when appropriate. . . . Thus it may be appropriate for the trial court to consider a minority interest factor or a lack of marketability factor.").
Hickory Creek Nursery, Inc. v. Johnston, 167 Ill. App. 3d 449, 455, 521 N.E.2d 236, 239–40 (1988) ("[W]e find such discounting does not apply in the instant case when a minority interest is being assumed by the remaining shareholders resulting in a substantial *pro rata* increase in their share and control of the corporation.").
Inst'l Equip. & Interiors, Inc. v. Hughes, 204 Ill. App. 3d 922, 930, 562 N.E.2d 662, 667–68 (1990) ("The trial court correctly held that the fair-market-value method did not apply in a situation where a dissenting minority shareholder in a closely held corporation was being bought out by a majority stockholder."). The court further held that it was not an abuse of discretion for the trial court to refuse to apply an illiquidity discount under the circumstances. *Id.*
Stanton v. Republic Bank of S. Chi., 144 Ill. 2d 472, 480, 581 N.E.2d 678, 682 (1991) ("With respect to the Bank's argument that the minority and illiquidity discounts were arbitrary and lacked foundation, we find that the trial court acted within its discretion to apply such discounts, even though not required to do so . . . .").

Weigel Broad. Co. v. Smith, 289 Ill. App. 3d 602, 608, 682 N.E.2d 745, 750 (1997) ("Applying such discounts, therefore, is left to the trial court's discretion." (citing to *Stanton v. Republic Bank of S. Chi.*, 144 Ill. 2d at 479, 581 N.E.2d at 682)).