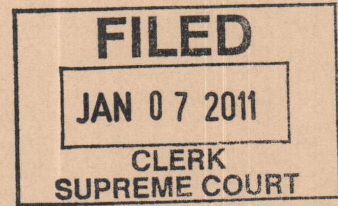


COMMONWEALTH OF KENTUCKY
SUPREME COURT
CASE NO. 2009-SC-000574-DG

SHAWNEE TELECOM RESOURCES, INC. — APPELLANT/CROSS-APPELLEE

v.

**APPEAL FROM COURT OF APPEALS**
**CASE NOS. 2008-CA-000042 and 2008-CA-000167**

KATHY BROWN — APPELLEE/CROSS-APPELLANT

# BRIEF OF *AMICUS CURIAE* KENTUCKY CHAMBER OF COMMERCE

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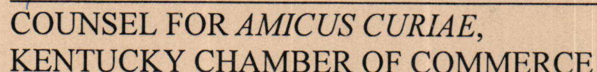
## CERTIFICATE OF SERVICE

This is to certify that a true and accurate copy of this Brief of Amicus Curiae was served via first class U.S. Mail, postage pre-paid, this 16th day of December, 2010, on Clark Case, Case & Case, LLP, 421 W. Second Street, Lexington, Kentucky 40507, Counsel for the Appellee; Duane Cook, 105 Thoroughbred Way, Georgetown, Kentucky 40324, Counsel for the Appellant; Hon. Samuel P. Givens, Jr., Clerk of the Court of Appeals, 360 Democrat Drive, Frankfort, Kentucky 40601, and on Hon. Gary D. Payne, Senior Judge, 3195 Paris Pike, Lexington, Kentucky 40511.

The undersigned further certifies that this *Amicus* has not withdrawn the record on appeal.



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## TABLE OF POINTS AND AUTHORITIES

PURPOSE OF THE BRIEF AND PARTICULAR ISSUES ADDRESSED .......... 1

*Ford v. Courier-Journal Job Printing Co.*,
639 S.W.2d 553 (Ky. App. 1982) .......... passim

KENTUCKY'S DISSENTER'S RIGHTS STATUTE AND THE *FORD* DECISION HAVE LONG DEFINED THE CONCEPT OF FAIR VALUE IN THE COMMONWEALTH .......... 1

TWO RECENT COURT OF APPEALS OPINIONS THREATEN TO FUNDAMENTALLY ALTER KENTUCKY VALUATION LAW, TO THE DETRIMENT OF KENTUCKY BUSINESSES .......... 2

*Brooks v. Brooks Furniture Mfgrs., Inc.*,
____ S.W.3d ___, 2010 WL 4290068 (Ky. App. October 29, 2010, finality December 10, 2010) .......... passim

*Cavalier Oil Corp. v. Harnett*,
564 A.2d 1137 (Del. 1989) .......... 4, 13

*In re Valuation of Common Stock of McLoon Oil Co.*,
565 A.2d 997 (Me. 1989) .......... 4

ARGUMENT .......... 5

I. THE *SHAWNEE* OPINION FAILS TO PROPERLY CONSTRUE THE LEGISLATURE'S MANDATE CONCERNING DISSENTERS' RIGHTS VALUATIONS .......... 5

*Donohue v. Heuser*,
239 S.W.2d 238 (Ky. 1951) .......... 5

*Lewis v. Jackson Energy Coop. Corp.*,
189 S.W.3d 87 (Ky. 2005) .......... 5

*Bank of the United States v. Norvell*,
2 A.K. Marsh. 101, 9 Ky. 101 (1819) .......... 5

KRS 271B.13-010(3) .......... 6

*Casey County Fiscal Ct. v. Burke*,
743 S.W.2d 26 (Ky. 1988) .......... 6

II. THE LEGISLATURE HAS CHOSEN NOT TO ADOPT MODEL BUSINESS CORPORATION ACT AMENDMENTS BARRING MINORITY OR MARKETABILITY DISCOUNTS. .......... 7

KRS 271B.13-020 .......... 7

Ky. Acts 2007, ch. 137 .......... 7

Ky. Acts 2007, ch. 51 .......... 7

*Rye v. Weasel*,
934 S.W.2d 257 (Ky. 1996) .......... 8

*St. Clair v. Com.*,
140 S.W.3d 510 (Ky. 2004) .......... 8

*McChesney v. Hager*,
104 S.W. 714 (Ky. 1907) .......... 8

*Yeager v. Paul Semonin Co.*,
691 S.W.2d 227 (Ky. App. 1985) .......... 8 - 9

*Carpenter v. Dummit*,
221 Ky. 67, 297 S.W. 695 (1927) .......... 9

*Kaplan v. First Hartford Corp.*,
484 F. Supp. 2d 131 (D. Me. 2007) .......... 9

*Pueblo Bancorporation v. Lindoe, Inc.*,
63 F.3d 353 (Colo. 2003) .......... 9

III. ABANDONING *FORD'S* PROVEN APPROACH FOR ANOTHER WOULD NOT SERVE JUSTICE, NOR IS DOING SO JUSTIFIED BY PUBLIC POLICY OR ECONOMIC THEORY. .......... 10

Rabbat, *Application of Share-Price Discounts and Their Role in Dictating Corporate Behavior: Encouraging Elected Buy-Outs Through Discount Application*,
43 Willamette L. Rev. 107 (2007) .......... 10

*Applebaum v. Avaya, Inc.*,
812 A.2d 880 (Del. 2002) .......... 11

Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*,
47 Duke L.J. 613 (1998). .......... 11

*Ex Parte Baron Services, Inc.*,
874 So.2d 545 (Ala. 2003) .......... 12

*Berger v. Berger*,
2006 WL 335828 (Ky. App. 2006) .......... 12

*Blackstone v. Blackstone*,
681 N.E.2d 72 (Ill. App. 1997) ........ 12

*Matter of Shell Oil Co.*,
607 A.2d 1213 (Del. 1992) ........ 12

*Yeager v. Paul Semonin Co.*,
691 S.W.2d 227 (Ky. App. 1985) ........ 13

*Cavalier Oil Corp. v. Harnett*,
564 A.2d 1137 (Del. 1989) ........ 13

*Tri-Continental Corp. v. Battye*,
74 A.2d 71 (Del. 1950). ........ 13

CONCLUSION ........ 14

## PURPOSE OF THE BRIEF AND PARTICULAR ISSUES ADDRESSED

The purpose of this brief is to assist the Court in considering the central question presented by this appeal: should Kentucky abandon the dissenter's rights valuation approach adopted in *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982), an approach which has served Kentucky well (and without any apparent controversy) for nearly 30 years, particularly where the alternatives are not justified by Kentucky's dissenter's rights statute, nor by public policies and economic realities?

An affirmative answer to this question would severely restrict the ability of Kentucky companies to fairly value their shares, based on the realities of the marketplace, while encouraging minority shareholders to reap windfall profits through dissent and litigation. And Kentucky courts will no longer have sufficient flexibility to determine "fair value" based on the facts and circumstances in each case.

This is an important issue for Kentucky's business community, thus compelling the Kentucky Chamber of Commerce's involvement as an *amicus curiae*. Because many Kentucky corporations will experience mergers or other transactions which may trigger a dissenter's rights action, a proper valuation approach will make a huge difference in the long-term prospects for such companies. If Kentucky businesses are subject to a valuation approach which imposes a cost higher than the statutory "fair value" standard, this will unfairly reward dissenters, who are no longer subject to the entrepreneurial risk of operating a business. As a result, the enterprise will be deprived of capital, money that could be better used to reinvest in the enterprise by purchasing new equipment or technology, or employing more workers. Accordingly, the business community would greatly benefit from a clear statement of Kentucky law, reaffirming the traditional and

time-tested valuation approach in *Ford*, rather than the uncertain and disruptive state of the law stemming from two recent Court of Appeals decisions.

## KENTUCKY'S DISSENTER'S RIGHTS STATUTE AND THE *FORD* DECISION HAVE LONG DEFINED THE CONCEPT OF FAIR VALUE IN THE COMMONWEALTH

Originally enacted in 1972, Kentucky's dissenter's rights statute has allowed shareholders to reject the compensation due under a plan of merger and, instead, receive "fair value" for their shares under a carefully prescribed, and legislatively mandated process. Prior to this year, *Ford* was the only published Kentucky appellate authority to address the "fair value" question, holding that three approaches should be considered in valuing dissenters' shares: (1) the market value approach; (2) the earnings or investment approach; and (3) the net asset approach. Under *Ford*, courts have been given the latitude to assign different weights to each approach, depending on the circumstances in each particular case.

*Ford* also recognized that because shares in a closely-held corporation are often illiquid, they are worth less than comparable shares that can be sold immediately on the open market, making a marketability discount appropriate in certain circumstances. This makes sense, because running a business is fraught with risk, and its fortunes are affected by many factors that are often outside a company's control. In a public company, the market value of a stock fluctuates daily based on the public's perception of the level of risk in the company. In a closely-held corporation, this constant and unpredictable fluctuation of stock value is appropriately reflected in a marketability discount applied to the company's appraised value.

TWO RECENT COURT OF APPEALS OPINIONS THREATEN TO FUNDAMENTALLY ALTER KENTUCKY VALUATION LAW, TO THE DETRIMENT OF KENTUCKY BUSINESSES

Two recent Court of Appeals opinions have now called into question this well-established methodology of valuing shares in a closely-held company, a result which – if affirmed by this Court – would adversely impact Kentucky's business community.

In the *Shawnee* decision under review here, the Kentucky Court of Appeals implicitly overruled *Ford*, holding that a marketability discount was not appropriate in determining the fair value of shares in a closely-held corporation ***under any circumstance***. *Shawnee* also concluded that because a net-asset approach deals with concepts of open-markets and fair market value, such approach is not appropriate in a closely-held corporation context. Recognizing the importance of this issue in Kentucky law, this Court granted discretionary review.

Further evidencing the importance of this issue is the Kentucky Court of Appeals' *en banc* opinion in *Brooks v. Brooks Furniture Mfgrs., Inc.*, ____ S.W.3d ___, 2010 WL 4290068 (Ky. App. October 29, 2010, finality December 10, 2010),[1] in which the full Court of Appeals split 9-5 on the very valuation issues decided in *Shawnee*. Although concluding that "there is no consensus" interpretation of "fair value" among the courts, *Brooks* held that "a marketability discount" – which accounts "for a lack of liquidity of a closely-held corporation on the theory that the potential pool of buyers is limited" – is, "except under extraordinary circumstances, … impermissible in the context of a squeeze-out merger," thus overruling *Ford*. *Id.* at *6-7.

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[1] This Court will not be afforded the opportunity to review *Brooks*, because the litigants have chosen not to further pursue appeals.

Like the *Shawnee* Court, *Brooks* principally relied on decisions from Maine and Delaware, ostensibly for the proposition that those courts rejected all marketability discounts, *id.* at *8-9, *citing In re Valuation of Common Stock of McLoon Oil Co.*, 565 A.2d 997 (Me. 1989) and *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989). In this, both *Shawnee* and *Brooks* are simply wrong, as neither court rejected marketability discounts at the ***corporate level***, instead rejecting marketability discounts solely ***at the shareholder level*** because to do so would impermissibly discount for the non-controlling status of those minority shares. *McLoon*, 565 A.2d at 1004; *Cavalier*, 564 A.2d at 1144-45.

But *Brooks* went even further, rejecting the circuit court's application of a marketability discount at the corporate level, holding that such a discount "diminished the value of the [dissenter's] shares ***based on the fiction of the corporation's marketability on the open market***." *Id.* at *9 (emphasis added). In this holding, *Brooks* ignored the fundamental economic reality that closely-held corporations are, in fact, worth less than a corporate entity whose shares are publicly traded. Rather than some theoretical basket of assets whose intrinsic value may be divined through a formulaic valuation process, a corporation is an entity whose "fair value" may only be reflected in the marketplace. To ignore that reality results in a windfall to those owning shares in such an entity, whose illiquid shares are suddenly valued as though they were readily marketable, when they are not.

As the largest business organization in the Commonwealth, the Kentucky Chamber of Commerce (the "Chamber") has more than 2,700 member businesses, which collectively employ more than half of Kentucky's private workforce. The Chamber

provides leadership and serves as a consensus-builder and advocate for the advancement of Kentucky.[2] In fulfilling that mission, the Chamber occasionally intervenes as an *amicus curiae* in cases of particular importance to Kentucky business and the administration of justice in our courts.

Unless this Court acts, the drastic shift in the law found in the *Shawnee* and *Brooks* decisions would have a negative impact on Kentucky businesses, restricting closely-held companies' ability to fairly value their shares, based on the realities of the marketplace, while encouraging minority shareholders to reap windfall profits through dissent and litigation. Kentucky businesses and the Commonwealth would be better served if valuations were based on all relevant facts and circumstances, with Kentucky courts retaining sufficient flexibility to determine "fair value" based on the particular facts and circumstances before them.

## ARGUMENT

### I. THE *SHAWNEE* OPINION FAILS TO PROPERLY CONSTRUE THE LEGISLATURE'S MANDATE CONCERNING DISSENTERS' RIGHTS VALUATIONS.

The Kentucky legislature has adopted myriad corporation laws dating back to the 1800s. *See, e.g., Donohue v. Heuser*, 239 S.W.2d 238, 241 (Ky. 1951). From these enactments, Kentucky courts have long acknowledged "the universally accepted principle that corporations are creatures of statute and that their powers are expressed and prescribed by statute." *Lewis v. Jackson Energy Coop. Corp.*, 189 S.W.3d 87, 90-91 (Ky. 2005) (citation omitted). *See also Bank of the United States v. Norvell*, 2 A.K. Marsh. 101, 9 Ky. 101, 102 (1819) ("It is a sound rule with respect to corporations created by

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[2] For a description of the Chamber's membership and mission, see http://www.kychamber.com.

statute, (and none in this country can be created in any other way) that they can only act in the manner prescribed by law. They are the mere creatures of the acts to which they owe their existence.").

For nearly 40 years, the Kentucky legislature has permitted shareholders to dissent from corporate transactions, in order to be bought out in a court-supervised appraisal proceeding in which they would receive "fair value" for their shares. *Brooks*, 2010 WL 4290068, at *6. Despite the existence of "fair value" appraisal statutes since 1972, *Ford* is the only published Kentucky opinion to explain the concept. Indeed, when the legislature revised Kentucky's corporation laws in 1988 – adopting the 1984 Model Business Corporation Act – it retained the "fair value" requirement for dissenter's rights appraisal proceedings:

> "Fair value," with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.

KRS 271B.13-010(3).

By enacting the dissenter's rights statute and retaining the "fair value" requirement, the legislature "may be presumed to have used language in the same sense in which it was used in the original statute." *Casey County Fiscal Ct. v. Burke*, 743 S.W.2d 26, 28 (Ky. 1988). And, until *Shawnee* and *Brooks*, *Ford* has supplied the only judicial construction of Kentucky's "fair value" dissenter's rights statute.

The *Ford* court's valuation approach has served the Commonwealth well for almost three decades, but the Court of Appeals' recent opinions have implicitly (in the case of *Shawnee*), and explicitly (in the case of *Brooks*), overturned *Ford's* well-founded valuation approach. Given our courts' deference to the public policy established by the

legislature concerning corporate law, legislative acquiescence to *Ford* over all these years should preclude its repeal, absent explicit legislative action.

## II. THE LEGISLATURE HAS CHOSEN NOT TO ADOPT MODEL BUSINESS CORPORATION ACT AMENDMENTS BARRING MINORITY OR MARKETABILITY DISCOUNTS.

Although our legislature has seen fit to revise Kentucky's corporation statutes periodically, and sometimes substantially – as in 2007 and again in 2010[3] – including amending and reenacting KRS 271B.13-020 (providing that a "shareholder shall be entitled to dissent from, and obtain payment of the fair value of his shares…" in the event of certain corporate transactions),[4] the legislature has not changed the "fair value" appraisal standard.

The *Brooks* court acknowledged the legislature's silence regarding minority or marketability discounts. And *Brooks* further acknowledged that our legislature has not amended the appraisal statute "to reflect the 1999 revised MBCA, which now states that the value of the corporation's share is determined without discounting for lack of marketability or minority status." *Brooks*, 2010 WL 4290068, at * 6, citing Model Bus. Corp. Act 3d, § 13.02(5).

The legislature is presumed to be aware of prior court interpretations of its laws, which are to be given continuing effect when the legislature re-adopts the language at

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[3] In 2007, the legislature amended and reenacted substantial portions of Kentucky corporate law, including KRS 271B, Ky. Acts 2007, ch. 137, but inexplicably titled the legislation "AN ACT relating to postsecondary education." As a result, earlier this year, the legislature amended and reenacted the same provisions it had addressed in 2007, with such act made retroactively effective to 2007. Ky. Acts 2010, ch. 51.

[4] See, Ky. Acts 2007, ch. 137, § 67; Ky. Acts 2010, ch. 51, § 67. The legislature's amendment and reenactment of this dissenter's rights statute, which explicitly referenced "fair value," compels the conclusion that the legislature sought to retain the existing judicial interpretation of that concept as articulated in *Ford*.

issue. *Rye v. Weasel*, 934 S.W.2d 257, 262 (Ky. 1996) ("Kentucky and Federal courts have recognized the failure of the legislature to change a known judicial interpretation of a statute as extremely persuasive evidence of the true legislative intent. There is a strong implication that the legislature agrees with a prior court interpretation of its statute when it does not amend the statute interpreted."). Our "rules of statutory construction presume that the legislature is aware of the state of the law at the time it enacts a statute, including judicial construction of prior enactments." *St. Clair v. Com.*, 140 S.W.3d 510, 570 (Ky. 2004) (citations omitted).

If there truly was a "national trend" to prohibit application of marketability discounts, as *Brooks* claims, our legislature is presumed to be aware of it, as well as the *Ford* court's divergence from that so-called trend. But many legislative sessions have come and gone since *Ford* was decided in 1982, and our legislature has done nothing to express its disagreement with that decision. Indeed, the legislature's decision not to amend the dissenter's rights statute to bar discounts must be viewed as its approval of the *Ford* decision. *See, e.g., McChesney v. Hager*, 104 S.W. 714, 715 (Ky. 1907) (Court did not overrule prior opinion despite some questions as to its soundness, given that "there have been four regular sessions of the Legislature [since the case at issue was decided], and, if the construction given to these statutes was not the one intended by the legislative department, it is fair to assume that the statute would have been so amended as to make effective the purpose of the Legislature in the enactment of these laws").

Moreover, even where our courts "find much to commend in ... opinions from sister states" on corporate law issues, our courts "should be guided best by what [they] view the law to be in Kentucky as expressed by our legislature." *Yeager v. Paul Semonin*

*Co.*, 691 S.W.2d 227, 228 (Ky. App. 1985) (opinion ordered published by this Court, June 26, 1985). And this Court and its predecessor court have long deferred to the legislature in this sphere, noting that the legislature has "declared the public policy of the state..." *Carpenter v. Dummit*, 221 Ky. 67, 297 S.W. 695, 698 (1927).

Further, given the deference which *Shawnee* and *Brooks* gave to Maine's courts, it is instructive that a Maine court recently refused to construe Maine corporate law to limit shareholder dissolution suits to closely-held corporations, where the legislature had not adopted revisions to its corporation law to do so. *Kaplan v. First Hartford Corp.*, 484 F. Supp. 2d 131, 146 (D. Me. 2007). Moreover, given the *Brooks* court's lengthy citation to the Colorado Supreme Court's decision in *Pueblo Bancorporation v. Lindoe, Inc.*, 63 F.3d 353 (Colo. 2003),[5] the three justice dissent in that 4-3 opinion forcefully argued that absent legislative adoption of the 1999 MBCA amendments (which specifically barred minority and marketability discounts) Colorado court interpretations of the existing statute should continue to prevail.

Likewise, this Court should defer to our legislature's preservation of "fair value," as construed by *Ford*, without judicially adopting statutory amendments the legislature has declined to adopt. Because the Kentucky legislature establishes the public policy of this state with respect to corporations, ***it*** must act to change the law concerning dissenter's rights appraisal valuations, ***if*** such laws are to be changed.

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[5] Appellant Shawnee Telecom aptly notes that the Colorado court did not renounce corporate level marketability discounts. (Brief for Appellant, p. 35).

## III. ABANDONING *FORD'S* PROVEN APPROACH FOR ANOTHER WOULD NOT SERVE JUSTICE, NOR IS DOING SO JUSTIFIED BY PUBLIC POLICY OR ECONOMIC THEORY.

Dissenter's rights sometimes arise in the context of so-called "squeeze out" mergers. The perceived rationale for denying a marketability discount is that a minority shareholder should receive his or her proportionate part of the value of the underlying enterprise without taking into account the illiquid nature of the stock because to allow a discount could transfer that value to the remaining, often majority, shareholders. One fundamental flaw in this reasoning is that when the minority shareholder purchased his or her shares in the closely held company, the illiquidity of the stock was taken into account in the purchase price, so why should illiquidity of that same stock be ignored when his or her stock is then purchased?

Second, and more importantly, the statute's mandate is "fair value," which is inherently a "facts and circumstances" test. "Fair value" should be exactly what the stock is worth; it should not be less than what it is worth, but it should not be artificially inflated by the elimination of discounts that are inherent in computing its true value. It is simply not enough to say that courts should value closely held corporations as "going concerns" without also factoring in the lack of marketability of such entities. Nor should "fair value" be construed as a "bonus" to make up for the fact that the shareholder's exit is involuntary. By establishing the process by which dissenting shareholders may be bought out, Kentucky's legislature has implicitly rejected the negative connotations many commentators have placed on such transactions. *See*, Rabbat, *Application of Share-Price Discounts and Their Role in Dictating Corporate Behavior: Encouraging Elected Buy-Outs Through Discount Application,* 43 Willamette L. Rev. 107, 137, 140 (2007) ("economic realities dictate that a marketability discount is 'fair' to all parties involved

because it spreads the burden of decreased marketability among every shareholder"; "[t]he discount is not related to good or bad conduct, it is an adjustment based on prevailing market conditions"). To have a blanket rule barring marketability discounts would necessarily prohibit courts from taking into account all the facts and circumstances relevant to a valuation determination, including the illiquid nature of the stock, and would invariably produce an artificially inflated result.

In the absence of dividends, even an investor in a liquid, actively traded stock will not realize any potential gain until he or she sells the stock. The active, liquid market determines the value of the stock. But in the case of a closely held company, no active market exists, and it is that illiquidity which renders the stock – of the dissenters as well as the control group – worth less than if it were actively traded on a stock exchange. If there is a consensus that the market provides the best measure of value, then ignoring that tool is improper. By doing so, courts are deprived of the best comparative measure of worth. And ignoring the fact that a closely-held corporation's shares are illiquid – and thus worth less – would be to grant its shareholders a windfall in the process. *See, e.g., Applebaum v. Avaya, Inc.*, 812 A.2d 880, 889-91 (Del. 2002) (noting that when a stock is actively traded and the value of the stock is "tested ... through the purchase and sale of the stock on the open market," the market price "provide[s] a measure of fair value superior to any estimate the court could impose.").

Even a staunch critic of discounts concedes that "the best evidence of value, if available, is third-party sales value. If such evidence is not available, there is no choice but to resort to less precise valuation techniques." Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 Duke L.J. 613, 655 (1998).

But the alternatives to the *Ford* valuation approach that other courts often employ are no better, and often worse. For instance, valuing a dissenter's stock based upon the expected stream of future profits (sometimes called the discounted cash flow method) is neither scientific – laden as it is with myriad underlying assumptions about future events – nor does it necessarily yield an accurate assessment of the stock's "fair value." It is, instead, a theoretical prediction of the company's future earnings, discounted to reflect: 1) the present value of those future earnings, and 2) the risk inherent in owning and operating that business. *See, e.g.*, *Ex Parte Baron Services, Inc.*, 874 So.2d 545, 551-52 (Ala. 2003) (court held that marketability discounts should not be applied at the shareholder level; the valuation model took into account that the corporation was a small closely-held company that presented a higher degree of investment risk than a large publicly traded company).[6] The resulting valuation is no more correct than that derived through the *Ford* approach. After all, valuation has often been described, by our courts and others, as an art, not a science. *Berger v. Berger*, 2006 WL 335828, at *4 (Ky. App. 2006);[7] *Blackstone v. Blackstone*, 681 N.E.2d 72, 78 (Ill. App. 1997) ("appraisal of a closely held corporation is as much an art as it is a science"); *Matter of Shell Oil Co.*, 607 A.2d 1213, 1221 (Del. 1992) ("weighing of evidence in the appraisal process" is, like valuation, "an art rather than a science").

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[6] This approach is not all that different from the valuation approach rejected in *Brooks*, involving the circuit court's application of a 20% discount to the corporation's net asset value, a discount premised on an expert's appraisal and the trial court's ultimate conclusion that "Brooks Furniture's shares were valued at less than the adjusted net book value of assets ***because it was a high risk investment*** and [because of] the financing and expenses required to find a potential buyer." *Brooks*, 2010 WL 4290068, at *5 (emphasis added).

[7] Although mindful of the CR 76.28(4)(c) obligation to attach "not to be published" Kentucky case authority, such rule is superseded by the explicit prohibition against exhibits to amicus briefs. CR 76.12(7).

Valuing a company based on its expected future profits is a little like predicting what your favorite team or player is going to do ***next year*** based upon ***this year's*** performance. Although Kentucky courts have noted that "[c]onsideration of the future prospects of the merged corporation in appraising the value of a dissenter's shares ... would do much to enhance the fairness of the appraisal," they have cautioned against speculation in making such determination. *Yeager*, 691 S.W.2d at 229 (opinion ordered published by this Court).

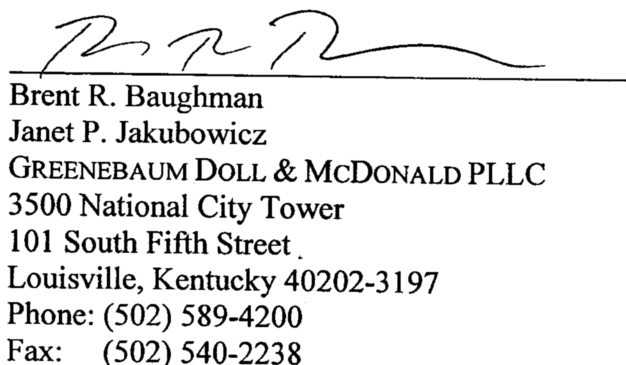
But whatever merits these or other methods may possess, if Delaware law is to serve as a sort of guidepost for Kentucky corporate law, it would at least help to understand what Delaware courts are holding. And in the *Shawnee* and *Brooks* cases, the Court of Appeals twice failed to properly interpret that authority, erroneously concluding that the Delaware Supreme Court's opinion in *Cavalier Oil* barred consideration of all discounts in valuing shares. Instead, a close reading of *Cavalier Oil* reveals that the Delaware Supreme Court, while rejecting discounts at the ***shareholder level***, cited with approval its prior seminal decision on corporate valuation whereby the court approved marketability discounts at the ***corporate level***. *Cavalier Oil*, 564 A.2d at 1144-45, citing *Tri-Continental Corp. v. Battye*, 74 A.2d 71 (Del. 1950). As *Cavalier Oil* did ***not*** prohibit the consideration of all marketability discounts in valuing closely-held companies for purposes of buying out minority shareholders, neither should this Court.

If this Court does not act to reverse *Shawnee* and overrule *Brooks*, our courts will be deprived of the flexibility they require in order to properly value a dissenter's shares using traditional valuation techniques, including marketability discounts.

## CONCLUSION

For the foregoing reasons, the Chamber asks this Court to respect the legislature's implicit adoption of the *Ford* valuation approach, including the application of marketability discounts if warranted under the facts and circumstances of a particular case. To hold otherwise will adversely impact Kentucky's business community with significant, judicially imposed, restrictions which ignore the realities of the marketplace. This *amicus* respectfully requests that the Court reverse the Court of Appeals' Opinion in *Shawnee*, and reinstate the judgment entered by the Fayette Circuit Court. This *amicus* further respectfully requests that the Court overrule the Court of Appeals' Opinion in *Brooks*.

Respectfully submitted,



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