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**

REPLY BRIEF FOR APPELLANT

Certificate Required By CR 76.12(6)

This is to certify that a true and accurate copy of the Reply Brief for Appellant was served by mail, postage pre-paid, this 28th day of February, 2011, 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, on Hon. Gary D. Payne, Senior Judge, 3195 Paris Pike, Lexington, Kentucky 40511, on Hon. James D. Ishmael Jr., Circuit Judge, Robert F. Stephens Circuit Courthouse, 120 N. Limestone, Suite C551, Lexington, KY 40507, and on Brent R. Baughman and Janet P. Jakubowicz, Greenebaum Doll & McDonald PLLC, 3500 National City Tower, 101 South Fifth Street, Louisville, Kentucky 40202-3197, counsel for Amicus Curiae, Kentucky Chamber of Commerce. The undersigned also certifies that the record on appeal was not withdrawn by counsel for Appellant.

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STATEMENT OF POINTS AND AUTHORITIES

APPENDICES

ARGUMENT

I. INTRODUCTION

This case requires a determination about how small businesses are to be valued. The Court of Appeals ruled that the net-asset valuation method may not be used in valuing a closely held business like Shawnee. Opinion [Appendix 3 to Appellant's Brief] at p.6.* Shawnee contends that the net-asset valuation method is the *only* proper method for valuing Shawnee.

The Court of Appeals also implicitly overturned its decision in *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982) and held that the use of marketability discounts in the valuation of closely held companies is improper. Opinion [Appendix 3] at p.6. Appellant contends that the best modern cases allow marketability discounts at the corporate level, but deny further discounts (variously called lack of control, minority or lack of marketability discounts) at the shareholder level. *Cavalier Oil Corp. v. Harnett*, 564 a. 2d 1137, 1144 (Del. 1989) is the leading case in this area and, as will be shown below, *Cavalier Oil* does not bar *corporate* level marketability discounts.

Ms. Brown's Brief makes some effort to give this case the sound and feel of a shareholder oppression case. But Ms. Brown was not oppressed; she quit and demanded payment for her shares. This case is a dispute about the price to be paid for her shares, an interesting dispute involving important issues, but nonetheless a dispute about price only.

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* Unless otherwise noted, references to an Appendix will be references to an Appendix attached to the Brief for Appellant.

II. USE OF THE NET ASSET VALUATION METHOD IN THIS CASE WAS NOT ONLY PROPER, IT WAS THE ONLY PROPER VALUATION METHOD UNDER THE CIRCUMSTANCES.

Ms. Brown cites not one case in support of the Court of Appeals decision on this point. In fact, many of the cases cited by Ms. Brown on other points are cases which involved the use of net-asset valuation methods to which on party objected. See, for example, *Brooks v. Brooks Furniture Mfgrs., Inc.*, --- S.W.3d ----, 2010 WL 4290068 (Ky. App., en banc, 2010) [Appendix 7 at p. 6.], *Wenzel v. Hopper & Galliher, P.C.*, 779 N.E.2d 30 at 36 (Ind. App., 2002); *In re Valuation of Common Stock of McLoon Oil Co.*, 565 A.2d 997, at 1002 (Me. 1989). Ms. Brown would have this Court ignore the fact that some businesses have no value over and above the value of their assets. A law practice, for example, like the one valued in *Wenzel, supra*, typically has no value over and above the value of its assets because no sane lawyer will buy a practice unless he knows that the selling lawyers will not, after the sale, just open a new practice with the same clients. Similarly, this Court determined in *Gaskill v. Robbins*, 282 S.W.3d 306 (Ky. 2009) that an oral surgery practice had no value over and above the value of its assets (it had no valuable good will, in other words) because 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. As detailed in Appellant's Brief, pp. 20-26, the Master Commissioner made the same determinations about the goodwill attributable to Mr. Clark as did this Court in *Gaskill* regarding the goodwill attributable to Ms. Gaskill, and yet the Master Commissioner, incorrectly, gave some weight to the valuation of Shawnee determined by the capitalized earnings method – a decision which awarded Ms. Brown a part of the goodwill which belonged only to Mr. Clark.

The Court of Appeals and the Circuit Court should be reversed and Ms. Brown's shares should be valued using only the net asset approach. The value of Ms. Browns 24% interest in Shawnee should be fixed at $322,526. See, Appendix 6.

III. FORD v. COURIER JOURNAL SHOULD NOT BE OVERTURNED AS TO THE USE OF MARKETABILITY DISCOUNTS AT THE CORPORATE LEVEL.

If an income valuation method is to be used at all in this case (and as noted above, it should not be), the application by the Master Commission of a lack of marketability discount at the corporate level was entirely proper.

In its Brief, Shawnee pointed out that a concern to punish majority shareholders or deter misconduct has improperly infected some decisions in this area. See, Brief for Appellant at pp. 10-18. Appellee's Brief made no effort to subject this contention to legal reasoning or case-by-case analysis. In its Brief, Shawnee pointed out confusion in the case law about the distinction between corporate level and shareholder level discounts. See, Brief for Appellant at pp. 27-30. Appellant's Brief also goes to some length to demonstrate that the Court of Appeals opinion in *Brooks v. Brooks Furniture Mfgrs., Inc., supra*, and the opinions relied upon by the *Brooks* court, are incorrect in their perceptions of the modern trend in this area. See, Brief for Appellant at pp. 31-39. Appellee counters these arguments by misinterpreting the holdings in *Cavalier Oil Corp. v. Harnett*, 564 a. 2d 1137, 1144 (Del. 1989), *Wenzel v. Hopper & Galliher, P.C.*, 779 N.W.2d 30 (Ind. App. 2002), and *In re Valuation of Common Stock of McLoon Oil Co.*, 565 A. 2d 997 (Me. 1989).

An illustration of the capitalized earnings valuation method used in this case will illuminate the distinction between corporate level discounts and shareholder level discounts - a distinction ignored by the Court of Appeals and by Ms. Brown:

STEP ONE:

Determine Value of the Earnings Stream of Shawnee	**$2,304,178**

The Master Commissioner used the capitalized earnings stream calculated by Mr. Ray (Ms. Brown's expert) rather than the much smaller value calculated by Mr. Roller. The difference between the two numbers was primarily attributable to the fact that Mr. Roller thought the income of Shawnee (an S corporation which did not pay taxes) should be reduced by the taxes it would have to pay if it were a public company. In other words, Mr. Roller testified that the earnings of Shawnee had to be "tax-effected" in order to properly compare the earnings of Shawnee to the earnings of comparable public companies. See, Appendix 6, at 9.

STEP TWO:

Determine the discount to be applied to account for differences in value between public and private companies	**CORPORATE LEVEL DISCOUNT** 25% of $2,304,178 = **$576,045**

Mr. Roller's description of discounts for lack of marketability and minority interest appears at pp. 15-17 of his appraisal. Appendix 4. His discussion makes clear that some discount is necessary, at the corporate level, to account for the differences in value between publicly traded companies (the normal source of information about company values) and closely held companies. See, for example, Appendix 4 at p. 17. Mr. Roller concluded that a marketability discount of 25%, applied at the corporate level, was necessary in this case and the Master Commissioner adopted Mr. Roller's discount.

Neither Mr. Roller nor the Master Commissioner applied a minority discount or other shareholder level discount.

STEP THREE:

Calculate Ms. Brown's 24% interest in the Value of Shawnee	($2,304,178 - $576,045) x .24 = **$414,751**[†]

The determination of the "fair" value of a dissenting shareholder's shares ends here. The minority shareholder gets her pro rata share of the value of the business – the same amount she would get if the company were sold and the proceeds distributed to all the shareholders.

The determination of the actual value of a minority shareholder's shares – necessary when the shares are part of an estate or when the shares are donated to charity for example – requires another step.

STEP FOUR:

Determine Fair Market Value of Minority Interest --Accounting for the fact that a minority interest in a closely held business is not worth as much as the controlling interest in the same business.	**SHAREHOLDER LEVEL DISCOUNT** $414,751 x .30 = **$124,425.30**

Here the discounts can be quite steep, because ordinarily minority shareholders in closely-held businesses have no right to control the corporation, have no right to employment, and do not have a ready market to sell their shares. One commentator has stated the matter quite succinctly:

> There are 51 shares ... that are worth $250,000. There are 49 shares that are not worth a _____.

[†] See, Appraisers Calculations attached to Report of Appraisal, Appendix 6.

Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 Duke L.J. 293, at 382 (November 2004). Studies suggest that the average minority discount is between 29-33%. *Id.* at n. 90. If Ms. Brown were to receive actual value of her shares, she would receive far less than her pro rata portion of the value of the company.

This illustrates the significant difference between a corporate level discount and a shareholder level discount. Both discounts are often referred to as "marketability" or "lack of marketability" discounts, although the corporate level discount is sometimes referred to as a "lack of liquidity" discount and the shareholder level discount is sometimes referred to as a "lack of control" or "minority" discount. Courts and commentators would be much better off using the terms "corporate level discount" and "shareholder level discount" to make clear which discount is being discussed. The Delaware Supreme Court started in that direction with its decision in *Cavalier Oil Corporation v. Harnett*, 564 A.2d 1137 (Dl. 1989). Unfortunately, many courts since then have not been as clear as the *Cavalier* court regarding which of the two "lack of marketability" discounts is being considered in a particular case. A notable exception is the decision of the Delaware Chancery Court in *Onti, Inc. v. Integra Bank*, 751 A.2d 904 (De. Ch. 1999):

> **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 *Cavalier Oil* decision is so critical to the Appellee's position, as well as to the decision of the Court of Appeals in *Brooks* and in this area generally, that it deserves extended treatment here. A copy of the decision is attached to this Brief as Appendix 1. Careful review of the *Cavalier Oil* case will show that the Delaware chancery court in *Onti, supra*, got the matter right – *Cavalier* "authorized corporate level discounting but not shareholder level discounting."

The *Cavalier Oil* court addressed a number of different shareholder disputes, but the appraisal action grew out of the objection of Mr. Harnett to the merger of EMSI (a mortgage servicing company) into Cavalier Oil. Harnett was frozen out in the merger and the Delaware court of chancery fixed the value of Mr. Harnett's EMSI stock at $347,000. Cavalier appealed "from the refusal of the Vice Chancellor to apply a **minority** discount in valuing Harnett's interest in EMSI." *Cavalier Oil, supra* at p. 1139. (Emphasis supplied.) This statement of the issue could be the end of the analysis – the only discount under consideration in the case was the "minority" discount, the shareholder level discount, in other words.

The court's discussion of this issue begins at part IV of the opinion, and the court set the stage for its analysis with this opening:

> Cavalier's final claim of error is directed to the Vice Chancellor's refusal to apply a minority discount in valuing Harnett's EMSI stock. Cavalier contends that Harnett's "de minimus" (1.5%) interest in EMSI is one of the "relevant factors" which must be considered under *Weinberger's* expanded valuation standard. In rejecting a minority or marketability discount, the Vice Chancellor concluded that the objective of a section 262 appraisal is "to value the ***corporation*** itself, as distinguished from a specific fraction

> of its ***shares*** as they may exist in the hands of a particular shareholder" [emphasis in original]. We believe this to be a valid distinction.

Cavalier Oil, supra, at p. 1144. Here again, the court made clear that it was only addressing the minority discount. The court's opinion again and again makes clear that it is addressing, and disapproving, only shareholder level discounts:

> [T]he Court of Chancery's task here was to value what has been taken from the shareholder: "viz. his proportionate interest in a going concern." [Citation omitted.] 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 Oil, supra, at 1144. (Emphasis supplied.)

Cavalier Oil can most definitely not be taken for the proposition that marketability discounts at the corporate level are not proper and it can most definitely not be relied upon as authority for the proposition that *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982), should be overruled.

The Court of Appeals seems to have relied almost totally on the *McLoon Oil* decision for support of its determination that use of marketability discounts is not appropriate when closely held businesses are valued. However, careful analysis of that decision will show that, like the court in *Cavalier Oil*, the *McLoon Oil* court addressed only *shareholder* level discounts, not *corporate* level discounts. The decision is included as Appendix 3 to this Brief.

McLoon Oil involved the valuation of 3 different businesses. The dissenters' experts valued the businesses using the net asset value; the company's witnesses used a

discounted cash analysis for two of the companies and a net asset analysis for the third. The referee valued the businesses by allotting 75% weight to the analysis of the company's expert and 25% weight to the analysis of the dissenters' expert. *McLoon Oil* at p. 1002. There was no other discussion in the case about how the values of the businesses were determined. We do not know from the opinion, in other words, whether the experts applied any corporate level discounts to determine the values of the companies. The referee then determined the value of the dissenters' shares by simply multiplying their percentage of ownership times the companies' total values. *Id.* at 1003.

On appeal, the company objected to the referee's refusal to <u>further</u> discount the value of each dissenter's shares. *Id.* In other words, the only issue raised in the appeal was the propriety of shareholder level discounts. The *McLoon Oil* court properly rejected the idea that once a shareholder's proportionate interest in the value of a company is determined, the value of that shareholder's shares should not be further discounted for lack of marketability or minority status. The opinion makes clear that the court was addressing shareholder level discounts and not corporate level discounts:

> *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: **<u>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</u>**?

McLoon Oil at p. 1003. (Emphasis supplied.)

The *Wenzel* decision, properly understood, is also a decision about shareholder level discounts, not corporate level discounts. *Wenzel* involved the valuation of a minority shareholder's interest in an incorporated law firm. Although they differed

somewhat in their treatment of certain items, all the experts agreed that the law firm should be valued using the net asset approach. *Id.* at p. 36. There is no indication in the opinion that the value of the law firm, taken as a whole, was discounted. Although the court here is not as clear as the *Cavalier Oil* court on the distinction between company level and shareholder level discounts, its description of the discounts themselves indicates that it was addressing shareholder level discounts:

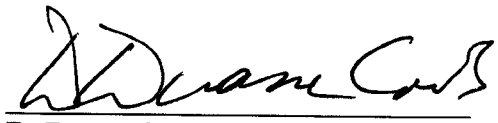
> Minority and marketability discounts are open market concepts. A minority discount allows an appraiser to adjust for a lack of control over the corporation on the theory that minority shares of stock are not worth the same amount to a third party as the majority holdings due to lack of voting power. A marketability discount allows an appraiser to adjust for a lack of liquidity in the stock itself on the theory that there is a limited supply of purchasers of the stock. [Citations omitted.]

Id. (Emphasis supplied.) The *Wenzel* decision is attached hereto as Appendix 3.

CONCLUSION

For reasons outlined above and in Appellant's Brief, the decisions of the Circuit Court and the Court of Appeals should be reversed and the value of Ms. Brown's shares should be fixed at $322,526, her proportionate interest in the net asset value of Shawnee. This decision will render moot the other issues raised in this appeal.

Respectfully submitted:



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