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In The
COMMONWEALTH OF KENTUCKY
SUPREME COURT
2009-SC-000574-DG

SHAWNEE TELECOM RESOURCES, INC. — **APPELLANT**

V.

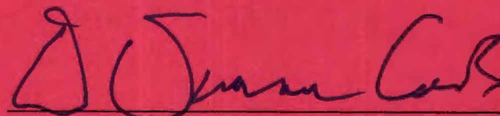
On Review from the Kentucky Court of Appeals
Case Nos. 2008-CA-000042 and 2008-CA-000167

KATHY BROWN — **APPELLEE**

BRIEF FOR APPELLANT

Certificate Required By CR 76.12(6)

This is to certify that a true and accurate copy of the Brief for Appellant was served by mail, postage pre-paid, this 24th day of November, 2010, on Clark Case, Case & Case, LLP, 421 W. Second Street, Lexington, Kentucky 40507, counsel for the Appellee, 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 The undersigned also certifies that the record on appeal was not withdrawn by counsel for Appellant.



D. Duane Cook
105 Thoroughbred Way
Georgetown, Kentucky 40324
502.570.0022

ATTORNEY FOR APPELLANT

INTRODUCTION

This shareholder's appraisal rights action requires review of the appraisal methodology and evidence to be used in valuing a closely held business. Ruling against Appellant, the Court of Appeals implicitly reversed the holding of *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982) and ruled that in valuations of closely held businesses: (a) the use of the net-asset approach to business valuations is not allowed, and (b) marketability discounts may not be used under any circumstances.

STATEMENT CONCERNING ORAL ARGUMENT

The Appellant respectfully requests oral argument in this case. The issues are complex, decisions in this area are conflicting and courts are sharply divided, and this case presents this Court with the opportunity to bring some much needed clarity to the law of business valuations.

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[1] The Hisle Appraisal and the Ray Appraisal were submitted as Plaintiff's Exhibits 45 and 46 during the appraisal hearing before the master commissioner. They are in the

6 Report of Appraisal [R. 1097]

7 Court of Appeals Opinion – *Brooks v. Brooks Furniture*

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record in a separate volume for exhibits, but were not separately numbered. Both documents are also attached as exhibits to Kathy Brown's Memorandum in Support of Objections to the Report of Appraisal and Motion for Adoption of The Report of Appraisal as Modified by those Objections, filed August 31, 2006. [R. 1158.]

STATEMENT OF THE CASE

I. Factual History:

Shawnee Installation Services, LLC ("Shawnee Installation") was organized in June of 1998. The original owners of Shawnee Installation were Jim Clark (49%), Kathy Brown (24%), Andrea Simmons (24%), and Gina Thomas (3%). The parties began using the name Shawnee Technology, Inc. ("Shawnee Tech") on January 1, 1999. *[Affidavit of Andrea Simmons in Support of Motion to Dismiss Counterclaim §§1-2, R. 405]* (Each of Shawnee Installation, Shawnee Tech and Appellant, Shawnee Telecom Resources, Inc. ("STR"), the successor by merger to Shawnee Tech, is sometimes referred to hereinafter as "Shawnee.")

Shawnee was organized to operate essentially as an employment agency for the telecommunications industry. *[Affidavit of Andrea Simmons attached to Shawnee Memorandum in Support of Motion for Stay of Judgment §2, R.1606]* Telecommunications companies would engage Shawnee to provide temporary workers. Ms. Brown and Ms. Simmons contacted the necessary people and sent them to the clients' jobs. *[Id. See, also, Report of Appraisal p. 1-2, R. 1097; App.6.]* Shawnee would pay the salaries and benefits of those employees, but their work was supervised by Shawnee's clients, not by Ms. Brown or Ms. Simmons. Neither Ms. Brown nor Ms. Simmons brought to the business any significant switch installation experience or any other technical hands-on telecommunications experience. *[Affidavit of Andrea Simmons attached to Shawnee Memorandum in Support of Motion for Stay of Judgment §2, R.1606]*

At the time of the formation of Shawnee, Mr. Clark had already been involved in the telecommunications business for many years as the owner of Shawnee Communications, Inc. ("ShawneeComm"). *[Report of Appraisal, App. 6, at p. 2]* At that time, ShawneeComm was doing telecommunications construction and installation work for a number of companies, including work for Siemens, performing primarily what is known as "Y-splicing" and "jumper" work. *[Affidavit of Andrea Simmons in Support of Motion to Dismiss Counterclaim §6, R. 405]*

Mr. Clark continued to operate ShawneeComm as a separate company until January 1, 2000, when he transferred all of his business to Shawnee. *[Affidavit of Andrea Simmons in Support of Motion to Dismiss Counterclaim §7, R. 405]*

In August of 2001, Ms. Brown resigned her position as president of Shawnee, stopped working for Shawnee, and demanded that the remaining shareholders buy her shares. *[Answer to Counterclaim, Cross-Claims and Demand for Jury Trial §16, R.418]* By that time, the telecommunications industry was in a major slump, and Shawnee had lost all of its business -- except the business transferred from ShawneeComm. *[Id.; Affidavit of Andrea Simmons attached to Shawnee Memorandum in Support of Motion for Stay of Judgment §§14, 15, R.1606]*

Negotiations over the purchase of Ms. Brown's shares were unsuccessful and, in July of 2003, the board of directors of the company adopted a plan to merge Shawnee Tech with STR. *[Affidavit of Andrea Simmons in Support of Motion to Dismiss Counterclaim §10, R. 405]* The plan called for Ms. Brown to receive the estimated value of her shares, while the remaining shareholders of Shawnee Tech were to receive shares in STR. In August of 2003, the shareholders of Shawnee Tech voted to approve the

merger. *[Affidavit of Andrea Simmons attached to Shawnee Memorandum in Support of Motion for Summary Judgment §2, R.2.]* Ms. Brown elected to exercise her dissenter's rights and delivered to Shawnee her Notice of Demand for Fair Market Value of Shares pursuant to KRS 271B.13-280 (the "Demand for Payment"). *[Affidavit of Andrea Simmons attached to Shawnee Memorandum in Support of Motion for Summary Judgment §5, R.24]* Shawnee then had two options – pay the amount demanded by Ms. Brown or file a lawsuit and have the court determine the value of her shares. KRS 271B.13-300.

II. Procedural History:

This action was filed on December 9, 2003. *[Complaint R.1]* The merger was not actually completed until the filing of the articles of merger with the Kentucky Secretary of State on December 31, 2003.

On April 1, 2005, Ms. Brown filed third-party claims against the other shareholders of Shawnee (Mr. Clark, Ms. Simmons, and Ms. Thomas), alleging that they breached their fiduciary duty by failing to pay dividends in 2003. *[Counterclaim, R.243]* Mr. Clark and Shawnee answered these new claims with their own cross-claims against Ms. Brown. *[Answer to Counterclaim, Cross-Claims and Demand for Jury Trial, R.418]* Mr. Clark's cross-claim alleged, among other things, that: (a) he transferred the ShawneeComm business to Shawnee because of the agreements made by Ms. Brown, and (b) Ms. Brown breached those agreements. *[Answer to Counterclaim, Cross-Claims and Demand for Jury Trial §14, R.418]*[1]

[1] The District Court has dismissed this claim, but its decision has not been made final and appealable. [*Order, August 14, 2006, R. 1112*]

The matter of the valuation of Ms. Brown's shares in Shawnee was referred to the master commissioner by the circuit court's order of July 15, 2005. *[R. 429]* Shawnee introduced a "Valuation of Shawnee Technology, Inc. as of December 31, 2003," prepared by Dewitt Hisle and James Roller (the "Hisle Appraisal"). [*Attached as Appendix 4*] Ms. Brown introduced a "Rebuttal Report on the Valuation Reports" prepared by Marc Ray (the "Ray Appraisal"). [*Attached as Appendix 5*] The master commissioner's Report of Appraisal was filed on August 14, 2006. *[R.1097; attached as Appendix 6]* The master commissioner valued the Shawnee business using two different valuation methods – the capitalized earnings (or income) method and the net-asset (or net-value) method. The master commissioner used a weighted average of the values arrived at using the two methods, giving more weight to the net-asset value (although he did not say how much more) and determined that the value of Ms. Brown's shares was $353,633. The court overruled the objections of both parties to the Report of Appraisal and affirmed the master commissioner's determination in an order entered January 1, 2007. *[R. 1373]* That order was not certified as final.

Ms. Brown's motion for attorneys' fees was filed on April 30, 2007 *[R.1380]* The court heard arguments of counsel on October 4, 2007, and rendered the Judgment *[R. 1579; attached as Appendix 1]*, which made final not only the court's decision on the attorneys' fee issue, but also its decision on the valuation of Ms. Brown's shares.

Shawnee moved the trial court to amend the Judgment to, among other things: (i) reduce Judgment concerning the value of Ms. Brown's shares to $322,526 (the value fixed by the "net-asset approach" to valuation), and (ii) reverse the determination that there was no just cause for delay. *[Motion to Amend Judgment and Stay Enforcement; R.*

1604] Shawnee also made a separate motion for recusal of trial judge on the ground that his comments during the attorneys' fees hearing created a circumstance in which the court's impartiality might reasonably be questioned. *[Motion for Recusal; R. 1677]*

On December 17, 2007, the trial court denied the Shawnee Post-Judgment Motions. *[Order, R. 1687; App. 2]* In that same order, the Shawnee motion for recusal was affirmed in part and denied in part. The trial judge ruled on the pending post-trial motions, including the motion to reverse the determination that there was no just cause for delay, but recused himself as to all additional matters. The order was certified as final and appealable.

Shawnee made the following arguments on appeal (among others): (a) the master commissioner should not have considered the capitalized earnings (or income) method in valuing Shawnee, and the circuit court, consequently, erred in adopting the findings of the master commissioner as to the value of Ms. Brown's shares; (b) the trial court erred in certifying its decisions as final, when counterclaims directly affecting the value of the shares remained to be decided; and (c) once the trial court determined to recuse himself from the case, recusal was required as to all the remaining issues.

In her cross-appeal, Ms. Brown urged the Court of Appeals to overturn the decision of the circuit court adopting the master commissioner's Report of Appraisal, arguing that: (a) no weight should have been given to the net-asset approach in valuing Ms. Brown's shares in Shawnee, (b) the master commissioner should not have applied a marketability discount in valuing Ms. Brown's shares, and (c) *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982), which sanctions the use of the net-asset valuation approach and marketability discounts, should be overruled. Ms. Brown

argued that the decision of the Maine supreme court in *In Re Valuation of Common Stock of Libby, McNeill & Libby,* 406 A.2d 54 (Me. 1979), upon which the *Ford* court relied, has been overruled by *In re Valuation of Common Stock of McLoon Oil Co.*, 565 A.2d 997 (Me. 1989). The Court of Appeals adopted that argument, without explicitly saying so:

> We find Ms. Brown's argument most persuasive. The Report of Appraisal admits that the net-asset approach deals with concepts of open-markets and fair market value and is based partly on the decision of *Ford v. Courier- Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982). Any valuation dealing with fair market values and issues of open-market would be appropriate for companies whose stock is available on the open-market, i.e. companies whose stock is bought and sold on the open-market. However, as stated above, this case revolves around a closely held corporation, one whose stocks are not openly bought and sold.
>
> . . . .
>
> We adopt the reasoning of *McLoon* as it pertains to *closely held corporations*, such as Shawnee. Closely held corporations should not be held to open-market standards. We therefore reverse and remand this case to the circuit court in order for it to determine the value of Ms. Brown's stock, giving no weight to the fair market considerations of the net-asset approach or the 25% marketability discount.

Court of Appeals Opinion. *[Attached as Appendix 3, at pp. 4-6]*

The Court of Appeals ruled in favor of Ms. Brown on all the other issues raised on appeal, except the issue of the attorneys fees assessed against Shawnee.

This Court granted discretionary review on September 15, 2010.

ARGUMENT

I. *FORD v. COURIER JOURNAL* SHOULD NOT BE OVERTURNED AS TO THE USE OF THE NET-ASSET VALUATION METHOD.

A. Preservation of Issue for Review: This issue was preserved for review by Shawnee's Objection to the master commissioner's Report of Appraisal *[R.1115]* and by Shawnee's Post-Judgment Motions. *[R.1604]*

B. Standard of Review: The question of whether the net-asset method was a proper valuation method to be used in the valuation of Shawnee is a question of law to be reviewed de novo by the Court. *Fox v. Grayson*, 317 S.W.3d 1 (Ky. 2010). The question of whether the net-asset method was the only proper method to be used in this case is a question of fact to be reviewed for abuse of discretion. However, "[i]n reaching a value, the trial court must have a rational basis for applying given accounting principles. Its decision must be supported by adequate evidence, and should avoid speculation and assumptions as much as possible." *Gaskill v. Robbins*, 282 S. W.3d 306 at 315 (Ky. 2009).

C. Introduction: An Overview of Fair Value and the holdings of *Ford v. Courier Journal*:

The essence of all of Ms. Brown's arguments about the Report of Appraisal is that Ms. Brown should receive more in this proceeding than she would if Shawnee were sold outright and the sales proceeds divided among the shareholders in proportion to their share ownership. This is not and cannot be the law.

"The valuation of a business is complicated, often speculative or assumptive, and at best subjective." *Gaskill v. Robbins*, 282 S.W.3d 306 at 310 (Ky. 2009). Business valuations in dissenters' rights cases have sharply divided the courts and have been made

more complicated than necessary because, as will be shown below: (a) courts are often motivated to punish the majority shareholders who have decided to "squeeze-out"[2] minority shareholders and some courts apply that punishment by improperly manipulating the valuation process, (b) in small service businesses like Shawnee, courts are often confused about how to value goodwill, and (c) courts are often confused about the proper starting point in the valuation of minority shares in a closely held business.

This confusion about valuations to be done in shareholder appraisal rights actions is demonstrated not only by the Court of Appeals' decision in this case, but also by the recent decision of the Court of Appeals in *Brooks v. Brooks Furniture Mfgrs., Inc.*, --- S.W.3d ----, 2010 WL 4290068 (Ky. App., en banc, 2010) – when a sharply divided Court ruled explicitly that *Ford v. Courier Journal* should be overruled with respect to marketability discounts. This decision, not yet final, but ordered to be published, is discussed in more detail below and is attached as Appendix 7. (Ironically, the valuation method used to value Brooks Furniture was the net-asset method – the method prohibited by the ruling of the Court of Appeals in Shawnee's case.)

The dissenters' rights statute provides almost no guidance on the valuation methodology to be used. The Kentucky statute defines "fair value" as follows:

> "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) (emphasis supplied). To say that "fair value" of a dissenter's shares means the value of the shares is not very instructive.

---

[2] Even use of this pejorative term is a suggestion that the majority have done something sinister.

Prior to *Shawnee* and *Brooks Manufacturing*, the only Kentucky decision addressing the method for computing "fair value" in a dissenters' rights case was *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982). The *Ford* court relied heavily on *In re Valuation of Common Stock of Libby, McNeill & Libby*, 406 A.2d 54 (Me. 1979) to rule that:

> This being a case of first impression, it is our opinion and holding that in all appraisals or valuations of fair value of stock, pursuant to KRS 271A.405, the three elements to be considered in computation of the fair value of the shares owned by dissenting stockholders are **market value**, **investment or earnings value**, **and net-asset value**. As stated in *In Re ... Libby, supra,* at p. 60:
>
> > All three components of "fair value" may not influence the result in every valuation proceeding, yet all three should be considered. "Compelling the consideration of all of them, including those which may turn out to be unreliable in a particular case, has the salutary effect of assuring more complete justification ... of the conclusion ... reach[ed]."

Ford, supra, at 556. (Emphasis supplied.) The *Ford* court affirmed a valuation which considered all the factors, but made clear that the weight to be given to each factor will vary from case to case.

The court in *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982) upheld the application of a marketability discount at the company level. There the appraiser described the use of the discount in the following language:

> The final step is to address the question of marketability. C-J Job Printing is not a public company and a closely held stock is considerably less attractive to an investor than a similar stock with access to the public marketplace. This difference is normally expressed in terms of a marketability discount applied to its "if-public" price. These discounts, in general, range between 20 and 50 per cent and reflect both the nature of the public market (which was generally unreceptive to new issues at the valuation date) and the characteristics of the subject company (in this case a small regional business with no express desire to go public).

* * *

> Considering these factors and focusing on these risks, we have selected an over-all discount of 25 per cent as appropriate in this case.

Ford, supra at 556. (Emphasis supplied.) The court found the use of the discount appropriate using the following rationale.

> The 25 per cent reduction in net-asset value based on marketability was not an arbitrary or clearly erroneous figure. The appraisers noted in their report that in sales of some eight publicly held corporations there was an average of 24.2 per cent in discount from net-asset value in similar sales.

Id. As will be seen below, *Ford v. Courier Journal* is consistent with the best modern thinking on the issue of marketability discounts – which is that the application of marketability discounts is appropriate where necessary to arrive at the fair market value of the corporation as a whole and that a dissenting shareholder is entitled to his or her pro rata portion of the fair market value of the corporation. However, further minority or marketability discounts are not to be applied to the value of the minority interest, even if such discounts would be appropriate in determining the fair market value of the minority interest.

D. The value of a business should be determined independently of any concern to punish majority shareholders or deter misconduct.

Business partners, like partners in marriage, sometimes decide to terminate the partnership. Courts in appraisal rights cases should fix the price to be paid to the partner leaving the business in the same way that courts in division of marital property cases fix the value of marital businesses when a marriage is dissolved. The same valuation methods spelled out in *Ford v. Courier Journal* are considered in Kentucky when valuations of corporate stock are necessary in connection with property divisions in divorce cases. See, *Rupley v. Rupley*, 776 S.W.2d 849 at 851 (Ky. App. 1989). Courts

are charged in Kentucky to "divide marital property without regard to marital misconduct in just proportions considering all relevant factors. . . ." KRS 403.190(1). There is no moral, legal, or logical reason for treating business valuations differently in a business partnership dissolution than in a marriage dissolution.[3] Majority shareholders sometimes do take advantage of minority shareholders, just as some spouses take advantage of their mates, but there are remedies for those circumstances that do not require manipulation of business valuations -- the award of attorneys' fees if the majority has acted arbitrarily, vexatiously or not in good faith (KRS 271B.13-310(2)(b)) or common law actions for breach of fiduciary duty, for example.

Most business break-ups probably do not involve majority shareholder misconduct. Kathy Brown quit her job with Shawnee and demanded to be paid for her shares. When Ms. Brown and the remaining shareholders were unable to agree on a price for those shares, this appraisal action – in which the court was asked to decide the value of her shares - was a logical way to proceed.

The opinions of members of a sharply divided court in *Brooks Furniture, supra,* illustrate the dangers of demonizing the majority shareholders in these cases. The valuation arrived at by the trial court in that case included a marketability discount taken at the corporate level:

> The [appraisal] report specifically stated that no consideration was given for "discounts for lack of control and marketability" <u>to the specific interest being valued.</u> However, based on certain marketability factors, he discounted the adjusted net book value of assets by thirty percent.

[3] Justification might be found for laws discouraging the breakup of marriages, but there is no reason to discourage the break-up of business partnerships. In fact, just the opposite should be true. If the partnership is not working, or if the partners just don't want to be in business together anymore, economic efficiency, and a healthy respect for the business judgments of the men and women actually running the business, should dictate that the law should facilitate (or at least not hinder or penalize) the business break-up.

App. 7 at pp. 4-5. (Emphasis supplied.) The Court of Appeals reversed the trial court's application of the marketability discount, explicitly overruled *Ford v. Courier Journal*, and held:

> Thus, the issue presented is whether the concept of a discount attributable to the marketability of the corporation's shares is appropriate in a squeeze-out merger of a closely-held corporation. Consistent with the modern view, we hold that a marketability discount should not be applied in determining the fair value of a dissenter's shares unless exceptional circumstances exist.

Brooks Furniture, supra, App. 7 at p. 11. (Emphasis supplied.)[4] The opinion of the majority quotes favorably those authorities which indicate that the business valuation itself should deter wrongful action by the majority --for example, the following language is quoted by the Court of Appeals from Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 Duke L. J. 613, 613-616 (1998):

> Minority shareholders are granted limited statutory rights as a check against rampant majority rule. One such right is the ability of shareholders to dissent from certain corporate actions, primarily mergers and other fundamental corporate changes and to receive the appraised fair value of their shares. This is sometimes known as the dissent and appraisal remedy, dissenters' rights, or simply, the appraisal remedy....
>
> Most of the current appraisal litigation involves cash-out mergers, often instituted by a controlling shareholder. The appraisal remedy today serves a minority shareholder protection role, providing liquidity to shareholders, but most often operating to protect minority shareholders who are cashed out of their investment. The remedy fulfills this function *ex ante*, deterring insiders from engaging in wrongful transactions, and *ex post*, providing a remedy to minority shareholders who are subjected to such transactions. (Footnotes omitted.)

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[4] As indicated by this statement of its holding, the major source of confusion for the majority of the court was created by the question of the propriety of applying the discount to determine the value of the corporation as a whole. (This difficulty is addressed in more detail below.)

Brooks Furniture, supra, App. 7 at 12. (Emphasis supplied.)

Assuming for the moment that the determination of the fair market value of the business as a whole requires the application of a marketability discount (and, as shown below, marketability discounts are among the least speculative elements of business valuations), there can be no moral or logical reason for granting a dissenting shareholder more than his or her pro rata portion of the fair market value of the business. The appraisal process should be neutral on the issue of whether the business partners' break-up involves any misconduct and leave to other remedies the correction of any actual oppression by the majority. Otherwise, we are left with a valuation jurisprudence in appraisal rights actions which differs radically from valuations done in other morally and legally indistinguishable contexts – a valuation jurisprudence which ultimately makes no sense.

If, for example, the fair market value of a business is determined by applying a 40% marketability discount, would the majority be sufficiently deterred by applying only a 20% marketability discount? Will awarding a dissenting minority 40% more than his or her pro rata value of the corporation have other adverse consequences? For example, the dissenting shareholder in *Brooks Furniture* was given his stock by his father. App. 7 at p. 2. If minority partners can only be removed by paying them a premium over their pro rata portion of the value of the corporation as a whole, the rule will preclude some decisions to include minority shareholders in the business in the first place. Similarly, such a rule will encourage minority shareholders to do just what Ms. Brown did here – quit working in the business and clamor for a share of the earnings generated by the efforts of others.

Similar difficulties are created by expressions like the following:

> "[F]air value" in minority stock appraisal cases is not equivalent to "fair market value." Dissenting shareholders, by nature, do not replicate the willing and ready buyers of the open market. Rather, they are unwilling sellers with no bargaining power.

Swope v. Siegal-Robert, Inc., 243 F.3d 486, 492 (8th Cir. 2001) (quoted in the concurring opinion of Judge Acree, *Brooks Furniture*, App. 7, at p. 24). The same could be said in divorce cases or probate cases, where the absence of ready buyers is equally common.[5] More importantly, however, determinations of fair market value, though difficult in many ways, at least have some history and some reference points (like sales of shares of similar companies). A court will have no reference points and no time-tested valuation theories to determine the value of a business to unwilling sellers and unwilling buyers. Yet this is just what the *Brooks Furniture* majority will now require:

> Thus, an adjustment for a hypothetical willing buyer and willing seller is inappropriate and contrary to the statute's purpose that the dissenter receive the full value of his proportionate interest in the corporation as a going concern.

Brooks Furniture, supra, App. 7 at p. 9. This point is driven home in Judge Acree's concurring opinion:

> Why is "fair market value" irrelevant in a dissenter's rights valuation? Because the goal under dissenters' rights statutes is not to determine how a third-party purchaser might value the company-by definition that *would* be its fair market value. Instead, the goal is to determine the "fair value" of the company to those who currently own it-that is, the intrinsic value of the stock held by the dissenters who do not want to part with it but are compelled to do so, and the intrinsic value of that same stock to the majority shareholders who approved the merger and desire the dissenters' stock for the corporation or for themselves.

[5] If there are willing sellers and willing buyers (if there is a market for the business, in other words), the appropriate valuation methodology is, of course, the market-value method, and marketability discounts are not relevant.

Brooks Furniture App. 7 at p. 24. (Emphasis supplied.) Even if one were to agree with this proposition, how are courts to go about determining the "intrinsic value" of the business to the particular litigants involved in the case? What experts are to be called to opine on the "intrinsic values" fixed in the minds of the business owners?

This concern to punish (or at least deter) the majority is most often seen in discussions of marketability discounts. There is no logical reason, however, that a concern to prevent wrongdoing should be confined to the elimination of marketability discounts. As will be seen below, the master commissioner made the decision not to "tax effect" the earnings of Shawnee because of his hyper-concern for fairness to Ms. Brown and this decision added $155,000 to the value of Ms. Brown's shares using the income method of valuing Shawnee. In fact, the master commissioner's hyper-concern for Ms. Brown was his only justification for giving any weight to the value derived using the income method. Where does this "reasoning" stop? If we are really concerned to deter majority shareholder misconduct, we should just award the minority shareholder 100% of the value of the corporation in every squeeze-out merger and every case of majority oppression.

Another example of the logical difficulties presented by this punitive mindset can be found in the 1999 amendments to the Model Business Corporations Act which now define "fair value" to exclude minority and marketability discounts. The Official Comments to the 1999 amendments to the definition of "fair value" provide:

> Subsection (iii) of the definition of " fair value" establishes that valuation discounts for lack of marketability or minority status are inappropriate in most appraisal actions, both because most transactions that trigger appraisal rights affect the corporation as a whole and because <u>such discounts give the majority the opportunity to take advantage of minority</u>

> shareholders who have been forced against their will to accept the appraisal-triggering transaction.

American Bar Association, *Model Business Corporation Act; Official Text with Official Comment and Statutory Cross-References*, Official Comment to Section 13.01 (Revised through 1999). (Emphasis supplied.) However, the very next sentence of the Official Comments goes on to say:

> Subsection (iii), in conjunction with the lead-in language to the definition , is also designed to adopt the more modern view that appraisal should generally award a shareholder his or her proportional interest in the corporation after valuing the corporation as a whole, rather than the value of the shareholder's shares when valued alone.

Id. The second sentence seems inconsistent with the first. How can the corporation be valued as a whole without consideration of marketability discounts where appropriate? If marketability and minority discounts are never to be applied (even at the corporate level), there is no difference between the shareholder's proportional interest in the value of "the corporation as a whole" and "shareholder's shares when valued alone".

The idea that valuation methodologies should be manipulated out of fairness considerations has infected business valuations in other contexts and has created the same divisions and logical problems addressed above. For example, the Alabama Court of Civil Appeals has recently ruled that minority and marketability discounts should not be used when valuing a spouse's business interests. *Grelier v. Grelier*, ____ So.3d ______2009 WL 5149267 (Al.Civ.App. 2009, cert. den. 2010). The court there noted that:

> Many jurisdictions, either by legislation or by caselaw, have adopted a "fair market value" standard by which the value of all marital property must be determined by gauging the price a willing buyer would pay to a willing seller in a hypothetical sales transaction. *See, e.g., Crismon v. Crismon,* 72 Ark.App. 116, 34 S.W.3d 763 (2000). Pursuant to that

> standard, it makes sense to apply minority and marketability discounts because those discounts **reflect the economic reality** that, unlike the case with publicly traded companies, no ready pool of willing buyers exists to purchase an interest in a private business organization that does not carry with it the ability to control that organization. *See generally In re Marriage of Barlow,* 111 Or.App. 179, 826 P.2d 18 (1992).
>
> However, Alabama law has not adopted a "fair market value" standard for assessing marital property. Rather, under Alabama law, a trial court must determine the value of property with the only limitation being that the value must be equitable under the circumstances of the particular case. *[citations omitted]* In cases in which a divorce court does not contemplate the sale of a business in which one of the spouses holds a minority interest but, instead, intends that the business shall remain a going concern, it makes little sense to determine fair value by the measuring stick of a hypothetical sales price. That methodology would **artificially** reduce the value of the marital asset in almost every case, which would be **unfair, i.e., inequitable**, to the party receiving only a portion of the reduced value or the property equivalent to that reduced value but would be advantageous to the party retaining the business interest, including its actual value to him or her as the holder.

Grelier, supra, at pp. 6-7 of the Westlaw case printout. (Emphasis supplied.) The court never makes clear how a valuation methodology which reflects economic reality can, at the same time, "artificially" reduce the value of an asset in a way that is "unfair" or "inequitable." There is no clarity to be had here.

The same issue has been recently considered by the Colorado Supreme Court in the case of *In re: Marriage of Thornhill*, 232 P.3d 782 (Co. En Banc 2010). In this case, the court allowed the use of marketability discounts in the valuation of marital property. This is the same court that probably decided, in *Pueblo Bancorp. V. Lindoe, Inc.*, 63 P. 3d 353 (Co. en banc 2003)[6], that the use of marketability discounts is not proper in appraisal rights actions. To be sure, the *Thornhill* court goes to great lengths to distinguish its holding in *Pueblo Bancorp.*, but in the end its reasoning boils down to this:

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[6] *Pueblo, discussed below, was* relied upon by the majority in *Brooks Furniture.*

> An extension of *Pueblo* to marriage dissolution cases is inappropriate given that *Pueblo* interpreted specific statutory language that is not present in the marriage dissolution statute. In *Pueblo,* we interpreted the statutory term "fair value" with respect to the value of a dissenter's shares. *Pueblo,* 63 P.3d at 358. . . .
>
> Such "fair value" language is not present in the statute governing the distribution of property in the dissolution of a marriage. Instead, section 14-10-113(1) directs courts overseeing a divorce proceeding to divide marital property "<u>in such proportions as the court deems **just** after considering all relevant factors</u>." Although the dissolution statute contemplates the valuation of marital property in general terms, it does not employ the specific "fair value" term interpreted by this court in *Pueblo.*

232 P. 3d at 785-786. (Emphasis supplied.) In other words, "fair" value in appraisal rights cases is not the same thing as "just" value in dissolution of marriage cases. Would this court really have us believe that there is a significant difference in meaning between the word "fair" and the word "just" when businesses are to be valued?

Of course, courts should be concerned with fairness to minority shareholders, but courts should be equally concerned with fairness to majority shareholders, and manipulation of business valuations to deter misconduct is inappropriate, illogical, and impossible to apply in practice. In a perfect world, it might make sense to punish those people who do not get along. However, we do not yet live in a perfect world and, if people determine that they no longer want to be in business together, the law should facilitate, not hinder, their separation.

The valuation made in this case, like the decision in *Brooks v. Brooks Furniture*, was distorted by the idea that a determination of "fair" value is an invitation to punish majority shareholders or deter shareholder misconduct. That distortion is particularly inappropriate here, where the genesis of the case was Ms. Brown's decision to terminate her employment with Shawnee and demand payment for her shares.

E. **There is no authority or legal argument that prohibits the use of the net-asset valuation method in dissenters' rights cases.**

Ms. Brown urged the Court of Appeals to find that consideration of the net-asset value of a business is never appropriate in a dissenter's rights action:

> The Report of Appraisal specifically recognizes that the Net Asset Approach is an open-market concept invoking valuation of assets at Fair Market Value, whereby, as a matter of law with the *Ford* case overruled, any weight given the Net Asset Approach must be removed from the Judgment.

Ms. Brown's Brief at p. 10. Ms. Brown's conclusion here is apparently drawn from language found in the decision of the Indiana Court of Appeals in *Wenzel v. Hopper & Galliher, P.C.,* 779 N.E.2d30 (In. App., 2002) -- a decision Ms. Brown refers to as "particularly compelling." (Ms. Brown's Brief at p. 9.) Ms. Brown described the holding in Wenzel as follows:

> According to the rulings from a "substantial majority" of jurisdictions, the Wenzel court held that Fair Value, by definition, does not allow for the introduction of an <u>**"open market concept"**</u> to a valuation that has no application in a statutorily-forced sale to the majority shareholders.

Ms. Brown's Brief at p. 9 (emphasis supplied). What the *Wenzel* Court *actually* said was "[M]inority and marketability discounts are open market concepts." *Wenzel* at p. 38. Whatever that means, it most definitely does not mean that the *Wenzel* decision can be taken for the proposition that the use of the net-asset valuation method is not properin dissenters' rights cases. <u>The **only** valuation method used by the trial court to evaluate the business in *Wenzel* was the net-asset method, and the Indiana Court of Appeals found that the trial court's valuation was **not** improper</u>. *Wenzel* at pp. 35 and 37.

McLoon, supra, cannot be cited for the proposition that the net-assets approach may not be used in valuing closely-held businesses. This court ruled, in *Gaskill, supra*, that the net-assets method of valuation was the only proper method to be used in that case. The valuation method used in *Brooks Furniture* was the net-asset method, and that method does not appear to have drawn an objection from the *Brooks Furniture* court or from the litigants themselves. In short, there appears to be no authority in Kentucky, and no authority cited by Ms. Brown or the Court of Appeals from anywhere else, for the startling proposition that the net-asset valuation method may not be used to value closely held businesses.

The Court of Appeals erred when it determined that the net-asset valuation method could not be used in valuing closely-held businesses. The error prevented it from considering Shawnee's claim that the net-asset valuation method was the only proper valuation method which could be used to value Shawnee.

F. The net-asset valuation method was the only proper valuation method to be used in this case.

The master commissioner determined that the goodwill of Shawnee was the personal goodwill of Jim Clark, yet still, incorrectly, determined that that goodwill had some value to Shawnee.

The recent decision of this Court in *Gaskill v. Robbins*, 282 S.W.3d 306 (Ky. 2009) is very instructive on the issue of how goodwill is to be addressed in general and on how it should have been addressed by the master commissioner in this case in particular. In a case involving the valuation of the wife's oral surgery practice, the trial court adopted the valuation proposed by the husband's expert and fixed the value of the practice at $669,075 – $400,000 in excess of the value of the tangible assets of the

business. The trial court found the husband's expert to be more credible, but based its decision primarily on "the premise that there is no legal authority for a distinction between personal and enterprise goodwill in Kentucky law." *Gaskill, supra*, at 310.

The Court affirmed the decision of the Court of Appeals (which reversed the valuation[7] made by the trial court) in an opinion which noted that:

> The question of how to value goodwill of a business has been a source of contention for many years, with trial courts left to decipher competing and frequently inconsistent theories and accounting practices into something meaningful. It is generally accepted in existing Kentucky law that goodwill is a factor to be considered in arriving at the value of a business, *Heller,* 672 S.W.2d at 947-48 . . . .

Id. at 312. The Court noted, however, that the question of whether goodwill can be divided between the business *and* the individual was a question of first impression for this Court. In reaching its conclusion that the distinction between enterprise and personal goodwill has a rational basis, the Court quoted from *Yoon v. Yoon,* 711 N.E.2d 1265, 1268-70 (In.1999):

> Enterprise goodwill is based on the intangible, but generally marketable, existence in a business of established relations with employees, customers and suppliers. Factors affecting this goodwill may include a business's location, its name recognition, its business reputation, or a variety of other factors depending on the business. Ultimately these factors must, in one way or another, contribute to the anticipated future profitability of the business.
>
> . . . .
>
> In contrast, the goodwill that depends on the continued presence of a particular individual is a personal asset, and any value that attaches to a business as a result of this "personal goodwill" represents nothing more than the future earning capacity of the individual and is not divisible.
>
> . . . .
>
> In sum, to the extent a business or profession has goodwill (or has a value in excess of its net-assets) it is a factual issue to what extent, if any, that

[7] The Court of Appeals reversed the goodwill valuation because the Court of Appeals recognized that not all businesses have goodwill, citing *Clark v. Clark,* 782 S.W.2d 56 (Ky.App.1990) and *Heller v. Heller,* 672 S.W.2d 945 (Ky.App.1984). *Id.* at 311.

> goodwill is personal to the owner or employee and to what extent it is enterprise goodwill and therefore divisible property.

Gaskill, supra, at 314-315. (Citations and quotation marks omitted.) The Court went on to find that:

> In a case such as this one, there can be little argument that the skill, personality, work ethic, reputation, and relationships developed by Gaskill are hers alone and cannot be sold to a subsequent practitioner.

Id. at 315. The Court ruled that the trial court had abused its discretion in adopting the valuation of the husband's expert – which had included a valuation of enterprise goodwill.

The decisions of the master commissioner and the trial court regarding Shawnee's goodwill had all the defects of the trial court's decision regarding goodwill in *Gaskill.* The master commissioner made the following findings about the application of the income method in this case:

> [T]hat approach assumes that the company will, with some reasonable certainty, continue to do as well as it did in the past. However, as noted, the income approach implicitly assumes that there will be a market for, or potential buyers of Shawnee at the value established by those approaches. Absent non-compete contracts, it is doubtful that a potential buyer would make that assumption.
>
> In a strikingly similar 'key man' case concerning value and income, the Tax Court in Macdonald v. Comm'r Internal Revenue, 3 T.C. 720, 728-729 (1944) noted:
>
> > "The facts in the instant cases established that any value which this business may have had on July 31, 1941, in addition to its tangible assets, was due to the personal ability, business acquaintanceship, and other individualistic qualities of D. K. MacDonald. As one witness put it, 'Mr. MacDonald was the heart and sole of the Company.' The policy of the corporation was decided by D. K. MacDonald and all employees worked under his supervision. There existed no contract between the corporation and any of its employees, including D. K. MacDonald, with respect to future services. Neither the name of the corporation, its location, its agency agreements, nor its existing

> policies with customers had any value . . . .Under these circumstances. . . It is difficult to see why a willing buyer would pay more for this corporation than the value of its tangible assets, where D. K. MacDonald was 'at liberty to set up a similar business in the same locality and carry it on in his own name."

> There was no evidence of a market for Shawnee, nor was there direct evidence of a lack of market. But common sense and the inferential proof indicate that because of its customer base, the absence of non-compete agreements, and the type of work it did in the early 2000's Shawnee probably would not have had a market for its corporate self. That potential lack of a market relates not so much as to the odds that Mr. Clark and Mrs. Simmons might leave and compete but, as Mr. Frees [Ms. Brown's Expert] indicated, to the absence of anything that would prohibit them from doing so (see e.g., testimony of Mr. Frees).

Report of Appraisal, App. 6, at pp. 12-13. (Emphasis supplied.)

As of December 31, 2003, Shawnee had only one significant customer (Siemens) and its contract with that customer did not require the customer to purchase any services from Shawnee. [Report of Appraisal, App. 6 at p.2.] Siemens' relationship with Shawnee as of December 31, 2003, was dependent on the relationship of Jim Clark, the principle shareholder of Shawnee, with the managers of Siemens. The master commissioner noted that:

> Mr. Meilinger, an officer of Seimens and Mr. Clark's personal friend, testified that if Mr. Clark left, Shawnee would not have the expertise or experience to continue servicing Seimens, and that if it didn't follow Mr. Clark, it would look elsewhere.

Report of Appraisal, App. 6 at p. 7. This testimony was not contradicted. The master commissioner went on to find that:

> In 2003, the evidence showed that Shawnee's future earnings were entirely, or nearly so, dependant on the relationships established by Mr. Clark with its customers and on his expertise and reputation in the telecom industry, and particularly so as regards its customer base in 2003, ie. Siemens.

Report of Appraisal, App. 6 at pp. 8-9.

To paraphrase the holding of this Court in *Gaskill, supra*, there can be little argument that the skill, personality, work ethic, reputation, and relationships developed by Jim Clark were his alone and could not be sold to a subsequent purchaser of Shawnee. *Gaskill, supra*, at 315. There was no evidence that Shawnee possessed any enterprise goodwill to be valued, and much evidence that it did not, and it was clear error for the master commissioner and the circuit court to adopt a valuation which included any value for goodwill. In other words, it was an abuse of discretion for the trial court to give any consideration to the capitalized earnings method of valuation in this case.

Like many courts and commentators, the master commissioner seems to have been under the impression that the appraisal rights statute is meant to be punitive and, consequently, that he had to resolve all the close calls in the case in Ms. Brown's favor. For example, the master commissioner used the capitalized earnings value as determined by Ms. Brown's expert (Mr. Ray) rather than the capitalized earnings value fixed by the Shawnee expert (Mr. Roller). The primary difference (other than the marketability discount) in the two values being that Ms. Brown's expert did not adjust the Shawnee earnings stream to take account of "tax effects." The master commissioner described his resolution of this issue as follows:

> Both experts gave conflicting opinions and reasons for, or not for, tax affecting Shawnee's value as determined by either the asset or income approach, but neither expert was persuasive. In fact, both experts use both methods in their practice depending, again, on the facts and circumstances of the entity being valued. In the case of an S Corporation, **the equities of a dissenter's rights action would seem to favor the disallowance of a hypothetical tax adjustment or discount for unpaid taxes**, even at the corporate level, that is based on data that may or may not apply to Shawnee's circumstances. The Plaintiff bears the burden to justify any claimed adjustment that would diminish the value of the company or that of its shareholders. It failed to do so and the consequences of tax affecting will be ignored.

Report of Appraisal, App. 6 at p. 9. (Emphasis supplied.) According to Mr. Ray, not adjusting the income stream for the tax effects increased the value of Ms. Brown's shares, as determined by the capitalized earnings method, by $155, 137. See, Ray Valuation App. 5 at p. 8.

In fact, this improper concern for "fairness" to Ms. Brown, appears to have been the only basis for the master commissioner's decision to consider giving any weight to the income method to value Ms. Brown's shares:

> In giving weight to the income and asset approaches (neither expert gave evidence of any attempt to weigh them), the liquidity and risk free nature of Shawnee's assets, when considering the net-asset approach (though not generally considered to be a reliable approach, Libby, p.66-67), requires that it be given considerable weight and consideration. The value of Shawnee, as a going concern, when utilizing the experts' income or earnings calculations to show the value of future earnings, which would generally be the preferred approach, is less certain. As noted, the capitalization rate is suspect. In addition, that approach assumes that the company will, with some reasonable certainty, continue to do as well as it did in the past. However, as noted, the income approach implicitly assumes that there will be a market for, or potential buyers of Shawnee at the value established by those approaches. Absent non-compete contracts, it is doubtful that a potential buyer would make that assumption.
>
> Nonetheless, Ms. Brown is entitled to the fair value of what was taken from her,[8] Cede & Co. and Cinerama, Inc. v. Technicolor, Inc., 684 A.2d 289 (Del. 1996), i.e. her proportionate interest in the company as a whole (its net-assets and any goodwill) as determined by the facts and circumstances of the case, but in an equitable manner and after a consideration of the approaches dictated by Ford, supra. In weighing those approaches, in view of the liquidity of the assets, the net-asset approach commands greater consideration and respect.

Report of Appraisal, App. 6 at p. 13. (Emphasis supplied.) In other words, even though he found it improbable that Shawnee had enterprise goodwill, the master commissioner felt compelled by equitable considerations to weigh the values arrived at using the two

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[8] Nothing was taken from Ms. Brown. She quit and demanded to be paid for her shares.

methods and, consequently, arrived at a value that awarded Ms. Brown some enterprise goodwill. The master commissioner did not make clear why or how he assigned any weight to the income approach, but instead attached a computation. That computation suggests that the master commissioner attached approximately twice the weight to the value fixed by the net-assets approach as to the value fixed by the income/capitalized earnings method.[9]

The master commissioner's weighing process demonstrates exactly the kind of speculation about value that was prohibited by this Court in *Gaskill v. Robbins, supra*:

> While the trial court is free to determine the credibility of any witness, it cannot make a determination that is clearly erroneous or an abuse of discretion. Using an average to obtain a value, without some basis other than an inability to choose between conflicting and competing valuation methods, is nothing more than making up a number, for there is no evidentiary basis to support that *specific* number. Employing all four methods, then averaging them, is tantamount to no method at all. If an expert believes four methods are valid, yet each produces a different number, this provides little or no help to the trial court. The trial court must fix a value, and there should be an evidence-based articulation for why that is the value used. While an average may present the easiest route, it lacks the proper indicia of reliability.

Id. at 315.

G. Conclusion:

Not only was the net-asset valuation method a proper valuation method to be used in this case, it was the *only* proper method.

[9] [$322,526 (value using net value approach) x 2] + $414,751 (value using capitalized earnings method)/3 = $353,267. The fair value fixed by the Report of Appraisal was $353,633.

II. *FORD v. COURIER JOURNAL* SHOULD NOT BE OVERTURNED AS TO THE USE OF MARKETABILITY DISCOUNTS AT THE CORPORATE LEVEL.[10]

A. Preservation of Issue for Review: This issue was preserved for review by Shawnee's Objection to the master commissioner's Report of Appraisal *[R.1115]* and by Shawnee's Post-Judgment Motions. *[R.1604]*

B. Scope of Review: The question of whether the marketability discounts are to be barred altogether (at the corporate level or the shareholder level) in appraisal rights actions is a question of law to be reviewed de novo by the Court. *Fox v. Grayson*, 317 S.W.3d 1 (Ky. 2010). The question of whether the marketability discount was properly applied in this case is a question of fact to be reviewed for abuse of discretion. *Gaskill v. Robbins*, 282 S. W.3d 306 at 315 (Ky. 2009).

C. Introduction: The confusion over valuation starting points.

There are only two logical starting points in the valuation process: (1) you can start by valuing 100% of the corporation and then award the dissenting shareholder his or her pro rata share of the value of the whole; or (2) you can start by valuing the shares held by the dissenter.

Reported cases are often confusing because courts have not made clear their valuation starting points, but in the most careful courts the corporation is valued as a whole and then the dissenter is awarded her proper percentage of the value of the whole enterprise. The most often cited case of this type is *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (De. 1989). The Court there made clear that, in a Delaware dissenter's rights

[10] As shown above, use of capitalization of income method was not appropriate in this case; but if it was used at all, the marketability discount was certainly warranted.

action, the dissenter is to be awarded his proportionate interest in the corporation as a going concern:

> To this end the company must be first valued as an operating entity by application of traditional value factors, **weighted as required**, but without regard to post-merger events or other possible business combinations. [Citation omitted.] The dissenting shareholder's proportionate interest is determined only after the company as an entity has been valued. In that determination the Court of Chancery is **not required to apply further weighting factors** at the shareholder level, such as discounts to minority shares for asserted lack of marketability.

Cavalier, supra, at 1144. (Emphasis supplied.) "Traditional value factors" can only mean a fair market value valuation. *Cavalier Oil, supra*, was cited, incorrectly, by counsel for Ms. Brown as authority for the proposition that marketability discounts are never appropriate. See, Ms. Brown's Brief at p. 9. On the contrary, the company in *Cavalier* argued that an earlier Delaware case, *Tri-Continental Corp. v. Battye,* De.Supr., 74 A.2d 71, 72 (1950), authorized the discounting of a dissenting shareholder's interest. The *Cavalier* court addressed that argument in the following language:

> We believe, however, that the *Tri-Continental* decision exemplifies the distinction between applying the discount at the company level against all assets and its use to further devalue a shareholder's proportionate interest. The company subject to appraisal in *Tri-Continental* was a regulated, closed-end investment company with leverage. *Id.* Because of its closed-end status, the shareholders of the company had no right at any time to demand of the company a proportionate share of the company's assets. This factor, coupled with the company's leverage requirements, resulted in the market value of the stock being historically lower than its net asset value, the difference being referred to as a "discount." *Id.* at 72-73. Under those specific circumstances, this Court held that a discount had to be applied to the net asset value of the company in order to arrive at the true or intrinsic value of that particular company's stock. *Id.* at 76. **However, no discounts were applied at the shareholder level.**

Id. at 1144 -1145. (Emphasis supplied.)

In spite of the clear language quoted above, many courts cite *Cavalier* for the proposition that lack of marketability discounts are never to be applied in appraisal rights cases. Other modern courts, those which have kept clearly in mind the distinction between valuing the corporation and valuing the minority shares, hold that the corporation is to be valued at its fair market value.

Most commentators agree that the fair market value of closely-held companies is less than the fair market value of similar publicly held companies:

> Close corporation shares are not traded on a public market. As a result, it is considerably more difficult to sell close corporation stock than public corporation stock. Factors contributing to this difficulty include the greater time and expense associated with selling close corporation shares and the smaller pool of potential buyers for such investments. The marketability discount is premised on a recognition of these factors and the accompanying reality that investors will generally pay less for close corporation shares because of the shares' relative illiquidity. As one noted valuation authority observes:
>
> > The market for securities in the United States is the most liquid market for any kind of property anywhere in the world. This is one of the major reasons companies are able to raise investment capital from both institutional and individual investors: the ability to liquidate the investment immediately, at little cost, and with virtual certainty as to realization of the widely publicized market price. Empirical evidence demonstrates that investors are willing to pay a high premium for this level of liquidity, or, conversely, extract a high discount relative to actively traded securities for stocks or other investment interests that lack this high degree of liquidity.[11]
>
> Empirical data "indicate that the discount for the lack of marketability factor alone averages between thirty-five and fifty percent." By itself, therefore, the marketability discount can have a dramatic effect on the amount of compensation provided in a buyout award.

Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, And Dastardly Deeds In The Close Corporation*, 54 Duke L.J. 293, at 317-318 (November

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[11] Citing, Shannon P. Pratt et al., *Valuing a Business: The Analysis and Appraisal of Closely Held Companies,* note 79, at 333 (3d ed. 1996)

2004) (Footnotes omitted.)(Emphasis supplied.) *See, also*, James H. Eggart, *Replacing the Sword with a Scalpel: The Case for a Bright-Line Rule Disallowing the Application of Lack of Marketability Discounts in Shareholder Oppression Cases*, 44 Ariz.L.Rev. 213 (2002):

> A lack of marketability discount accounts for the fact that there is no ready market for the stock of closely held corporations. This lack of a ready market makes it very difficult for a shareholder to liquidate his or her investment expeditiously. Accordingly, a purchaser of such stock would demand a discount in order to account for such illiquidity. This discount, or difference between what an outside investor would pay for the shares of a close corporation and the shares of an identical public corporation, is often called a lack of marketability discount. The lack of marketability discount can be quite large; empirical studies indicate that it alone averages between thirty-five and fifty percent.

Eggart, supra, 44 Ariz. L. Rev. at 220. (Footnotes omitted.)[12]

Most people would also agree that the fair market value of a minority interest in a closely-held corporation is worth less than the interest's pro rata share of the value of the entire corporation. The real-world fair market value of a minority interest in a non-public corporation, in other words, is discounted because a minority interest is less attractive and harder to sell (i.e., less valuable) than the controlling interest in the same corporation. With a few exceptions,[13] courts have generally held that minority interests will not be valued at fair market value in dissenters' rights actions because this would result in the dissenter receiving <u>less</u> than her pro rata portion of the value of the company.

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[12] Yet, in spite of their findings about real-world values, both of these commentators – as suggested by the titles of their articles – advocate the elimination of any consideration of marketability discounts, at least in cases involving actual shareholder oppression. The problems associated with manipulating values to punish wrongdoers have already been discussed above.

[13] See, for example, *Weigel Broadcasting Company v. Smith*, 682 N.E. 2d 745 (Ill. App. 1996) (upholding the application of minority and marketability discounts to dissenters' shares).

Consequently, most courts have said that minority interest discounts and lack of marketability discounts will not be applied at the shareholder level.

In the most well-reasoned dissenter's rights cases, the corporation is valued at its fair market value (using any necessary discounts); the dissenter's shares in the corporation are not valued at their fair market value, but are valued as a pro rata portion of the value of the corporation as a whole, with no further discounting. The cases and authorities that are cited for the proposition that marketability discounts are never appropriate generally exhibit either: (a) a desire to punish wrongdoing by manipulating the valuation, (b) confusion about valuation starting points, (c) a misreading of the holding in *Cavalier*, or (d) all of the above.

D. The holding of Ford v. Courier Journal on marketability discounts is consistent with the best modern thinking on the issue.

Ms. Brown argued in the Court of Appeals that *Ford* should now be overruled because *Libby* has been overruled:

> In the quarter of a century since Ford, the Libby case on which the Kentucky court relied has been overruled by In re Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1005 (Me., 1989), and the consensus among jurisdictions has changed dramatically.

Ms. Brown's Brief at p. 9. There is not the slightest hint in *McLoon Oil Co.* that *Libby* was overruled. Not only was the *McLoon Oil Co.* decision, in large part, a long rumination on the continuing validity of *Libby,* the Court there cited *Ford v. Courier-Journal Job Printing* as supporting authority! *McLoon Oil Co.* at 1005.

McLoon Oil Co. held only that dissenting shareholders should not be awarded less than their proportionate share of the whole firm's fair market value. *Id.* at 1005. The

essence of the *McLoon Oil Co.* dispute and the court's resolution of the dispute is summarized by the court in the following passage:

> *Weinberger* stands for the simple proposition that the value of the business entity as a whole should be determined by the best available valuation methods. No one can quarrel with that proposition. It has nothing to do, however, with the critical issue raised by Lido's appeal, which arises only after completion of the valuation of the whole firm by the best available methods: Should the dissenting shareholder's proportionate part of that whole firm value as so determined be discounted because of the minority status and lack of marketability of his stock? The Delaware Supreme Court, the same court that decided *Weinberger*, has recently said no: Delaware emphatically rejects the application of those discounts in determining the fair value of a dissenting shareholder's stock. *See,* *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1141 (Del. 1989).

Id. at 1004. (Emphasis supplied.) *McLoon Oil Co.*, in other words, stands only for a proposition that Shawnee concedes – once a dissenting shareholder's portion of the value of the entire enterprise is determined, that portion cannot be further discounted because the dissenter's shares are not marketable. *McLoon Oil Co.* can in no way be cited for the claims made by Ms. Brown, which are, at bottom, efforts to be awarded more than her proportionate share of the value of Shawnee.

The Court of Appeals in *Brooks Furniture* overruled the holding in *Ford v. Courier Journal* respecting the use of marketability discounts, even at the entity level, in large part because of its perception that "there is a modern trend against applying marketability discounts in determining fair value among the jurisdictions with 'fair value' statutes. *Brooks Furniture*, App. 7 at p. 7. There is no such modern trend. There is a modern trend holding that the value of minority interests is to be fixed as the shareholder's pro rata portion of the value of the corporation as a whole, without the application of additional marketability or minority discounts at the shareholder level.

There is no trend toward the denial of the applicability of marketability discounts in valuations done at the corporate level.

The perception of the trend supposed by the *Brooks Furniture* majority is primarily the result of the confusion (discussed above) – on the part of the *Brooks Furniture* majority and the decisions on which it relies -about valuation starting points. For example, the *Brooks Furniture* majority cite *McLoon Oil, supra*, and *Cavalier Oil, supra*, for the proposition that marketability discounts are never to be considered in appraisal rights cases. *Brooks Furniture*, App. 7 at p. 8. As pointed out above, however, those decisions stand only for the more limited proposition that minority shareholders are to receive their pro rata portions of the value of the corporation without further discounts calculated at the shareholder level. Many of the courts cited by the *Brooks Furniture* majority as being a part of the "trend" make the same mistake about the holdings in *McLoon Oil* and *Cavalier Oil.* For example, in *Offenbecher v. Baron Services, Inc.*, 874 So.2d 532 (Al. Civ. App. 2002) (cited by the *Brooks Furniture* majority at App. 7 at pp. 18 and 20), the Alabama court of civil appeals relied, in part, on *Cavalier Oil* as authority for reversing a trial court valuation which used a corporate level discount. However, the dissent there correctly pointed out that in *Cavalier Oil*:

> [T]he Delaware Supreme Court distinguished between a permissible corporate-level discounting and an impermissible stockholder-level discounting. The court affirmed the lower court's refusal to apply a minority discount to the dissenter's stock in valuing that stock. The court stated that the dissenting shareholder should receive his proportionate share of the company after it had been valued as an entity.

Offenbecher, supra, at p 543 (Judge Thompson concurring in part and dissenting in part).

Of the many other cases cited by the *Brooks Furniture* majority for the proposition that "fair value" statutes have held that "a marketability discount should not

be applied in determining fair value" [*Brooks Furniture* App. 7 at p. 17-18] most can only be taken for the proposition that minority and marketability discounts cannot generally be taken at the shareholder level. For example, *Blitch v. Peoples Bank,* 246 Ga.App. 453, 540 S.E.2d 667 (2000), *Rigel Corp. v. Cutchall,* 245 Neb. 118, 511 N.W.2d 519 (1994), *First Western Bank Wall v. Olsen,* 621 N.W.2d 611 (S.D.2001), and *Advanced Communication Design, Inc. v. Follett,* 615 N.W.2d 285 (Minn.2000) all involved discounts applied at the shareholder level; none of those decisions express or imply that marketability discounts may not be used to determine the value of the corporation as a whole. In fact, the *Advanced Communication Design* court found that extraordinary circumstances justified the application of a marketability discount at the shareholder level, and directed the trial court on remand to "apply a marketability discount of between 35% and 55% to respondent's pro rata share of the value of ACD in accordance with our ruling herein." 615 N. W.2d 285 at 293. (Emphasis supplied.) Other cases cited by the *Brooks Furniture* majority in that same passage make clear that the corporation is to be valued at its fair market value and that discounts at that level are appropriate. For example, *Hogle v. Zinetics Medical, Inc.*, 63 P.3d 80 at 85 (Utah 2002) ("[t]he appraisal proceeding is not at all concerned with the losses to the *particular* dissenting shareholders or with the benefits derived by the *particular* acquiring corporation in the merger, except as those losses and benefits would be reflected in the price that would be bargained out in a completely free market between *any* willing buyer and *any* willing seller in the absence of the merger."[14]) and Matthew G. Norton Company

[14] The court here is quoting from *In re Valuation of Common Stock of Libby, McNeill & Libby,* 406 A.2d 54, 62 (Me.1979) – the case relied upon by the Kentucky court in *Ford v. Courier Journal Job Printing.*

v. Smyth, 51 P.3d 159, 160 (Wash. App. 2002) ("Insofar as the trial court's ruling was intended to provide a bright line rule that such discounts [marketability discounts] are never appropriate in dissenters' rights actions, *even at the corporate level,* we reverse.")

The *Brooks Furniture* court relied heavily on the decision of a sharply divided court in *Pueblo Bancorporation v. Lindoe, Inc.*, 63 P.3d 353 (Co. En Banc 2003) (3 dissents):

> A detailed summary of the law on the subject was given in *Pueblo Bancorporation* wherein the Court noted that the majority of states have dissenters' rights statutes which require that a dissenting shareholder be paid "fair value" for his shares. *Pueblo Bancorporation,* 63 P.3d. at 364-65. [FN2] The Court's research further revealed that there is a modern trend against applying marketability discounts in determining fair value among the jurisdictions with "fair value" statutes. *Id.* at 366. Only six states, including Kentucky, are cited as having approved marketability discounts. *Id.* at 367.

Brooks Furniture, App.7 at p. 15-16. The decision in *Pueblo Bancorp* has all the problems of the *Brooks Furniture* decision – misreading of *Cavalier*, string cites to cases that do not support the proposition that marketability discounts are never to be considered, confusion about valuation starting points – but in the end even the *Pueblo Bancorp* case cannot easily be cited for the proposition that marketability discounts are never allowed in shareholder appraisal rights actions. In the part of its opinion labeled "Conclusions" the *Pueblo Bancorp.* court described its holding in the following language:

> We hold that the term "fair value," for the purpose of Colorado's dissenters' rights statute, means the dissenting shareholder's proportionate interest in the corporation valued as a going concern. 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**. The court of appeals decision is affirmed.

Pueblo Bancorp., 63 P.3d at 369. (Emphasis supplied.)

The *Pueblo Bancorp* court asserted that:

> [O]nly six states with "fair value" statutes have clearly concluded that fair value may include marketability discounts." *Munshower v. Kolbenheyer*, 732 So.2d 385, 386 (Fla.Dist.Ct.App.1999) (interpreting fair value in the context of a buy-out of a shareholder who petitioned for corporate dissolution); *Weigel Broadcasting Co. v. Smith*, 289 Ill.App.3d 602, 225 Ill.Dec. 1, 682 N.E.2d 745 (1996) (holding that the decision of whether to apply a marketability discount is within the trial court's discretion); *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky.Ct.App.1982); *McDonough v. Alpha Const. Eng'g Corp.*, No. 12757, 1994 WL 1031191 (Va. Cir. Ct. May 19, 1994) (trial court, interpreting Maryland law, applied marketability discount in buy-out proceeding); *In re Dissolution of Gift Pax, Inc.*, 123 Misc.2d 830, 475 N.Y.S.2d 324 (N.Y.Sup.Ct.1984) (interpreting "fair value" in context of statute authorizing buy-out of shareholder who petitioned for corporate dissolution); *Columbia Mgmt. Co. v. Wyss*, 94 Or.App. 195, 765 P.2d 207 (1988).

Pueblo Bancorp. at p.367. This list underestimates the number of courts that have expressly allowed discounts at the corporate level. The list should have also included such cases as *Cavalier, supra; Advanced Communication Design, supra; Hogle v. Zinetics Medical, supra; Matthew G. Norton Company, supra*; *Onti, Inc. v. Integra Bank*, 751 A.2d 904 (De. Ch. 1999); *Balsamides v. Protameen Chemicals, Inc.*, 734 A.2d 721 (N.J. 1999); *Seagroatt Floral Company, Inc. v. Riccardi*, 583 N.E.2d 287 (NY 1991) and *Hall v. King*, 675 N.Y.S.2d 810, 813-814 (S. Ct. N.Y. Co. 1998) affirmed 265 A.2d 244 (Supreme Ct. App. Div. 1999)(slip opinion). ("The value of the corporation itself "should be determined on the basis of what a willing purchaser, in an arm's length transaction, would offer for the corporation as an operating business, rather than as a business in the process of liquidation.")(Upholding a 25% lack of marketability discount).

In *Onti, Inc. v. Integra Bank*, supra, a Delaware chancery court interpreted the often-cited Delaware Supreme Court decision in *Cavalier* in the following language:

> In *Cavalier Oil Corp. v. Harnett,* the Supreme Court authorized corporate level discounting but not shareholder level discounting-*i.e.,* if a stock

discount affects the entire company, it should be considered in the appraisal, but if it only affects certain shareholders (such as a minority discount does), it should be eliminated by an upwardly adjusted market value. The *Cavalier Oil* Court found that a shareholder level discount "fail[s] to accord to a minority shareholder the full proportionate value of his shares [which] imposes a penalty for lack of control, and unfairly enriches the majority shareholders." **Here, however, the discount that results from the restrictions on the shares affects not just Counterclaimants but also Counterclaim Defendants. I consider it corporate level discounting and, therefore, appropriate.**

Onti, supra, at p. 913. (Emphasis supplied.) The New Jersey supreme court reached the same conclusions in *Balsamides v. Protameen Chemicals, Inc.*, 734 A.2d 721 (N.J. 1999):

We further observe that a thirty-five percent marketability discount, if properly applied, was appropriate in this case. The Appellate Division, although rejecting the use of the discount, commented that marketability discounts typically have ranged between thirty percent and forty percent. *Balsamides, supra,* 313 *N.J.Super.* at 27, 712 *A.*2d 673. One author cites a study documenting marketability discounts in the range of thirty percent to forty percent for closely-held companies. Harris, *supra,* 42 *Ark. L.Rev.* at 658-59; *see also* Hood, et al., *supra,* 65 *UMKC L.Rev.* at 439-40 (citing study concluding that "35% nonmarketability discount from intrinsic value is appropriate for stock in a closely-held corporation"). Accordingly, we find that a thirty-five percent marketability discount is within the generally accepted and reasonable range given the facts presented.

Balsamides, supra, at pp.378-379. (Emphasis supplied.)

The decision of New York's highest court in *Seagroatt Floral, supra*, is very instructive. The court there allowed, in fact mandated, consideration of the marketability of shares in a closely-held company in an opinion which included the following holdings:

Thus, once Seagroatt Floral and Henry J. Seagroatt elected to buy out petitioners, the misconduct charges became irrelevant. The issue became one of valuation.

Business Corporation Law § 1118 offers no definition of fair value and no criteria by which a court is to determine price or other terms of the purchase (*see also,* Business Corporation Law § 623). Rather, fair market value, being a question of fact, will depend upon the

> circumstances of each case; there is no single formula for mechanical application.
>
> The objective of a proceeding under Business Corporation Law § 1118-including the one now before us-is to determine what a willing purchaser in an arm's length transaction would offer for petitioners' interest in the company as an operating business. . . .
>
> Valuing a closely held corporation is not an exact science. Accordingly, courts in such proceedings confront a variety of evidence and methods aimed at determining the price of minority interests in closely held corporations-legal entities that by their nature contradict the concept of a "market" value. The 1979 amendments to the Business Corporation Law were motivated, in part, by recognition of the fact that shareholders in closely held corporations, as contrasted with shareholders in public companies, are unlikely to find prospective buyers for their shares. It follows that, whatever the method of valuing an interest in such an enterprise, it should include consideration of any risk associated with illiquidity of the shares.
>
> . . . .
>
> While lack of a public market for the shares of a closely held corporation should certainly be considered in determining what a willing purchaser would pay for such shares-which is the purport of the quoted language from *Amodio,* involving contractual restrictions on transfer-there is no single method for calculating that factor.

583 N.E.2d 287 at 290-219. (Citations omitted.)(Emphasis supplied.)

The *Pueblo* court's list of cases allowing marketability discounts should have included not only shareholder oppression and appraisal rights cases, but also other cases in which courts have been required to value businesses where no ready market exists. That list would include cases like: *In re: Marriage of Thornhill*, 232 P.3d 353 (Co. en banc 2003)(marketability discounts allowed in valuation of marital property in a divorce); *In the Estate of Hjersted*, 175 P.3d 819 (Kan. 2008)(marketability discounts allowed in valuation of business required because wife petitioned in probate to take her spousal share of her husband's estate); and a multitude of estate tax cases like *Gross v. Commissioner*, T.C. Memo 1999-254 (25 percent discount); *Estate of Hendrickson v.*

Commissioner, T.C. Memo 1999-278 (30 percent discount); *Estate of Marmaduke v. Commissioner*, T.C. Memo 1999-342 (30 percent discount); *Estate of Desmond v. Commissioner*, T.C. Memo 1999-76 (30 percent discount); and *Estate of Brookshire v. Commissioner*, T.C. Memo 1998-365 (40 percent discount).

Marketability discounts, applied to determine the fair market value of the corporation in the first instance, like the discounts which were the subject of *Ford v. Courier Journal,* are appropriate. There is no "trend" of authority to the contrary. *Ford v. Courier Journal* should not be overruled.

E. The Hisle Valuation – Appendix 4.

The discussion of the valuation methodologies used by Shawnee's expert begins on page 10 of the Hisle Valuation. [App. 4.] Valuing Shawnee using the net-assets method was straight-forward, since Shawnee's assets at December 31, 2003, consisted primarily of cash ($1,071,585), accounts receivable ($279,105), and minor property, plant and equipment (with a value, before depreciation, of $33,311) and Shawnee had few liabilities. See, Shawnee Historical Balance Sheet Summary as of 12/3/2003 attached to the Hisle Appraisal (App. 4) at Exhibit 5.

However, the Hisle Appraisal makes clear that the application of the income approach to valuing Shawnee was much more complicated. Hisle chose to use the capitalized earnings method and determined the appropriate capitalization rate using the "build-up method" to arrive at a value, before the application of the marketability discount, of $1,292,812. See, Appendix 4 at page 15. This value was determined using published sources of information about public companies and the application of a company specific risk factor of 15%. This value was the value of Shawnee calculated as

if Shawnee were a public company and its shares were easily traded. Mr. Hisle then determined on a marketability discount using a number of published sources of information about real-world discounts for lack of marketability, including: (a) information on sales of restricted shares of publicly traded companies, (b) comparisons of sales of closely held company shares to sales of shares in the same companies after an initial public offering, and (c) relevant tax court cases. See, Hisle Appraisal, Appendix 4 at p. 15-16. The twenty-five percent discount used by Hisle was actually on the very low end of the actually marketability discounts shown by the published data. See, Hisle Appraisal, Appendix 4 at Exhibits XI and XII.

F. The discount was applied, properly, at the entity level:

The marketability discount was applied at the entity level not only by Mr. Hisle, but also by the master commissioner. In discussing his decision to use the discount, the master commissioner explained:

> *Marketability Discount:* The marketability of a company stock, in whole or part, refers to the loss of the use of its monetary value during the time that it takes to convert that stock into cash, i.e., its liquidity: That time will depend on the history, nature and circumstances of that particular company. The sale of a listed stock takes little time, and no discount would be necessary because of its liquidity. At the other extreme is the time it would take to sell an interest, total or otherwise, in a close corporation such as Shawnee, which has no ready market for its shares. In that case liquidity would be a valid and proper consideration in determining the company's present value.

Report of Appraisal, App. 6, at p. 9-10. See, also, the "Appraisers Calculations" attached to the Report of Appraisal. [App.6.]

G. Conclusion:

Without the discount for lack of marketability, the valuation process will sometimes overstate the values of closely-held companies. If the *Ford* decision is out of the mainstream of decisions in this area, it is because the *Ford* court was thinking more clearly than other courts have, not because the *Ford* decision has been left behind by the best modern thinking in this area. Appellant is not arguing that marketability discounts are always appropriate, just that their application should be left to the evidence. For example, the master commissioner correctly determined that a marketability discount should not be applied to the net-asset value of Shawnee, since most of Shawnee's assets were highly liquid. [Report of Appraisal, App. 6, attached calculation.]

In his capitalized earnings valuation, Mr. Roller applied a 25% discount for lack of marketability at the company level – a discount which was consistent with the market evidence as he saw it and is consistent with discounts allowed in *Ford* and other cases. Mr. Ray did not take issue with the size of the discount and did not research the market evidence; instead, he rejected the use of the discount altogether. It is Mr. Roller's approach, and not Mr. Ray's, which is consistent with the law in this area.

To the extent the master commissioner gave any weight to the "income method" in valuing Shawnee (and, as shown above, giving any weight to the income method was not appropriate in this case), the value of the Shawnee income stream was correctly discounted to reflect its status as a closely-held company.

III. THE TRIAL COURT ERRED IN CERTIFYING ITS DECISIONS ON THE STOCK APPRAISAL ISSUES AS FINAL. [15]

A. Preservation of Issue for Review: This issue was preserved for review by Shawnee's Shawnee's Post-Judgment Motions. *[R.1604.]*

B. Scope of Review: The trial court's decision on this issue should be reviewed for abuse of discretion. *Watson v. Best Financial Services, Inc.*, 245 S.W.3d 722 (Ky. 2008).

C. Argument.

Mr. Clark claimed that Ms. Brown breached a contract made with Mr. Clark at the time Mr. Clark transferred his ShawneeComm assets to Shawnee. *[Answer to Counterclaim, Cross-Claims and Demand for Jury Trial §14, R.418]* At the time of the transfer, Mr. Clark was in poor health and planned to retire from the active management of the business. He transferred his ShawneeComm business into Shawnee, without charge to Shawnee and without increasing his ownership interest in Shawnee, based on the promise by Ms. Brown and Ms. Simmons that they would work full time in the business, would use their best efforts in the business, and would buy out Mr. Clark's interest in Shawnee within five years. *[Answer to Counterclaim, Cross-Claims and Demand for Jury Trial §14, R.418]*

However, the circuit court precluded any consideration by the master commissioner of the Clark cross-claim or the claim that the value of Shawnee should

[15] The finality and recusal issues addressed in Parts III and IV below (which, at root, both go to the question of whether the master commissioner should have been allowed to consider the impact – on Shawnee's income -- of the Jim Clark cross-claim) are relevant only to the extent that this Court determines that the master commissioner's consideration of income in his valuation of Shawnee was proper.

exclude the value of the Siemens switching business. The circuit court's order of January 25, 2006, contained the following paragraphs:

> 2. For the purposes of the upcoming hearing before the Fayette County master commissioner to determine the Fair Value of Kathy Brown's stock pursuant to the Kentucky dissenter's right statutes, there shall be no evidence admitted or argument made concerning an alleged oral contract to purchase Jim Clark's stock or a claim that Jim Clark was fraudulently induced to transfer Shawnee Communications' business to Shawnee Technology, Inc. The issues raised by Mr. Clark's cross-claims against Ms. Brown are reserved for later determination by the Court.
>
> 3. All Shawnee Communications' business that was transferred to Shawnee Technology, Inc. and all revenues generated by such business shall be included as part of the total revenues of Shawnee Technology, Inc. in determining the Fair Value of Kathy Brown's 24% ownership interest in Shawnee Technology, Inc.

[R. 830.] The Siemens switching business, transferred to Shawnee by Mr. Clark's business (ShawneeComm) was the only business remaining in Shawnee at the time of the merger. *[Answer to Counterclaim, Cross-Claims and Demand for Jury Trial §16, R.418; Affidavit of Andrea Simmons attached to Shawnee Memorandum Support of Motion for Stay of Judgment §§14, 15, R.1606.]* The circuit court's order, in other words, prevented the master commissioner from even considering claims which, if successful, would have rendered Ms. Brown's stock worthless.

This action involves multiple claims and multiple parties and the circuit court could enter a final and appealable judgment on some, but not all, of the claims "only upon a determination that there is **no** just reason for delay." CR 54.02 (Emphasis supplied.) The claims remaining in this case are intimately related to the valuation decision. The circuit court did not make a considered determination that there was no

just cause for delay and the finality certification would not have been supported by the record even if the circuit court had chosen to consider the issue.

The circuit court does not have unfettered discretion to enter a certification of finality under CR 54.02. *Jackson v. Metcalf*, 404 S.W.2d 793 (Ky. 1966). The circuit court must consider the Supreme Court's historic policy against piecemeal appeals and actually make a considered judgment that there is no just cause for delay. *Id.*

Mr. Clark's cross-claims include the claim that he transferred certain assets to Shawnee in reliance on promises of Ms. Brown. *[Answer to Counterclaim, Cross-Claims and Demand for Jury Trial §14, R.418.]* Yet, the circuit court's order of January 25, 2006 precluded consideration of this claim by the master commissioner during the valuation hearing. *[R. 830.]* The only significant business still being conducted by Shawnee on the date of the valuation was business transferred to Shawnee by Mr. Clark. For this reason, Mr. Clark's claims should have been considered in the valuation decision and the decision on the Clark counterclaims should have been finally resolved before the valuation decision was finalized.

This case is very similar to *Nelbro Packing Company v. Baypack Fisheries*, 101 Wash. App. 517, 6 P.3d 22 (2000). That case involved claims for breach of contract, breach of the covenant of good faith and fair dealing, tortuous interference, "lender liability" and fraud, on the one hand, and a simple claim on a promissory note, on the other hand. The trial court granted summary judgment on the note claim and certified it as final under the State of Washington's virtually identical counterpart to CR 54.02. The appellate court determined, in a lengthy and well-reasoned opinion, that the trial court abused its discretion in certifying its decision on the promissory note claim as final. The

opinion included the following conclusions, all of which are equally applicable to this case:

> Even if individual claims are in some sense separable from the remaining unresolved claims, not all final judgments should be immediately appealable. The trial court should consider judicial administrative interests, as well as equity. The factors relevant to the determination whether there is no just reason for delay include:
>
> (1) [T]he relationship between the adjudicated and the unadjudicated claims, (2) whether questions which would be reviewed on appeal are still before the trial court for determination in the unadjudicated portion of the case, (3) whether it is likely that the need for review may be mooted by future developments in the trial court, (4) whether an immediate appeal will delay the trial of the unadjudicated matters without gaining any offsetting advantage in terms of the simplification and facilitation of that trial, and (5) the practical effects of allowing an immediate appeal.

6 P.3d at 26-27. The court of appeals found particularly troubling the trial court's failure to consider (and address in the judgment) all of the relevant factors. *Id.* at 27. The court then did its own analysis of those factors, including judicial economy and the impact of the judgment on the remaining issues.

> When adjudicated and pending claims are closely related and stem from essentially the same factual allegations, judicial economy generally is best served by delaying the appeal until all the issues can be considered by the appellate court in a unified package. Although the claims the trial court dismissed could have been enforced separately from the remaining claims, all of Baypack's claims were closely related.

Id.

The claims remaining in this case are intimately related to the valuation decision. Resolution of those claims will likely affect the final valuation decision and the final decision on the valuation question will likely affect the resolution of the remaining claims. The circuit court did not make a considered determination that there was no just cause for delay and such a determination would not have been supported by the record in

this case in any event. The Judgment should be vacated and the case remanded to the circuit court for final resolution of all the claims made in this case.

IV. RECUSAL WAS REQUIRED AS TO ALL THE ISSUES REMAINING IN THIS CASE AT THE TIME OF THE RECUSAL MOTION.

A. Preservation of Issue for Review: This issue was preserved for review by Shawnee's Motion for Recusal. *[R.1677.]*

B. Scope of Review: This issue presents a question of law and the trial court's decision is to be reviewed de novo. *Appalachian Regional Healthcare, Inc. v. Coleman*, 239 S.W.3d 49 (Ky. 2007).

C. Argument.

At the end of the October 24, 2007, hearing on Ms Brown's motion for attorneys' fees the trial court informed the parties that this case would "probably" go back to the regular Third Division trial court because "**I am sure I will be accused of being prejudiced**." *[October 24, 2007 Hearing Video at 12:51:46pm; R.1576.]* Neither Shawnee nor its counsel had ever even hinted, during that hearing or any other time, that they believed that the trial judge was biased against Shawnee or biased in favor of Ms. Brown. Regrettably, however, the statement itself, suggesting as it does that the circuit court thought that grounds for disqualification probably existed, created a circumstance in which the court's impartiality might reasonably be questioned. The court's statement can only be taken to mean that the court thought that there are grounds for disqualification in this case, either because: (1) he had developed prejudice against Shawnee, or (2) he believed that Shawnee or its counsel would falsely accuse the court of being prejudiced, or (3) he believed that his impartiality might otherwise reasonably be questioned. These

are the only possible explanations for the court's statement and each, if true, requires disqualification under KRS 26A.015(2)(e). Where disqualification of the presiding judge is required, it is required on the entire case.

The statement itself, made in open court, made in the presence of the principals of Shawnee and counsel for Shawnee, creates a circumstance in which the impartiality of the circuit court might reasonably be questioned.

Disqualification of judges is addressed in KRS 26A.015, which provides, among other things:

> (2) Any justice or judge of the Court of Justice or master commissioner **shall** disqualify himself in any proceeding:
>
> (a) Where he has a personal bias or prejudice concerning a party, or personal knowledge of disputed evidentiary facts concerning the proceedings, or has expressed an opinion concerning the merits of the proceeding; . . . [or]
>
> **(e) Where he has knowledge of any other circumstances in which his impartiality might reasonably be questioned.**

(Emphasis supplied.) Judicial impartiality is the foundation on which respect for our system of justice, even our respect for the law, rests; and for that reason, the appearance of impartiality is as important as impartiality itself:

> [R]ecusal is required whenever there is substantial doubt as to a judge's ability to preside impartially, even though the judge is not conscious of any bias or prejudice, or the judge personally believes himself or herself to be unprejudiced, unbiased, and impartial. The test is whether a reasonable person, knowing all the circumstances, would have a reasonable basis for doubting the judge's impartiality, or whether the alleged facts would create in a reasonably prudent person a well-founded fear of not receiving a fair and impartial trial.

48 CJS Judges §239.

The judge's statement that he thought a basis existed or might exist for believing the circuit court was prejudiced in this case, coming after an oral argument in which counsel for Ms. Brown repeatedly went outside the record to make improper and highly prejudicial arguments, certainly creates a circumstance in which the circuit court's impartiality might reasonably be questioned. Counsel for Ms. Brown obviously thought the circuit court was susceptible to improper, prejudicial argument. Something motivated the circuit court to indicate that he would probably disqualify himself and something motivated the circuit court to say: "I am sure I will be accused of being prejudiced."

The statute does not suggest, of course, that where grounds for disqualification exist, a court may disqualify itself in only a portion of a case. Prejudice or the appearance of partiality taints every part of a proceeding, and a litigant is entitled to impartiality in every decision made in his or her case. Courts that have considered the matter have ruled that recusal from only a portion of a case is impermissible. *See, U.S. v. Feldman*, 983 F.2d 144 (9th Cir. 1992).

The trial judge's consideration (and denial) of Shawnee's motion to set aside the judge's finality findings was improper.

CONCLUSION

The decisions of the Court of Appeals and the circuit court should be reversed and this case remanded to the circuit court with instructions that it enter a judgment that the value of Ms. Brown's interest in Shawnee as of December 31, 2003, was $322,526 – the value determined by the master commissioner using only the net-assets valuation method. See, calculations attached to Report of Appraisal. [App. 6.]

Respectfully submitted:

D. Duane Cook
Attorney-at-Law
105 Thoroughbred Way
Georgetown, Kentucky 40324
502.570.0022

COUNSEL FOR APPELLANT