

THE APPRAISAL REMEDY AND THE DETERMINATION OF FAIR
VALUE BY THE COURTS

by

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*This dissertation is dedicated to the memory of
Rowan Hillis*

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1. Introduction

1.1 The appraisal remedy as a new minority shareholder protection

It is an established norm that companies are democratic institutions where the majority can subject the minority to its rule. The power of the majority is not unchecked, however. Company law has a history of developing measures to protect minority shareholders against the abuse of power by majority shareholders.¹

South African company law has recently taken further steps to develop new minority protections through the promulgation of the new Companies Act 2008², which came into force on 1 May 2011. For the most part, these developments had their origins in the policy paper entitled *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform*³ published by the Department of Trade and Industry in 2004. The policy paper emphasised the importance of having effective remedies in place to enable shareholders and investors to exercise their basic rights. In particular, the paper stated that exit and appraisal rights should be identified and given content, to provide smaller investors the ability to make informed choices where they are unable to influence company direction and decisions effectively or to pursue private actions against the company in civil courts. The appraisal remedy in section 164 of the Companies Act 2008 is the result of this particular recommendation.

Section 164 allows dissenting shareholders, provided they follow the prescribed procedure⁴, to elect to be bought out by the company for fair value if the majority of shareholders of the company pass resolutions to:

- a) amend the company's Memorandum of Incorporation by altering the preferences, rights, limitations or other terms of any class of the company's

¹ For instance, under the Companies Act 61 of 1973 minority shareholders could rely on the oppression remedy in section 252 to protect them against unfairly prejudicial, unjust or inequitable conduct by the majority shareholders or by the board, and could apply to the court for an order that the other shareholders or the company buy-out their shares.

² Act 71 of 2008, hereinafter referred to as the 'Companies Act 2008'.

³ Published in *Government Gazette* 26493, General Notice 1183 dated 23 June 2004.

⁴ Discussed in paragraph 1.3 below.

shares in any manner materially adverse to the rights or interests of holders thereof,⁵ or

- b) enter into a transaction contemplated in sections 112 (proposal to dispose of all or the greater part of the assets or undertaking of a company), 113 (proposal for an amalgamation or merger) or 114 (proposal for a scheme of arrangement).⁶

These resolutions are collectively referred to as "triggering actions" for the remedy contained in section 164.

It should be emphasised that dissenting shareholders are not automatically entitled to hand in their shares and demand compensation under section 164 in the event of a triggering action.

1.2 Philosophical underpinnings of the appraisal remedy

The specific circumstances referred to above which allow for the appraisal remedy can be seen as situations where the relationship of the shareholders *inter se* and/or between management and shareholders in a company is subject to a "fundamental change"; in other words when power between those participants is fundamentally reallocated.⁷

The appraisal remedy is considered by some as a means of softening the provisions in company legislation which allow majority shareholders or a group of connected shareholders to effect fundamental changes.⁸ Majority shareholders are given the flexibility to fundamentally change the company but as a trade-off the minority shareholders are permitted to realise their equity if they believe such changes will threaten their rights or alter their expectation of their investment.⁹ Essentially, in this sense, the appraisal remedy's purpose is to provide liquidity to dissatisfied minority shareholders who oppose a fundamental change.

⁵ Section 164 (2)(a).

⁶ Section 164 (2)(b).

⁷ Kraakman R, Armour J, Davies P, Enriques L, Hansmann HB, Hertig G, Hopt KJ, Kanda H & Rock EB *The Anatomy of Corporate Law 2 ed* (Oxford University Press 2009) at 183.

⁸ Manning B 'The shareholders appraisal remedy: an essay for Frank Coker' (1962) *72 Yale Law Journal* 223 at 226.

⁹ Cassim FHI, Cassim MF, Cassim R, Jooste R, Shev J & Yeats JL *Contemporary Company Law 2 ed* (Juta 2012) at 699.

An alternative purpose of the appraisal remedy is to provide a means of ensuring minority shareholders are treated fairly in situations of fundamental change, especially situations which involve the acquisition of the minority shareholder's shares for a cash consideration.¹⁰ More specifically, it protects the minority shareholders from wrongful conduct by the controlling shareholder(s) or insiders of the company.¹¹ In the case of an acquisition through a fundamental transaction in the form of a merger or scheme of arrangement, for example, minority shareholders can use the threat of the appraisal remedy to challenge the offer consideration if they believe it does not represent the fair value of their shares. The existence of the appraisal remedy thereby provides an inducement to management and majority shareholders to ensure that any offer consideration approved by them reflects the fair value of the company. In such situations the purpose of the appraisal remedy is something more than an exit right. It has a prophylactic function whereby it discourages a controller or offeror from oppressing the minority shareholders by imposing an objective standard of fairness on the offer consideration.

As this dissertation will aim to demonstrate, the purpose that is ascribed to the appraisal remedy is significant in that it may substantially influence the manner in which a dissenting shareholder's shares are valued by the court in appraisal proceedings.

1.3 Involvement of the court in section 164 proceedings

At any time before a resolution proposing a triggering action is voted on, a dissenting shareholder may give the company a written notice objecting to the resolution in terms of section 164(3). Within 10 business days after the company adopts such a resolution, it must send a notice in terms of section 164(4) that the resolution has been passed to each dissenting shareholder who gave the company the aforesaid written notice of objection, provided that such dissenting shareholder did not withdraw its notice or vote in support of the resolution. If the dissenting shareholder satisfies these procedural requirements, and has voted against the resolution, he may make written demand within 20 business days after receiving the notice of adoption or the date of learning of the adoption of the resolution (if no notice of adoption is received), that the

¹⁰ Idem at 720.

¹¹ For example, management could have been offered incentives in the form of new employment benefits such as pre-agreed bonuses or side-payments in return assisting with the favourable timing of the vote to approve the fundamental transactions and general support for the deal. A controlling shareholder on the other hand may have been privy to inside information which assisted it in pricing or timing the deal.

company pay him the fair value of all of the shares held by him in the company.¹² In the case of an amendment to the company's Memorandum of Incorporation, the dissenting shareholder must also hold shares of the class that is materially and adversely affected by the amendments.¹³

Within five business days after the later of (i) the day on which the action approved by the resolution is effective, (ii) the last day for the receipt of demands by dissenting shareholders who received the adoption notice, or (iii) the date the company receives a demand by a shareholder who did not receive the adoption notice but who submitted a demand within 20 business days of learning of the adoption of the resolution, the company must send to the applicable shareholders a written offer to pay an amount considered by the company's directors to be the fair value of the shares of those shareholders, accompanied by a statement setting out how that value was determined.¹⁴

Section 164(16) provides that the fair value of shares must be determined as at the date on which, and time immediately before, the company adopted the resolution that gave rise to the aforesaid rights of dissenting shareholders. If the company fails to make such an offer to a dissenting shareholder within the prescribed periods, or if a dissenting shareholder considers the offer inadequate and the offer has not collapsed, he may apply to a court to determine a fair value of the relevant shares and an order requiring the company to pay the shareholder the fair value so determined.¹⁵ An application to the court as aforesaid must join all dissenting shareholders who have not accepted an offer from the company as at the date of the application and the decision of the court shall bind all such other dissenting shareholders.¹⁶ In hearing such an application the court must determine a fair value in respect of the shares of all dissenting shareholders, subject to the principle in section 164(16), and may in its discretion appoint one or more appraisers to assist it in determining the fair value in respect of such shares.¹⁷

¹² Section 164 (5)-(7). The demand must also be delivered to the Takeover Regulation Panel (section 164(8)).

¹³ Section 164 (5)(a)(ii).

¹⁴ Section 164 (11).

¹⁵ Section 164 (14).

¹⁶ Section 164 (15)(a).

¹⁷ Section 164 (15)(c)(i) and (iii)(aa).

The involvement of the courts in the appraisal procedure is therefore limited, presumably with the aim to make section 164 cost-effective and more appealing to minority shareholders.¹⁸

1.4 The significance of section 164 court appraisals

The risk to some companies is that if a large proportion of the dissenting shareholders elect to redeem their shares for cash in response to a triggering action, their election could financially cripple the company. Such debility would be undesirable at the sensitive, post-transaction stage of a transaction when creditors will need to be reassured.¹⁹ The appraisal remedy therefore has the potential to constitute a financial threat to a company.²⁰ Thus, in the case of a fundamental transaction where consideration is offered to shareholders the amount of such offer and whether it is recommended by management or approved by the majority shareholder, may be influenced by the amount which the company may be compelled to pay the dissenting shareholders under the appraisal remedy, however slight the risk, should the fundamental transaction be approved. On the other hand, in such fundamental transactions a minority shareholder will be encouraged to use the appraisal remedy if he is confident of the price he will receive for his shares.

Accordingly, should certain principles or methods of valuation be favoured by the courts in appraisal proceedings, such methods and principles will be relied upon by management, purchasers, minority shareholders and majority shareholders when making decisions in connection with such fundamental transactions based on the effect of the appraisal remedy.

It is therefore submitted that the determination of fair value by our courts, and the methods and principles laid down in doing so, will significantly influence the manner in which the appraisal remedy is treated by purchasers, management and both majority and minority shareholders in certain fundamental transactions.

¹⁸A court may only intervene in the section 164 procedure in one other instance, namely if there are reasonable grounds to believe that compliance by a company with subsection (13)(b), or with a court order in terms of subsection (15)(c)(v)(bb), would result in the company being unable to pay its debts as they fall due and payable for the ensuing 12 months (see section 164(17)).

¹⁹ Manning op cit note 8 at 234.

²⁰ Ibid.

1.5 The valuation of section 164 appraisal shares

The Companies Act 2008 does not provide any guidance on the method of valuation or principles to be used in determining the fair value of the shares of dissenting shareholders. It has been proposed that the considerations relied upon to ascertain the value of shares under the Companies Act 61 of 1973²¹, such as those in relation to compulsory acquisitions under section 440K and court orders for the buying-out of minority shares under section 252,²² may not necessarily lend themselves to an appraisal of shares under section 164.²³

This study examines the different share valuation methods and principles likely to be used by a court in determining the fair value of dissenting shareholders' shares under section 164 proceedings. The aim of this study is to make a case that section 164 court appraisals are likely to be guided by the valuation methods and principles developed in section 252 and section 440K court appraisals under the Companies Act 1973, as well as by the decisions of the courts in the state of Delaware relating to share valuations under the appraisal remedy. Furthermore, that the purpose ascribed to the appraisal remedy will influence the application of these valuation methods and principles.

A comparative study of valuation techniques used in appraisal remedy proceedings in the state of Delaware is included in this dissertation because of its pioneering role in the development of the law in this regard.

2. Judicial appraisal under the Companies Act 1973

Determining the fair value of a company's shares is not new to our courts. As will be seen below, there were a number of provisions in the Companies Act 1973 which permitted a court to decide on the fair price of shares.

²¹ Act 61 of 1973, hereinafter referred to as the Companies Act 1973.

²² See paragraphs 2.1 and 2.2 below for a discussion of these considerations.

²³ Cassim MF 'The introduction of the statutory merger in South African corporate law: majority rule offset by the appraisal right (Part 2)' (2008) 20 *SA Mercantile Law Journal* 147 at 168.

2.1 Relief against oppressive or unfairly prejudicial conduct in terms of section 252

Section 252 of the Companies Act 1973 permitted a minority shareholder to approach the court for relief in the event that a particular act or omission of a company, or the affairs of the company were being conducted in a manner which was unfairly prejudicial, unjust or inequitable to him or some part of the shareholders of the company.²⁴

If, pursuant to an application in terms of section 252, a court found that the particular act or omission, or the conduct of the affairs of the company was unfairly prejudicial, unjust or inequitable, the court could, if it considered it just and equitable and with a view to bringing the matter complained of to an end, make such an order as it deemed fit. The order could involve the regulation of the future conduct of the company's affairs or the purchase of the shares of the affected shareholders by other shareholders or by the company.²⁵

However, the most common form of relief sought by a complainant under section 252 was to be bought out by the company or the other shareholders.²⁶ This was unsurprising as by the time such a matter approached the court, the relationship of the parties had, more often than not, irretrievably soured.

When ordering such a purchase under section 252, our courts endeavoured to make the parting of ways as equitable as possible, principally by ensuring that the buy-out shares were purchased at a "fair price" and that the company or other shareholders could afford to comply with such an order.²⁷ The court would not order the company or a shareholder to purchase the claimant's shares without first satisfying itself that the company or shareholder was in a position to do so, and that an order to purchase would not render the purchaser insolvent or illiquid.²⁸ The fundamental consideration though was the method and amount of the "fair price" valuation.

²⁴ Section 252(1) of the Companies Act 1973. Section 252 has been replicated in the Companies Act 2008 in the form of section 163.

²⁵ Section 252(3) of the Companies Act 1973.

²⁶ Blackman MS, Jooste RD, Everingham GK, Larkin M, Rademeyer CH & Yeats YL *Commentary on the Companies Act* (Juta 2002) at 49.

²⁷ *Idem* at 50. Also see *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Collieries Ltd* 1983 3 SA 96 (A) at 120; *Hickman v Oban Infrastructure (Pty) Ltd & others* 2010 JOL 25176 (GSJ).

²⁸ *De Franca v Exhaust Pro CC* 1997 (3) SA 878 (SE); *Re Cumana Ltd* 1986 BCLC 430 (CA).

In developing the jurisprudence on the subject of "fair price" valuations under section 252, South African case law and academic literature have tended to rely on the numerous decisions emanating from the United Kingdom.²⁹ This reliance was because section 459 of the Companies Act 1985³⁰ was very similar in form and tone to section 252. As a result the law in South Africa on this subject was notably homogenous with that in the United Kingdom and, for that reason, this study has incorporated the decisions and financial principles of the United Kingdom in its analysis of "fair price" determinations in terms of section 252 buy-out orders.

Courts in the United Kingdom were given a wide discretion in buy-out orders provided they achieved a result that was fair to both parties having taken into account all the applicable facts.³¹ Accordingly in the United Kingdom there were no hard and fast rules that were strictly applied to all valuations; rather, the circumstances of each case dictated which principles of valuation and valuation methods were most appropriate.³² As a starting point, however, the fair price was generally considered to be the price of the complainant's shares as at the date of the court petition, had there been no unfair oppression or prejudice.³³ There were also other circumstances when an earlier date could have been chosen, for instance, where the unfairly prejudicial conduct had negatively affected the business of the company, where there was a reconstruction of the business of the company or if there was a general decline in the market for the shares following the date of the court petition.³⁴

While in theory the court was invested with the power to compute the "fair price" of the buy-out shares itself, in practice, the court would hear and weigh-up evidence submitted by financial experts. As in the United Kingdom, South African courts were reluctant to become enmeshed in matters of commercial judgment.³⁵ The source of

²⁹ Blackman op cit note 26 at 51; Meskin P, Kunst J, Schmidt KE & Henochsberg ES *Henochsberg on the Companies Act 61 of 1973* 5 ed (Lexis Nexis Butterworths Durban 1994) at 484.

³⁰ Companies Act 1985 (c 6), hereinafter "the Companies Act 1985". This section was replaced by the similarly worded section 994 of the United Kingdom's Companies Act 2006 (c 46).

³¹ Blackman op cit note 26 at 51; *Re Bird Precision Bellows Ltd* 1986 Ch 658 at 672.

³² Davies PL & Worthington S *Gower and Davies' Principles of Modern Company Law* 9 ed (Sweet & Maxwell Limited 2012) at 743; Blackman op cit note 26 at 51.

³³ Lord Denning in *Scottish Co-operative Wholesale Society v Meyer* 1959 AC 324 at 369, reaffirmed by Pennycuik J in *Re Jermyn Street Turkish Baths Ltd* 1970 3 All ER 57 at 67. Also see *Donaldson Investments Pty Ltd v Anglo-Transvaal Collieries Ltd* 1983 3 SA 96 (A).

³⁴ Davies & Worthington op cit note 32 at 43 referring to the decision of the Court of Appeal in *Profinance Trust SA v Gladstone* 2002 1 BCLC CA 243.

³⁵ Hicks A & Gregory A 'Valuation of shares: a legal and accounting conundrum' (1995, Jan *Journal of Business Law* 56).

evidence usually stemmed from expert valuers appointed by each party, and in some cases, the court took the further step of directing the company's auditor or an independent expert to perform the role of valuer.³⁶

When providing evidence, financial experts rely on a host of accounting formulae and conventions to support their conclusions. Section 252 valuations, however, could be distinguished from market transactions and other share valuations as their ultimate aim was to provide relief from unfairness or inequity. Accordingly, a number of specific rules on buy-out valuations have percolated from the case law, most important of which is the recognition that the market price of a share is not always the best indicator of its fair price.³⁷ As Preiss J remarked in the judgment of the court of first instance in *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Collieries Ltd: SA Mutual Life Assurance Society*³⁸, the present price of a share on the Johannesburg Stock Exchange does not necessarily represent its true value, especially in the case of large parcels of shares.

In light of this, other valuation methods were sometimes deemed more appropriate, such as a valuation based on the company's ability to generate earnings, historical dividends or net asset value.³⁹

The guiding principle remains that the circumstances of each case dictate which particular method of valuation is appropriate.⁴⁰ For instance, Preiss J in *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Collieries Ltd: SA Mutual Life Assurance Society* was of the view that the net asset value of a share was not an appropriate index for determining the fair price of shares in the circumstances before him.⁴¹ The Court held that the net asset value of the shares would place the disaffected shareholder in the same position as if the company were to be wound up with immediate effect, which *in casu* would lead to a price far in excess of the shares' actual value. The Court held that, in these circumstances, it would be more appropriate to

³⁶ Meskin et al op cit note 29 at 484, *Hickman v Oban Infrastructure (Pty) Ltd & others* 2010 JOL 25176 (GSJ).

³⁷ *Benjamin v Elysium Investments Ltd* 1960 3 SA 467 (E).

³⁸ [1979] 4 All SA 361 (W) at 383 - 384.

³⁹ See paragraph 3.2 below for a detailed consideration of these different valuation methods.

⁴⁰ Davies & Worthington op cit note 32 at 742.

⁴¹ *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Collieries Ltd: SA Mutual Life Assurance Society and Another Intervening* supra note 38 at 384.

assess the value of the shares on a dividend-yield basis rather than a net asset value basis.

Earnings-based methodologies appear to have been the favoured approach to valuing shares in section 252 buy-outs.⁴² But the use of these methodologies was by no means uniform. For instance, the question often arose as to whether dividends or corporate cash flow should form the basis of the earnings analysed by the experts. In the United Kingdom there was usually a preference for cash flow where the company was a "quasi-partnership", that is, where the owners of the shares took an active role in the running of the business, and a preference for dividends where the buy-out shares were owned by a silent shareholder.⁴³

2.1.1 Minority discounts

By far the most important question was whether it was appropriate to apply a discounted value to the buy-out shares of minority shareholders, what has been termed a "minority discount". Simply put, minority discounts are the discounts applied to the value of minority shares because they do not entitle the holder thereof to control the company.⁴⁴ In practice, a valuer chooses to value either the minority interest held by the shareholder, or the company as a whole divided by the percentage shareholding of the minority shareholder.⁴⁵ The former valuation results in a minority discount whilst the latter does not. It is worth pointing out that the quoted share price of a public listed company incorporates a minority discount given that the share price is quoted per single share.

A minority discount should be distinguished from a marketability discount, which reflects the compensation to the investor for the inability to convert the shares to cash at a later date.⁴⁶ Simply put, shares that incur large transaction costs or price concessions to sell are worth less than the same shares that are readily marketable.⁴⁷

⁴² Davies & Worthington op cit note 32 at 743; Hicks & Gregory op cit note 35 at 66; Griffin S 'Section 459 of the Companies Act 1985 and the valuation of shares' (1990) 11(1) *Company Lawyer* 16 at 16.

⁴³ Hicks & Gregory op cit note 35 at 67.

⁴⁴ Cassim MF op cit note 23 at 170.

⁴⁵ Wertheimer BM 'The shareholder's appraisal remedy and how courts determine fair value' (1998) 4 *Duke Law Journal* 613 at 641.

⁴⁶ Booth RA 'Minority Discounts and Control Premiums in Appraisal Proceedings.' (2001) 57 *The Business Lawyer* at 14; Bajaj M 'Firm value and marketability discounts' (2001) 27 *Journal of Corporation Law* 1 at 3.

⁴⁷ Bajaj idem at 3.

Shares are generally not readily marketable if there are relatively few shareholders holding the issued shares or relatively few issued shares remaining outside of a main block of shares beneficially held by a single party or small group of concert parties. In practice, valuers tend to first value shares as if they were marketable and then, afterwards, apply a marketability discount to the assessed value to the extent appropriate.

On the other hand, the price of shares held by a controlling shareholder reflects a "control premium", being the added value that a controlling block of shares gives its holder vis-à-vis the company. A question that normally arises in share appraisals is whether the valuation of the minority's shares should be adjusted upwards to incorporate a proportionate percentage of the control premium derived by a controlling shareholder following a transaction.⁴⁸

*Re Bird Precision Bellow Limited*⁴⁹ was the first English case which expressly dealt with the minority discount when valuing shares subject to an order issued in terms of section 459 of the Companies Act 1985. The decision of the Court of first instance, whose decision was affirmed on appeal by the Chancery Division, held that the question of applying a minority discount is a matter of law as opposed to a question to be decided by the valuer.⁵⁰ Further, given that the company *in casu* was essentially a quasi-partnership, it "would not merely not be fair, but most unfair" should the minority shareholder's shares be valued on the fictional basis that he was making a free election to sell his shares, and therefore at a discount.⁵¹ Rather, the method that was most fair would be to calculate the price of the shares on a *pro rata* basis according to the value of the shares as a whole, without applying any minority discount to the shares of the dissenting shareholder.⁵² The point of departure from such principle would be justified where the minority shareholder had acted in a delinquent manner which merited an exclusion from the company on a minority-discount basis.⁵³ The Court went to some length to emphasise that its approach was not a general rule against minority

⁴⁸ Wertheimer op cit note 45 at 646.

⁴⁹ 1984 1 Ch 419; affirmed 1986 1 Ch 658.

⁵⁰ 1984 1 Ch 419 at 436A.

⁵¹ *Idem* at 449.

⁵² *Ibid.*

⁵³ See also the decision of *Brownlow v G H Marshall Ltd & Others* 2001 BCC 152, quoted with approval in Eastaway N, Elliott D, Booth H, Eamer K & Kennedy S *Practical Share Valuation* 5 ed (Bloomsbury 2009) para 2.05.

discounts, but only suitable in the context of quasi-partnerships.⁵⁴ The principle of discounting a minority shareholding would still apply if the company is not a quasi-partnership or if the minority shareholder had bought the shareholding at a price which reflected its minority status or if such shareholding had been awarded by operation of law.⁵⁵ A minority shareholder who had invested without an expectation of management participation could not readily expect to avoid a minority discount on his exit from the company.⁵⁶

Thus, when valuing shares for purposes of a section 252 buy-out order, a minority shareholder's stake in a quasi partnership should have been deemed to be equivalent to a *pro rata* value of the company, without a minority discount.⁵⁷ On the other hand, if the minority shareholder held the shares as a silent investor it was suggested that it would be more appropriate to subject the valuation of his shares to a minority discount.⁵⁸ Nevertheless, there was no South African legal precedent that specifically defined those situations in which a minority discount would be deemed appropriate in a section 252 buy-out order valuation. However, in an obiter statement in the decision of *Robson v Wax Works (Pty) Ltd*⁵⁹ Binns-Ward AJ stated that he could see no reason why a court in making an order in terms of section 252 (3) could not, in framing that order, give appropriate directions that the applicant's shareholding be valued on a basis or formula which would address the prejudice suffered by the applicant.⁶⁰

2.1.2 Effect of the articles and shareholders agreements

Another factor that was considered in the valuation of the shares was the effect of the provisions of the company's constitutional documents or a shareholders agreement concluded among the shareholders of the company. By way of background, it was common to find pre-emptive provisions in shareholders agreements and articles of association that required a shareholder who wished to sell his shares, first to offer his shares to the other shareholders before he could sell them to a third party. These

⁵⁴ *Re Bird Precision Bellow Limited* supra note 50 at 450.

⁵⁵ Davies & Worthington op cit note 32 at 742.

⁵⁶ Hicks & Gregory op cit note 35 at 60.

⁵⁷ Hurter S 'Enkele aspekte rakende die waardasie van aandele by 'n bevel vir die aankoop van aandele ingevolge artikel 252(3) van die Maatskappywet 61 van 1973' (1998) 10 *SA Mercantile Law Journal* 183 at 192.

⁵⁸ *Idem* at 192.

⁵⁹ [2001] 3 All SA 546 (C).

⁶⁰ *Idem* at 560 para [51].

provisions usually provide for the shares to be sold at a price determined by a valuer, who is either nominated by agreement, or failing such agreement, by an impartial third party such as the president of the relevant regional law society. In some instances preemptive provisions even go so far as to prescribe the methodology to be applied by the valuer when making his determination.

It was submitted by Hurter that, based on the judgments in the United Kingdom, in South Africa a minority shareholder should use the voluntary sale mechanisms set out in the articles before approaching a court under section 252 for relief, and if the shareholder is dissatisfied with the outcome of the valuation, and believes it to be incorrect, the dissenting shareholder's remedy would be to sue the valuer for the negligent performance of his duties.⁶¹ In Hurter's view, to do otherwise would be to allow the shareholder to escape its commitments under the articles.⁶²

The question that has arisen in a number of English cases is whether it is appropriate for a valuer to have reference to such provisions when a court is assessing the fair value of the shares of an unfairly prejudiced minority shareholder. The first notable case in this regard was that of *Re Castleburn Ltd*⁶³ which concerned the removal of a director from the board who also happened to hold 44% of the shares in the company. A clause in the articles of the company stipulated that a director so removed was required to sell his shares at fair value on a willing-buyer, willing-seller basis, which by implication would result in the application of a minority discount.⁶⁴ The claimant applied to the court for relief under section 459 of the Companies Act 1985 arguing that the valuation should instead reflect 44% of the value of the net assets of the company. In his judgment Baker J disagreed with the claimant, and held that the articles were a crucial consideration when determining whether the valuation had been carried out correctly. Accordingly, the company had not unfairly prejudiced the claimant by incorporating a minority discount as it was implied by the valuation method stipulated in the articles of association, which was in essence a contract between the company and its shareholders.⁶⁵

⁶¹ Hurter op cit note 57 at 186.

⁶² Idem at 187.

⁶³ 1989 5 BCC 652.

⁶⁴ Griffin op cit note 42 at 16.

⁶⁵ Ibid.

The Court of Appeal in *Virdi v Abbey Leisure Ltd*⁶⁶, however, saw fit to draw a distinction from the general principle laid down in *Re Castleburn Ltd*⁶⁷. In this case, which concerned an application to wind up a company, alternatively to have the petitioner's shares bought out by the other shareholders under section 459, it was held that the valuation methods and principles agreed to by the parties in relation to voluntary sales were not necessarily applicable to sales by unwilling and aggrieved shareholders;⁶⁸ the point being that the right of a minority to a fair price would be significantly undermined if there was strict adherence to the principle in *Re Castleburn Ltd*⁶⁹. The distinction in *Virdi v Abbey Leisure Ltd*⁷⁰ was upheld and expanded in later judgments, with the effect that a section 459 petitioner in the United Kingdom is not automatically deemed to be unreasonable if he refuses to follow a contractual term governing valuation.⁷¹ Instead, each application was to be considered on the facts and, if merited, a section 459 petitioner would be entitled to an independent valuation notwithstanding any pre-agreed valuation methodology.⁷²

2.2 Compulsory acquisition of securities of minorities under section 440K

Section 440K was another section of the Companies Act 1973 which gave South African courts scope to consider the fair valuation of shares.

By way of short summary, section 440K applied to affected transactions⁷³ under the Companies Act 1973 and permitted an offeror, whose offer has been accepted by nine-tenths of the shareholders of the company in question, to give notice to the dissenting shareholders coercing them to sell their securities to him on the same terms as those applicable to the accepting nine-tenths. Such notice, however, could be challenged by

⁶⁶ 1990 BCLC 342.

⁶⁷ Supra note 64.

⁶⁸ Shapira G 'Valuation of shares in buyout orders' (1995) 16 (1) *Company Lawyer* 11 at 14.

⁶⁹ Supra note 64.

⁷⁰ Supra note 67.

⁷¹ See *Re a Company (No 00330 of 1991) Ex parte Holden* 1991 BCLC 597.

⁷² Shapira op cit note 68 at 15.

⁷³ Section 440A of the Companies Act, 1973 defined an "affected transaction" as a transaction the result of which the "control" of the company would shift to a person or persons acting in concert in whom control did not vest prior to such a transaction or that such a person or persons will acquire all of the securities, or all of the securities of a particular class, of the company, or would become sole owners of the securities. "Control" was further defined to mean the holding of securities in a company entitling the holders thereof to exercise the specified percentage (which was 35% under the Code on Takeovers and Mergers) or more of the voting rights at meetings of the company, irrespective of whether such holding gave *de facto* control or not.

the minority shareholders on application to a court within six weeks of the date of such notice. If grounds existed and circumstances permitted, the court could have either ordered that the offeror was not entitled to issue the coercive notice, or imposed conditions for the squeeze-out that were different from those of the offer.⁷⁴

2.2.1 Evaluating fairness in section 440K applications

In section 440K applications the court was fundamentally concerned with the fairness of the transaction brought before it,⁷⁵ and given that the value of the consideration was a useful indicator of fairness, the court's enquiry was usually focused on the true value of the targeted securities.⁷⁶ The reported decisions in this regard have a heightened significance for the purposes of this dissertation, as section 440K was concerned with takeovers and achieving fairness for dissenting shareholders. This is opposed to fair price determinations under section 252 which took into account the particular circumstances of a specific shareholder or shareholders with the aim of remedying prejudicial conduct and which were imbued with an element of restorative justice.

The most notable point of departure in section 440K enquiries was the guiding principle that a court, when evaluating the fairness of an offer, would consider whether the consideration was fair from the perspective of all the members whose securities were involved, not just the disaffected minorities.⁷⁷ In other words, the test of fairness was to be applied to the shareholders as a body and a court would not delve into considerations of whether it was fair to a particular shareholder in the context of his own unique or special circumstances.⁷⁸ It is submitted that in section 252 applications the special circumstances of the complaining shareholder were usually the basis of the claim of unfairness or prejudice. The consideration of such circumstances could not be divorced from the determination of the fair value of the shares of the complaining shareholder.

⁷⁴ Section 440K(1)(a)(i) and (ii).

⁷⁵ Meskin op cit note 29 at 987.

⁷⁶ Ibid and *Sammel v President Brand Gold Mining Co Limited* 1969 (3) SA 629 (A) where the Court held the enquiry into the fairness of the take-over essentially tapered down to the question of the reasonableness of the price of 60 cents per share *in casu*.

⁷⁷ Meskin op cit note 29 at 988; *Sammel* case supra note 76 at 670.

⁷⁸ *Re Grierson Oldham & Adams Ltd* 1968 CH 17 at 32.

2.2.2 Approaches to valuation under section 440K

It is notable though that in section 440K enquiries the courts did not tend to favour one method of valuation over others. Rather, it was recognised that a valuation is only an expression of opinion, which may "be made on one of a number of bases, but the final test of what is the value of a thing is what it will fetch if sold".⁷⁹

A few valuation principles have nevertheless emerged from our courts. For instance, if the target shares were traded on the stock exchange, the stock market price could be taken as a satisfactory indication of the value of the shares in question⁸⁰ provided, however, that such indication was not conclusive, but merely cogent, evidence of the true value of the shares.⁸¹

A point of difference between section 440K of the Companies Act 1973 and the dissenting shareholders appraisal rights in terms of section 164 of the Companies Act 2008 is that the onus was on the dissenting shareholder under section 440K proceedings to prove that the transaction was unfair. Given that at least 90% of shareholders had already accepted that the transaction was fair it was a heavy onus for the section 440K applicant to discharge.⁸² Conversely, in section 164 proceedings, the dissenting shareholder is not under any onus, but instead the court is left to determine the fair value of the shares.⁸³

2.2.3 **Sammel v President Brand Gold Mining Co Limited**

For a detailed summary of the approach of our courts to evaluating fairness of price for shares under section 440K evaluations, one need look no further than the judgment of the Appellate Division in *Sammel v President Brand Gold Mining Co Limited*.⁸⁴

*Sammel v President Brand Gold Mining Co Limited*⁸⁵ dealt with an application by certain dissenting shareholders of the company Free State Saaiplaas Gold Mining Co Limited ("Saaiplaas") who objected to a notice by President Brand Gold Mining Co

⁷⁹ *Re Press Caps Ltd* 1949 1 ALL ER 1013 at 1018.

⁸⁰ *Ibid.*

⁸¹ *Re Grierson Oldham & Adams Ltd* supra note 78 at 197, quoted with approval in the *Sammel* case supra note 76 at 649 and *Mia v Anglo-Alpha Cement Ltd* [1970] 1 All SA 11 (W) at 17.

⁸² Blackman op cit note 26 at 155.

⁸³ Section 164(14).

⁸⁴ *Sammel* case supra note 76.

⁸⁵ *Ibid.*

Limited ("President Brand") to compulsorily acquire their shares in terms of section 103 of the Companies Act, 46 of 1926 (the precursor to section 440K in the Companies Act 1973), following the acceptance by 93% of the Saaiplaas shareholders of President Brand's offer to acquire all of the shares of Saaiplaas for a consideration of 60 cents per share.

Prior to making the offer for the shares of Saaiplaas, President Brand had entered into an agreement with Saaiplaas and its loan creditors in terms of which it was agreed that Saaiplaas would reduce its share capital and create and issue new shares at par to its loan creditors in settlement of its loans. A term of the agreement required President Brand to make an offer to the shareholders of Saaiplaas for the entire issued share capital of Saaiplaas at 60 cents per share, which term was conditional on acceptance by at least 90% of the shareholders. It is worth pointing out that at the time of the agreement, Saaiplaas had a large, assessed tax loss and was laden with considerable loan debts; but following the implementation of the scheme, the outlook of both companies improved significantly.

In the decision of the court of first instance, the court found that the terms of President Brand's offer to the shareholders of Saaiplaas was fair and reasonable and accordingly dismissed the application. In coming to this conclusion, the court *a quo* took into account the relevant circumstances of the transaction, in particular the history and reasons for the take-over. What was most pronounced was the fact that the shareholders of Saaiplaas would have received nothing for their shares if Saaiplaas were liquidated on or before the offer.⁸⁶ The court *a quo* had emphasised that it was reluctant to base its valuation on events that transpired after the date on which the shares were to be valued.⁸⁷

The court *a quo* held further that a court's approach to share valuation should be to place itself in the shoes of a "hypothetical intending purchaser" who would be assumed to have made complete enquiries and would have access to the accounts and other information which would be available to him, or, in the case of a public company, assumed to have access to its published information, such as annual reports and

⁸⁶ *Idem* at 648.

⁸⁷ *Idem* at 649; Trollop JA quoting with approval the following passage from Estate Duty Case No.1 (1958), 23 SATC at 363: the valuer must "firmly reject the wisdom which might be provided by the knowledge of subsequent events".

accounts.⁸⁸ Confidential information which would not in the ordinary course be available to such a hypothetical purchaser and developments occurring after the take-over, should be ignored. The decision of the court *a quo* also stressed that when appraising shares, the value of the underlying assets is generally relevant only if the company in question is expected to go into liquidation or the offeror plans to put the company into liquidation following the implementation of the transaction.⁸⁹

On appeal to the Appellate Division, the appellants challenged the court *a quo*'s decision on the basis that an assessment of the fairness of the cash consideration should take into account the "profit potentialities" of Saaiplaas as at the date of the offer.⁹⁰ It was common cause, however, that the improvement in the position of Saaiplaas following the transaction could be attributed to the implementation of the scheme and new subsequent developments.

In responding to this argument, Trollip JA held that in assessing the fairness of the price offered, the court will concentrate on the value of the shares to shareholders of the transferor company and disregard the value of the securities to the offeror and any special or added profit potentialities that the company will have in its hands.⁹¹ Accordingly, the enquiry is focused on the inherent profit potentialities that the company would have in the absence of the potential synergies in the proposed acquisition. It was noted by Trollip JA that such a principle was well established in expropriation cases.⁹²

The Court drew the distinction between potentialities in the offer and potentialities divorced from the act of the offer. Only the latter would be recognised by a court when determining a fair price of the shares under consideration.⁹³ In conclusion, the Court found that on the probabilities evident at the time of the offer, the price offered for the

⁸⁸ *Idem* at 649.

⁸⁹ *Ibid.*

⁹⁰ *Ibid.*

⁹¹ *Idem* at 693, where it was said "one must ordinarily take the value of the shares to the shareholders of the transferor company with its own profit potentialities as at the date of the take-over bid, and not the value to the bidder with any special or added profit potentialities that the company will have in its hands".

⁹² *Ibid* quoting *Halsbury Laws of England*, 3 ed, Vol.10 at para. 157: "The purpose for which the undertakers intend to use the land is not such a use as can be considered in estimating the potential value, when that value is created or enhanced simply by the act or scheme of the B undertakers. The loss is tested by the value to the person from whom the land is taken, and not by the value to the persons acquiring it".

⁹³ *Idem* at 692-693.

shares was fair and reasonable, and that the appellants had failed to prove to the Court that it was unfair or inadequate.⁹⁴

3. Principles and methods of share valuation

The focus of a corporate share valuation is to determine the monetary amount attributable to a shareholder's proportional interest in the company.⁹⁵ By and large this is done firstly by ascertaining the intrinsic value of the company, and secondly by apportioning that value among the constituent shareholder interests.⁹⁶ The first step in this exercise involves a choice of valuation methods and principles. The choice of methodology usually turns on the circumstances of the case and the order being sought from the court but, as we will see, certain methodologies are generally preferred by financial experts and foreign courts.

After the first step has been completed, the focus is turned to the method of allocating the value among the shareholders. This second step takes into account factors such as control premiums, minority discounts and the nature of the event triggering the valuation.⁹⁷

It is virtually impossible to give full attention to all the various aspects of share valuation in this dissertation, and so this dissertation will focus on the more important methods and principles thought to be relevant to the topic under discussion.

3.1 General principles of valuation

Before the most influential valuation methodologies are analysed, it is worth summarising a number of valuation principles which have come to be accepted in international valuation practice.⁹⁸

⁹⁴ Idem at 694. Incidentally, the appellants had also contended that an offer of shares in President Brand would have been fairer than the cash consideration of 60 cents per share. The Appellate Division, though, dismissed such claim on three grounds: first, the values of respective shares were too disparate; second, major creditors would not approve the consideration shares; and third, Saaiplaas shareholders who wanted to remain invested could buy President Brand shares on the market with the money they received in terms of the takeover scheme.

⁹⁵ Krishna V 'Determining the Fair Value of Corporate Shares' (1987-1988) *Canada Business Law Journal* 132 at 136.

⁹⁶ Ibid.

⁹⁷ Ibid.

⁹⁸ This summary has been derived from Vern Krishna's article in the *Canada Business Law Journal*, see Krishna op cit note 95 at 136 onwards. These valuation principles are in addition to minority discounts, marketability discounts and control premiums discussed in paragraph 2.1.1 above.

First, it is trite that share valuation is time specific, that is to say the intrinsic value of a company and its apportionment amongst shareholders is determined by reference to a specific point in time.⁹⁹ Most notably, the appraisal of a publicly-traded share by market valuation techniques is heavily influenced by the time at which the appraisal is to apply. In this respect it is striking that the market value of a share prior to the announcement of a triggering action is markedly different from the value after the announcement.

Second, there is the rule that hindsight evidence is not admissible.¹⁰⁰ As seen in *Sammel v President Brand Gold Mining Co Limited*¹⁰¹, our courts are reluctant to take into account a valuation based on data gained only by hindsight. A valuation should focus on pricing a company's future on the basis of information available at the specific time of valuation. One must exclude information or evidence that arose or became public knowledge after the valuation date. By way of example, if a petroleum company discovers a large oil deposit after the valuation date, such information must be excluded from a share valuation, notwithstanding that such information may have influenced the future value of the company in the present. Hindsight evidence, however, should be distinguished from historical data available at the valuation date, which a valuer is perfectly entitled to rely upon when projecting the future value of a company.¹⁰²

Third, modern methods of share valuation focus on future expectations of the intrinsic value of a company. Given that these valuations are forward-looking, historical data are not the sole or absolute determinant when determining fair price, but only an indicator.¹⁰³ Rather, a prediction of value involves a number of enquiries, some of which are more concerned with historical fact than others. For instance, it would have been absurd to have valued a bank's shares in 2009 based solely on numbers generated by its performance up until the 2008 global financial crisis. It is for this reason that valuations are usually presented as a range of numbers each of which is premised on a variety of hypotheses.¹⁰⁴

⁹⁹ Krishna op cit note 95 at 136.

¹⁰⁰ Idem at 137.

¹⁰¹ Sammel case supra note 76.

¹⁰² Krishna op cit note 95 at 136.

¹⁰³ Idem at 138.

¹⁰⁴ Ibid.

3.2 Methods of share valuation

In the decisions and academic writing on the subject of share valuation, one often comes across the platitude that valuation is an art not an exact science.¹⁰⁵ Indeed, it is quite common for multiple experts to hold starkly different views on a particular valuation of shares.¹⁰⁶ Despite this, a valuer's findings are still expected to fall within a proper bracket of valuation.¹⁰⁷ In order to do so, it is crucial that the valuer choose the most appropriate valuation method for the circumstances under consideration.

What follows is a summary of valuation methods that have been applied by foreign courts in appraisal proceedings in the past. As is apparent from the analysis, some valuation methods are more suitable to section 164 appraisal proceedings than others.

3.2.1 Asset based valuations

As a starting point, the net asset value ("NAV") method of valuation is based on the premise that the shares in a company signify a proportionate claim of the company's residual assets.¹⁰⁸ The assets are residual in the sense that all liabilities and preference equity claims will be satisfied before a determination of value can be made.

There are generally two approaches to assessing the value of a company's assets: the book value approach and the liquidation value approach. As the name implies, the book value approach relies on the recorded values of the assets in the company's books of account, which values are arrived at by depreciating the historical costs of the assets in accordance with the generally accepted accounting practices at the time. This approach is considered inappropriate for court valuations as the book value tends to vary widely from the present value of the assets.¹⁰⁹ It may, however, prove useful in setting the "floor price" payable for the assets owned by a company.¹¹⁰

The liquidation value of the shares essentially involves substituting the current fair market value of the assets for the "book value" of those assets in the company's

¹⁰⁵ Idem at 135; *In re Appraisal of Shell Oil Co* 607 A.2d 1213 Del (1992) at 1221.

¹⁰⁶ Tude B 'Sweden: disputes over the valuation of shares in compulsory purchase' (1998, Sep) 39 - 40 *International Commercial Litigation* 52 at 56.

¹⁰⁷ *Axa Equity & Law Home Loans Ltd v Goldsack & Freeman* 1994 1 EGLR 175.

¹⁰⁸ Hicks & Gregory op cit note 35 at 62.

¹⁰⁹ Seligman J 'Reappraising the appraisal remedy' (1984) 52 *George Washington Law Review* 829 at 848.

¹¹⁰ Krishna V 'Determining the value of company shares' (1987) *Company Lawyer* 66 at 69.

balance sheet.¹¹¹ In the past the courts in the United States have offered contradictory methods of determining the current fair market value of a company's assets. In one judgment, the court ascertained fair market value by focusing on the depreciated reproduction cost of the assets.¹¹² Another decision relied on current appraised values of the assets but refused to acknowledge the values of fully amortised assets with income generating potential.¹¹³

It submitted that the most accurate method of valuing a company's assets would be to determine the current fair market value of each of the assets or asset classes on the balance sheet through the appointment of a number of specialised valuers.¹¹⁴ Admittedly, this approach could prove a costly and lengthy exercise, being especially disproportionate and unsuitable in situations where large diversified companies are being valued.

It should be kept in mind that the practice of asset appraisal is also not an exact science. Asset appraisal is a hypothetical exercise involving the consideration of posited factors which can prove disputatious. For instance, factors such as (i) the choice of the stage in the economic or seasonal business cycle when the assets are assumed to have been sold, (ii) whether the assets are appraised on an urgent "fire sale" basis or in the ordinary course of business, and (iii) the manner in which the assets are grouped for purposes of the sale, can all vary the outcome of the appraisal.¹¹⁵

It is submitted that the NAV method, and the liquidation approach in particular, is unsuitable for determining the fair value of shares in a company conducting a business as a going concern. A company that is both liquid and solvent should be considered as something more than merely an aggregation of its assets and accordingly be valued on a basis that takes this aspect into account. The exception seems to fall in those situations where the company is financially distressed and on the cusp of liquidation or business rescue proceedings. In such circumstances it would make sense to accord a break-up value to each of the assets. In the case of fundamental transactions, however, where it is envisaged that the business will continue as a going concern, it is

¹¹¹ Seligman op cit note 109 at 849.

¹¹² *Heller v Munsingwear* 33 Del Ch 593, 98 A.2d 774 (1953).

¹¹³ *Francis I DuPont & Co v Universal City Studios* Del Ch 312 A.2d 344 (1975) at 351.

¹¹⁴ Based on the assessment of current practice in the valuation industry, following an interview with AJ Naude, Managing Partner BDO South Africa.

¹¹⁵ Hicks & Gregory op cit note 35 at 62 - 63.

submitted that the assets should not be valued in a piece-meal fashion but should rather be valued in their entirety on a going-concern basis.

In summary, it is proposed that the net asset value method of valuation is generally inappropriate for valuing dissenters' shares in section 164 appraisal proceedings, except where the company in question is in financial distress or where the NAV can assist in mapping out a valuation range for the court.

3.2.2 **Market value**

This valuation method is concerned with the price that can be secured for the shares "on the market". In the case of private companies, available data of prices of recently sold similar-sized companies or businesses may be indicative of the market value of the private company being valued. But given that there is no publicly traded market price for private companies there is no check on whether this data is an accurate indicator of value.¹¹⁶ Accordingly, the market value method of valuation is more relevant in the context of public companies in South Africa whose shares are listed on the JSE Limited.

On the face of it, one could be forgiven for thinking that the quoted price of shares listed on a stock exchange such as the JSE Limited provides an unassailable indicator of the fair value of the shares at any given time. Indeed, advocates of the efficient markets hypothesis would assert that shares always trade at their fair value on stock exchanges, making it impossible for investors to either purchase undervalued shares or sell shares for inflated prices.¹¹⁷

The advantages of relying on stock market prices for purposes of share valuation are self-evident: they are easily accessible and cost nothing or little to determine. But, whilst stock market indices provide a useful repository of empirical data regarding historical share prices and the market's estimation of the present value of listed shares, it is doubtful whether they should be the sole determinant of the fair value of a dissenting shareholder's listed shares.

¹¹⁶ Hamermesh LA & Wachter ML 'The Fair Value of Cornfields in Delaware Appraisal Law' (2005) 31 *Journal of Corporate Law* 119 at 132.

¹¹⁷ See Fama E 'Efficient capital markets: a review of theory and empirical work' (May 1970) vol 25 *The Journal of Finance* 383.

There are a number of notable shortcomings of market valuations in the context of fundamental transactions. Generally it is trite that the market anticipates the impact of the fundamental transaction which is reflected in the share price. In particular, it is acknowledged that market prices may be distorted where the fundamental transaction involves a controlling shareholder.¹¹⁸ The market may factor a discount into the price of the shares in response to a perception that the controlling shareholder will mismanage the company's business, divert or underutilise the company's resources to suit its own ends or have the company engage in some other kind of opportunistic behaviour.¹¹⁹ A large controlling shareholder also results in fewer trades, less liquidity and in turn, a less reliable market price for the shares in the company.¹²⁰

The market value of shares is also at risk of being manipulated by the offeror or the board of the company in fundamental transactions. These actors control the timing of fundamental transactions and timing is crucial in terms of market valuation of shares.¹²¹ For example, a well timed offer by an offeror in a period of historically low share prices could result in an unfavourable market price for dissenting shareholders.¹²² Another example is of a board timing the fundamental transaction before favourable results are published, knowing full well that the share price at or before the fundamental transaction is not a true reflection of the value of the company. In a more sinister vein, directors or other insiders may conduct the business of the company in a manner that intentionally depresses the share price for the purpose of a fundamental transaction and its associated appraisal rights.

Another situation where the market value of a listed share is less convincing is where there is a thin market for the shares.¹²³ In other words, where trades in the shares are irregular or out-of-date. In such cases the illiquidity of the market counters the efficient markets hypothesis of fair value being inherent in the share price.

One must also acknowledge that bourses are susceptible to irrational influences manifested in extreme cases in shareholder panic or unbridled optimism, which are

¹¹⁸ Hamermesh LA & Wachter ML 'Rationalizing appraisal standards in compulsory buyouts' (2009) 50 *Boston College Law Review* 1021 at 1034.

¹¹⁹ Idem at 1035 and 1036.

¹²⁰ Wertheimer op cit note 45 at 640.

¹²¹ Idem at 636.

¹²² Idem at 636 - 637, referring to the case of *Berkowitz v Power/Mate Copr* 342 A.2d 566 NJ Super. Ct. Ch. Div. (1975) where a merger cashing out minority shareholders was timed to coincide with the historical low point in the market price of the company's stock.

¹²³ Seligman op cit note 109 at 843.

often unconnected with the earnings or asset value attaching to the underlying shares. As was noted in the judgment of the Delaware Court of Chancery in *Chicago Corp v Munds*,¹²⁴ there are too many accidental circumstances influencing the making of market prices to accept them as sure and exclusive reflectors of fair value. The share price of a listed company is capable of fluctuating dramatically over short periods, despite, in some cases, there being no meaningful change in the company itself or the industry in which it operates.¹²⁵ The relation of supply to demand of a share on a particular day is the true cause of the market value of the share; and temporary supply and demand are in turn affected by numerous circumstances which are completely disconnected from considerations related to the share's intrinsic worth.¹²⁶

In view of the above, one might conclude that there are too many potential accidental and intentional factors entering into the construction of market prices to accept them as "sure and exclusive reflectors of fair value".¹²⁷ It is submitted, however, that the importance of market value in court appraisals in South Africa will mostly depend on the nature of the market for the shares and, to a large extent, the prevailing judicial view of the purpose of the appraisal remedy and the approach of financial experts to share valuations.¹²⁸

3.2.3 Discounted cash flow

The discounted cash flow ("DCF") method of valuation is based on the theory that the value of a business or asset depends on the expected future net cash flows of that business or asset determined with reference to the cost of capital or discount rate.¹²⁹ The method applied consists of three distinct components: first, an estimation of net cash flows that the company will generate, and when, over some period; second, a terminal or residual value equal as at the end of projection period, which represents the value of the company's cash flows thereafter; and lastly, a cost of capital with which to discount to a present value both the projected net cash flows and the estimated

¹²⁴ Del Ch 172 A 452 (1934) at 455.

¹²⁵ Wertheimer op cit note 45 at 635. An example of a dramatic fluctuation was seen in the Johannesburg Stock Exchange all share index for the 21-week period from 24 May 2012 to 18 October 2012 which exhibited a low of R33 046.13 and a high of R37 051.95 *Business Day* website <http://www.bdlive.co.za/markets/> accessed on 20 October 2012.

¹²⁶ Supra note 124 at 455.

¹²⁷ Ibid.

¹²⁸ See the discussion in paragraph 6.3 below.

¹²⁹ Hicks & Gregory op cit note 35 at 63; Krishna op cit note 110 at 70.

terminal of residual value.¹³⁰ In simple terms, the process of discounting is essentially the converse of compounding.¹³¹

The "cost of capital" or "discount rate" is theoretically the rate of return that suppliers of capital – bondholders, lenders and owners – require as compensation for the contribution of their money or capital.¹³² Given that a company has a number of sources for raising capital, such as loan financing from a financial institution or issuing securities such as bonds or preferred or ordinary shares, the cost of capital usually reflects each component cost of capital, which, when weighted accordingly for the company, is known as the weighted average cost of capital ("WACC") of the company.

Discounted cash flow valuation can be explained more easily by the use of an example. Assume for purposes of this example that the WACC, that is, the cost of capital, is constant for the period under discussion. An investor, X, is owed an amount of R133 100 by Y which is payable in three years' time. X has other funds which he has invested at a current rate of interest of 10% per annum. If Y wishes to settle the loan in full today, it is obvious that Y should not offer to pay back the full amount of R133 100 to X, because such amount does not reflect the present value of the loan. If X had the cash today he could invest it and expect to receive a return on the investment in line with his other investments which are increasing at a rate of 10% per annum, understood as a rate of return of 1.1 on the principal amount per annum which extrapolates to a rate of 1.331 over a period of three years. In other words, if X had to invest R100 today at the rate of interest of 10% per annum he can expect to receive R133.10 at the end of the third year. In order to reach a present value we must therefore discount the future value or R133 100 by the expected rate of interest for the three year period, being 1.331. Accordingly, we divide the sum of R133 100 by 1.331 to reach a present value of R100 000.

¹³⁰ Thompson 'A lawyer's guide to modern valuation techniques in mergers and acquisitions' (1996) 21 *Journal of Corporation Law* 457 at 464 & 465, quoting the decision of *Cede & Co. Technicolor, Inc.* 1990 WL 161084 Del. Ch. Oct. 19, (1990) at 7.

¹³¹ Krishna op cit note 110 at 70.

¹³² Chartered Financial Analyst ("CFA") Program Curriculum *Corporate Finance and Portfolio Management* CFA Institute Volume 4 (Pearson 2008) at 38.

This example of the use of discounting to reach a present value can be reduced to the following formula:

$$P = \frac{F}{(1+i)^n}$$

where P = present value

F = future value

i = rate of interest per year

n = number of years

which is the converse of the formula for reaching future value by compounding, namely:

$$F = P(1+i)^n$$

There are a number of drawbacks to the DCF method of valuation. The first drawback is the assumption that the discount rate remains constant over the relevant period. The use of WACC as the cost of capital or discount rate is only suitable where the capital structure of the target or merged company is stable over time.¹³³ If the WACC fluctuates over the relevant period it will be an imprecise reflection of the company's cost of capital. For the purposes of this study it is worth noting that the WACC is susceptible to change following a fundamental transaction given the propensity of the target to change its capital structure or debt/equity ratios following implementation. This is most pronounced in acquisitions that impose a high level of debt on the target post implementation. Accordingly, the assumption that the cost of capital or WACC is likely to remain constant is unrealistic.

This is an important consideration in leveraged transactions given that the use of a constant WACC based on the first year's leverage ratio when the capital structure of a company is changing usually leads to an overvaluation of a minority's shares.¹³⁴ This is because a WACC calculation based on too much debt, which typically has a lower cost than equity, will result in a lower WACC with the effect that the cash flows will be higher giving an elevated value to the shares.¹³⁵ Admittedly, expert witnesses could

¹³³ Subramanian G 'Note, Using Capital Cash Flows to Value Dissenters' Shares in Appraisal Proceedings' (1998) 111 *Harvard Law Review* 2099 at 2106.

¹³⁴ *Idem* at 2106. This is put down to (i) calculating the interest tax shield based on the first year's leverage ratio will overstate its value, and the benefits of the interest rate tax shield is included in the discount rate; and (ii) using an unduly high leverage ratio will understate the WACC because the after-tax cost of debt is typically lower than the cost of equity.

¹³⁵ Subramanian *op cit* note 133 at 2106.

correct this imbalance by permitting the WACC to change from year to year but such assumptions are liable to lead to further disputes.¹³⁶

The other major drawback of DCF valuations is the wide spectrum of outcomes that may result from a slight difference in the cash flow forecasts or the discount rate used in the formula.¹³⁷ It is understood that estimating cash flows is a problematical task as it requires the valuer to consider both the rate of growth and the duration of growth expected of the cash flows of the company.¹³⁸ As a consequence a valuer may justifiably arrive at a number of cash flow forecasts, each of which when included in the formula can have a significant impact on the result.

Of more concern though is the impact on price when the discount rate is changed. For example, if the valuation is performed over a five-year period, a 1% change in the discount rate or WACC will reduce the value of the shares by 5%.¹³⁹ As noted in the United States case of *Cede & Co. v Technicolor, Inc*, experts using the same historical data in separate DCF valuations can arrive at results covering an astonishing range, from \$13.14 per share to \$62.75 per share, as was heard by the Court in that case.¹⁴⁰

In summary, whilst it is probably the most academically renowned form of financial valuation, the DCF model is imperfect in two respects: first, it is susceptible to diverging assumptions about the future and second, there are different methods of generating inputs for inclusion in the model. Regrettably, there is no case law or legislation in South Africa that provides a yardstick as to what assumptions or inputs are to be used in such valuations.

3.2.4 Earnings-multiple approach

In practice, valuers often use relative valuation techniques to determine the going concern value of a company.¹⁴¹ Many valuers use such techniques in conjunction with the discounted cash flow valuation models, given that it is possible to use the DCF method to arrive at values that are significantly above or below prevailing prices in the market depending on how the valuer adjusts his assumptions to the prevailing

¹³⁶ *Idem* at 2107.

¹³⁷ *Ibid.*

¹³⁸ Krishna *op cit* note 110 at 70.

¹³⁹ Subramanian *op cit* note 133 at 2107.

¹⁴⁰ *Cede & Co. v Technicolor, Inc* *supra* note 130 at 7.

¹⁴¹ Hicks & Gregory *op cit* note 35 at 62.

environment.¹⁴² The benefit of relative evaluation models, such as the earnings-multiple approach, is that they incorporate information about how the market is presently valuing shares which information combines a number of factors, such as the aggregate market, alternative industries and individual stocks within industries.¹⁴³

The earnings-multiple approach involves the determination of the net earnings of the company and applying the price-earnings ratio ("PER") of shares in similar companies in the same industry, which provide a marker of how much investors are willing to pay upfront for expected earnings in the future.¹⁴⁴ The purpose of such method is to apply appropriate analogues to the company being valued to arrive at an estimate of the value of the company as if it were traded on a stock exchange.¹⁴⁵

The first shortcoming of this technique is that it relies on current valuation data which do not acknowledge that the market valuation may be too high or too low at the particular point in time of the valuation.¹⁴⁶ The second shortcoming is that it is inappropriate when valuing smaller and unlisted companies to use the PER of larger companies, given that a smaller company's costs of capital are generally higher than those of a large company which would ordinarily result in a lower PER.¹⁴⁷ Accordingly, it is a common practice of valuers to apply a discount to the valuation of a small, unlisted company when using the PER of listed companies, as a means to acknowledge the lack of marketability of the unlisted company's shares.¹⁴⁸ Unfortunately, the amount of discount to be applied in this situation may lead to a dispute between different valuers.

In view of the above, it is submitted that relative valuation techniques could only be suitable in appraisal proceedings where, firstly, the valuer has access to information on a similar group of comparable companies which are analogous in respect of size,

¹⁴² Chartered Financial Analyst ("CFA") Program *Equity and Fixed Income* CFA Institute Volume 5 (Pearson 2008) at 176.

¹⁴³ Ibid.

¹⁴⁴ Hicks & Gregory op cit note 35 at 65 & CFA Program Curriculum op cit note 142 at 186.

¹⁴⁵ Hicks & Gregory op cit note 35 at 65.

¹⁴⁶ CFA Program Curriculum op cit note 142 at 176. The concerns in this regard are similar to those canvassed in para 3.2.2 above, dealing with market related valuations.

¹⁴⁷ Hicks & Gregory op cit note 35 at 65.

¹⁴⁸ Ibid.

industry and risk and, secondly, the industry in which the company operates is not at risk of being considerably overvalued or undervalued at the time of valuation.¹⁴⁹

3.2.5 Delaware block method

The Delaware block (or weighted average) method was a doctrine of valuation developed by the Delaware courts on the premise that no one method is conclusive of value and that each method should carry some weight.¹⁵⁰ Under the Delaware block method the value of a company is determined by assigning a weight to a number of factors to obtain a weighted average share value. The weighted factors are generally:

- a) the market value of the company before the triggering action;
- b) the value of the company determined by the earnings-multiple valuation technique discussed above;
- c) the net asset value of the company; and
- d) the value of the company based on its past dividend yield.¹⁵¹

The respective weightings assigned to each of the factors listed above are to be dictated by the surrounding circumstances of each valuation.

An academic on corporate law in the United States has gone as far as to label the Delaware block method as one that no professional analyst would deem acceptable.¹⁵² As will be seen in the following paragraphs, the Delaware block method has fallen out of favour in the courts of the United States.

4. The US approach to appraisal remedy valuations

The appraisal remedy is not unique to South Africa. Canada¹⁵³ and New Zealand¹⁵⁴, as well as all the states in the United States of America¹⁵⁵, have adopted legislation which provides an appraisal remedy to minority shareholders in certain situations of

¹⁴⁹ CFA Program Curriculum op cit note 142 at 176.

¹⁵⁰ Krishna op cit note 95 at 157.

¹⁵¹ Thompson op cit note 130 at 463.

¹⁵² Idem at 464.

¹⁵³ Canada Business Corporations Act, R.S.C. 1985 C.- 44.

¹⁵⁴ New Zealand Companies Act, 105 of 1993.

¹⁵⁵ See analysis in par 4 below.

fundamental change in the company. Furthermore, out of all the states in the United States, the state of Delaware has contributed more than any other to the development of the law in respect of the appraisal remedy, especially with regard to the principles governing share valuations.¹⁵⁶ This hegemony is hardly surprising given that more than 50% of all publicly traded companies in the United States are registered in Delaware.¹⁵⁷

It is instructive to note that historically Canadian and New Zealand courts have generally followed the decisions of the Supreme Court of Delaware regarding share appraisals.¹⁵⁸ Accordingly, given this trend and the appraisal remedy's relative novelty in South African law, it is submitted that South African courts can be expected to do likewise.¹⁵⁹ As such, it seems appropriate for this paper to concentrate on the valuation principles and methods arising from the courts in Delaware.

The appraisal remedy has existed in the United States in a number of state corporation statutes since the late 19th century.¹⁶⁰ Today all 50 states in the United States, as well as the District of Columbia, provide for an appraisal remedy in one form or another.¹⁶¹ Whilst the provisions of the relevant state statutes may differ in scope, on the whole they provide shareholders with the means to cash out their shares in certain defined situations for a price equal to the value of shares.

In a number of states the remedy's origin is regarded as a trade-off arising from the transition from the requirement of unanimous shareholder approval for certain fundamental changes, to the requirement that only majority or super majority shareholder approval be obtained. The remedy was seen as a means of compensating the individual shareholder for his loss of veto power over fundamental changes.¹⁶² In addition to this historical reason, the appraisal remedy also came to be seen as

¹⁵⁶ Schwenk MR 'Valuation problems in the appraisal remedy' (1994) 16 *Cardozo Law Review* 649 at 673.

¹⁵⁷ See www.corp.delaware.gov/aboutagency.shtml last accessed on 7 January 2014.

¹⁵⁸ Cassim MF op cit note 23 at 168.

¹⁵⁹ It should be noted that the Delaware Corporation Law Del. Code Ann tit 8, only grants appraisal rights to a dissenter in the event of a merger or consolidation. Appraisal rights do not apply to transactions where a majority or all of a company's assets are sold or the constitutional documents of the company are amended, as is the case under section 164 in the Companies Act 2008.

¹⁶⁰ Wertheimer op cit note 45 at 616.

¹⁶¹ Seligman op cit note 109 at 832.

¹⁶² Wertheimer op cit note 45 at 614.

performing a liquidity function for minority shareholders who, against their wishes, were locked into companies which had undergone a fundamental change.¹⁶³

Once the concept of majority rule in corporate affairs had become firmly entrenched in the United States, however, American jurists began to criticise the historical purpose of the appraisal remedy. Most pronounced of these critics was Manning who, in his seminal journal article of 1962, argued that the only justifiable rationale for the appraisal remedy was as an economic substitute for the stock exchange, and accordingly, its use should be limited to situations where an exchange or some other kind of reasonable market is unavailable.¹⁶⁴ In other words, the only acceptable purpose for the appraisal remedy was to perform a liquidity function for private, unlisted companies. In the years following Manning's article the appraisal remedy fell out of favour with the courts and a number of states adopted a stock-market exception that prevented the use of the appraisal remedy by shareholders in listed companies.¹⁶⁵

Notwithstanding these events, the US capital markets began to revolutionise in the last third of the 20th century and the use of fundamental transactions in business activity became more frequent and pronounced. These developments, coupled with a move from reliance on remedies in federal securities law to remedies in state legislation, brought the appraisal remedy to the attention of academics and businessmen who recognised it as an underutilised resource for protecting minority shareholders.¹⁶⁶ The appraisal remedy was seen by them as a means of deterring insiders from participating in inequitable conduct, and of remedying the position of minority shareholders who found themselves unwillingly drawn into fundamental transactions such as cash-out mergers, where the acquiring company purchases the target company's shares for cash instead of offering shares in the acquiring company as consideration.¹⁶⁷

The statutory appraisal remedy in Delaware Corporation Law permits a shareholder who objects to a fundamental change to commence an appraisal proceeding to

¹⁶³ Idem at 615.

¹⁶⁴ Manning op cit note 8 at 261.

¹⁶⁵ Mahoney PG and Weinstein M 'The appraisal remedy and merger premiums' (1999) 1 *American Law and Economics Review* 239 at 239; the American Bar Association Committee on Corporate Laws *Model Business Corporation Act Annotated* (Library of Congress Cataloguing-in-Publication Data 2005) at 13 - 20, notes that approximately half of the states have enacted market exceptions to their appraisal statutes.

¹⁶⁶ Wertheimer op cit note 45 at 621.

¹⁶⁷ Idem at 616.

determine the "fair value" of the shares of all the dissenting shareholders.¹⁶⁸ Typically, the term "fair value" was not defined in state legislation other than to provide that it is to be determined immediately before the effectuation of corporate action, and that any appreciation or depreciation in anticipation of the corporate action is to be excluded.¹⁶⁹

Whilst the term "fair value" itself does not provide any guidance to the courts on what method to use, a substantial precedent built up prior to 1983 in support of the use of the Delaware block method as the standard method of valuation.¹⁷⁰ This was predominantly because of the Delaware courts' desire for an analytical framework in which the valuation judgments of court-appointed appraisers could be identified and reviewed by the courts.¹⁷¹ The Delaware block method, however, was roundly criticised as doing a poor job of protecting minority shareholders and failing to accord with current financial valuation techniques.¹⁷² As a result minority shareholders in the US were inclined to rely on other remedies as a form of redress in situations of fundamental change, such as a breach of the directors' fiduciary duties towards the company.

All was to change in the pivotal 1983 decision of *Weinberger v UOP*.¹⁷³ Although the claim in *Weinberger v UOP* centred on an alleged breach of a fiduciary duty by the board of a merger target, the Supreme Court of Delaware chose to consider the use of the appraisal remedy in protecting minority shareholders.¹⁷⁴ In what can be considered a watershed dictum, the Court held that in subsequent proceedings dissenting shareholders should rather look to the appraisal remedy as a form of redress, instead of relying on a claim for breach of fiduciary duty.¹⁷⁵ To encourage the use of this approach, the Court held that exclusive reliance on the standard Delaware block method of valuation should be abandoned in favour of a more "liberal approach" that:

...includes proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court...[which] will

¹⁶⁸ See s 262 (a) and (e) of the Delaware Corporation Law Del. Code Ann tit 8.

¹⁶⁹ Wertheimer op cit note 45 at 626.

¹⁷⁰ Hamermesh & Wachter op cit note 116 at 124.

¹⁷¹ Idem at 5, citing *Jacques Coe & Co. v Minneapolis-Moline Co.* 75 A.2d 244 246 Del Ch (1950).

¹⁷² Wertheimer op cit note 45 at 625 & Thompson op cit note 130 at 463.

¹⁷³ 457 A.2d 701 Del (1983).

¹⁷⁴ Thompson op cit note 130 at 463.

¹⁷⁵ Ibid.

obviate the very structured and mechanistic procedure that has heretofore governed such matters.¹⁷⁶

The Court was intentionally vague about the exact measure of determining fair value but stressed that "fair price obviously requires consideration of all relevant factors involving the value of a company".¹⁷⁷ The Court was clear, however, that in determining fair value based on the relevant factors:

"only the speculative elements of value that may arise from the accomplishment or expectation of the merger are excluded,...but elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation may be considered".¹⁷⁸

It is worth noting that this approach accords with the approach adopted in *Sammel v President Brand Gold Mining Co Limited*.¹⁷⁹ Furthermore, it is significant that in the *Weinberger v UOP* case, the plaintiff's investment analyst used both the DCF method and a relative valuation model to value the company.¹⁸⁰

The effect of *Weinberger v UOP* was to restore the appraisal remedy as a means for minority shareholders to challenge a merger and, most importantly for our purposes, profoundly change the process of determining the "fair value" of shares by making it, in the opinion of American jurists, both reasonable and workable.¹⁸¹ State legislatures followed the lead of *Weinberger v UOP* by passing amendments to corporate legislation to encourage the use of the appraisal remedy by minority shareholders who risk being cashed-out at an unsatisfactory price.¹⁸² All of these developments combined to result in an uptick of appraisal-related activity in the United States.

Since *Weinberger v UOP* the decisions of the Delaware Court of Chancery have tended to favour the DCF technique as the foremost method of valuing shares under the appraisal remedy.¹⁸³ In particular, in the case of *Cede & Co. v Technicolor, Inc*¹⁸⁴,

¹⁷⁶ *Weinberger* case supra note 173 at 712 - 713.

¹⁷⁷ *Idem* at 713.

¹⁷⁸ *Ibid.*

¹⁷⁹ *Sammel* case supra note 76.

¹⁸⁰ Thompson op cit note 130 at 463.

¹⁸¹ Wertheimer op cit note 45 at 617.

¹⁸² Mahoney and Weinstein op cit note 165 at 257.

¹⁸³ Hamermesh & Wachter op cit note 118 at 1027 & Hamermesh & Wachter op cit note 116 at 124.

¹⁸⁴ Supra note 131.

the Court recognised the discount cash flow method in theory as the single best method to estimate the value of an economic asset and acknowledged that this method had become prominent with the implicit encouragement of the *Weinberger v UOP* judgment.¹⁸⁵ This is no coincidence given that the DCF analysis resonates with the current generation of business students who consider it the pre-eminent approach to valuing assets.¹⁸⁶

Notwithstanding that the DCF method it is the most prominent and frequently used valuation technique of the Delaware courts, it needs to be stressed that it is not the exclusive means of determining fair value.¹⁸⁷ The courts in the United States have used a variety of methods to determine fair value; the choice of method normally dictated by the circumstances in the case and being highly dependent on the evidence tendered by the parties.¹⁸⁸ Relative valuation methods, NAV and book value, as well as combinations of valuation methods have all been used by US courts following the *Weinberger v UOP* judgment. There are, however, a number of Delaware judgments that have held that the liquidation value of the company's assets should not be used as the exclusive method of determining the fair value of a dissenter's shares.¹⁸⁹

A number of valuation principles have also percolated from the Delaware case law. First, it has been made clear that "fair value" excludes any gains or potential gains arising from the merger.¹⁹⁰ This principle is similar to the conclusion in *Sammel v President Brand Gold Mining Co Limited*¹⁹¹ that was considered above. Control premiums are generally not a consideration in appraisal proceedings in the United States, as appraisal statutes invariably require the share valuation to be based on the value of the company prior to the proposed fundamental change.¹⁹² Shareholders are also not entitled to share in the anticipated benefits of the fundamental change.¹⁹³

¹⁸⁵ *Idem* at 7.

¹⁸⁶ Hamermesh & Wachter op cit note 118 at 1027 - 1028.

¹⁸⁷ Thompson op cit note 130 at 464.

¹⁸⁸ Wertheimer op cit note 45 at 628.

¹⁸⁹ Hamermesh & Wachter op cit note 116 at 151.

¹⁹⁰ *Idem* at 31.

¹⁹¹ *Sammel* case supra note 77.

¹⁹² *Idem* at 31.

¹⁹³ *Ibid.*

Furthermore, in the cases of *Cavalier Oil Corp v Harnett*¹⁹⁴ and *In re Appraisal of Shell Oil Co*¹⁹⁵ it was held that the aim of the appraisal remedy is to determine the value of the corporation as a whole and then to award the dissenter with the value of his shares on a *pro rata* basis. Thus the shares that a minority shareholder owns are legally equal to each and every other share of the same class and there is no reason to award the minority a lesser value for those shares merely because the minority does not exercise control of the company.¹⁹⁶ In other words, there is no justification for applying a minority discount to a dissenter's shares in appraisal proceedings.

Courts have acknowledged, however, that in some situations it would be appropriate to apply a marketability discount to a dissenter's shares where such discount would apply to all the shares of a company if they were sold.¹⁹⁷

Chapter 13 of the Model Business Corporation Act¹⁹⁸ ("MBCA") in the United States provides minority shareholders with an appraisal right in a number of situations of fundamental change. The MBCA is prepared by the Committee on Corporate Laws of the American Bar Association for use by state legislatures as a basis for revision of the state's corporation law or is adopted by the state legislature in its entirety.¹⁹⁹ What is most striking from a South African perspective is that the MBCA provides an appraisal remedy in the event of a merger, share exchange, sale of assets or upon certain amendments to the articles of incorporation.²⁰⁰ These trigger events are the same or similar to the trigger events in section 164(2) of the Companies Act 2008.²⁰¹

It should be noted though that the recommended provisions of the MCBA are not slavishly followed by many of the states which have chosen to adopt it. States have in a number of instances chosen to limit the number of triggering events for the appraisal

¹⁹⁴ 564 A.2d 1137 1144 Del (1989).

¹⁹⁵ 607 A.2d 1213 1218 Del (1992).

¹⁹⁶ Booth op cit note 46 at 1.

¹⁹⁷ Idem at 5.

¹⁹⁸ Model Business Corporation Act Annotated (4th ed, 2008) adopted and published by the Committee on Corporate Laws of the Section of Business Law, with the support of the American Bar Association, Section of Business Law.

¹⁹⁹ Goldstein E 'The Revised Model Business Corporation Act: Comment and Observation: Revision of the Model Business Corporation Act' (May, 1985) 63 *Texas Law Review* 1471 at 1471.

²⁰⁰ § 13.02 (a) (1) - (5) MBCA.

²⁰¹ The one comparison which is slightly different is between the MBCA share exchange trigger event and the section 114 trigger event (ie schemes of arrangement). But of course share exchanges are a common form of implementing a scheme of arrangement, so in this sense the comparison remains true.

remedy, for example Delaware restricts the use of the appraisal remedy to events of merger or consolidation.²⁰²

If the appraisal right is properly exercised the dissenting shareholder is entitled to the fair value of that shareholder's shares, "fair value" being the value of the corporation's shares determined (i) using customary and current valuation concepts and techniques and generally employed for similar businesses in the context of the transaction requiring appraisal; and (ii) without discounting for lack of marketability or minority status except, if appropriate, in respect of certain amendments to the articles of incorporation.²⁰³

It is noteworthy that the MBCA provides a market-exception where the dissenting shareholders can obtain fair value for the shares by selling them in the market.²⁰⁴ This exception is premised on the theory that an efficient market exists and that the markets in which the shares are traded is "liquid" and the value of the shares established by the appraisal-triggering event is "reliable".²⁰⁵ The market-exception has been adopted by approximately half of the states in the United States.²⁰⁶

5. South African court appraisals under section 164 of the Companies Act 2008

In view of the different approaches that are likely to be taken in respect of the valuation of listed and unlisted shares, this study shall consider each in turn in the South African context.

5.1 Listed shares

In a judicial appraisal of listed shares pursuant to an application to a court under section 164(14) to determine fair value in respect of shares that were subject to a dissenter's demand in terms of section 164(5) to (8), the question that is likely to preoccupy a court is whether the circumstances surrounding the triggering action justify a departure from the listed market price of those shares at the date on which, and time immediately before, the company adopted the resolution giving rise to the triggering

²⁰² Wertheimer op cit note 45 at 621.

²⁰³ § 13.01.4(ii) and (iii) MBCA.

²⁰⁴ § 13.02.(b)(1) MBCA.

²⁰⁵ American Bar Association op cit note 165 at 13-20.

²⁰⁶ Ibid.

action.²⁰⁷ This is because the listed market price of the shares would *prima facie* be the most persuasive indicator of fair value if the stock market is liquid and reliable at the time of the vote.

After receiving a demand from the dissenting shareholder as contemplated in section 164(7), the board must offer an amount considered by the directors to be the fair value of the dissenter's shares.²⁰⁸ Presumably this offer would be the higher of (i) the offer price under the transaction, if applicable, or (ii) the listed price of the dissenting shareholder's shares at the date on which, and time immediately before, the company adopted the resolution.²⁰⁹ Practically speaking, in the context of a fundamental transaction involving listed shares, a dissenting shareholder would only challenge this offer in court under section 164 (14) if he (i) deems the consideration offered in terms of the fundamental transaction inadequate, and (ii) believes that neither the listed share price on the day of the resolution nor the current listed price of the shares is a true reflection of the company's value.

There are a number of factors that may convince a court to depart from the listed market price as the benchmark for fair value of the dissenter's shares. In particular, if the dissenting shareholder could prove that there was no market for the shares or that the share price was artificially depressed as a result of the actions of insiders, the offeree or other shareholders, or even because of the announcement of the proposed triggering action itself.²¹⁰ The stock market is a less reliable indicator of value where there is an interested transaction or where there is the potential for self-dealing by a controlling shareholder or company insiders.²¹¹ But, one also needs to take into account that a premium on the stock market price is usually built into the offer price in a fundamental transaction. The premium is the price required to convince a sufficient number of different shareholders to pass the relevant resolution.²¹² It could also be

²⁰⁷ Section 164(16) of the Companies Act 2008.

²⁰⁸ As required by section 164 (11) of the Companies Act 2008.

²⁰⁹ The author has made this presumption as the board would struggle to justify an offer of a lower amount in the event of a challenge given the benchmark set by the listed price or the offer price.

²¹⁰ The circumstances surrounding the fundamental change could have been manipulated by insiders, the offeree, or by one or more substantial shareholders, with the result that the listed market price of the shares as at the date of the resolution, and immediately before it was passed is depressed. One must remember that those in control of a fundamental transaction have the ability to orchestrate the timing of the transaction, and the dates of significant events in the transaction, such as the date of the general meeting called to pass the resolution and the dates on which material conditions precedent are fulfilled.

²¹¹ Seligman op cit note 109 at 840.

²¹² Idem at 837.

seen as the control premium. It is arguable that when the appraisal rights are used in the protective sense²¹³, the listed share price should be adjusted upwards to take into account the inherent minority discount reflected in publicly listed shares.²¹⁴ As noted earlier, minority discounts are usually not applied in court appraisals in the US state of Delaware but this could be because of the protective purpose ascribed to the appraisal remedy in that state. If the purpose of the appraisal remedy is purely for liquidity, no such adjustment will be required. Another factor is that the size of the offer itself is likely to have a positive effect on the share price prior to the vote. As a consequence the listed price of the shares on the day of, and immediately before, the vote is likely to be inflated as a result of the offer.

Should the court accept that a market value of the shares is inadequate in the circumstances, it is submitted that it will follow the same line of enquiry as is taken in assessing the fair value of unlisted shares.²¹⁵

Nevertheless, one must also remember that fundamental transactions involving public companies are affected transactions subject to the Takeover Regulations in Chapter 5 of the Companies Regulations, 2011 published under the Companies Act 2008.²¹⁶ Regulation 110(1) requires the independent board of the offeree regulated company to obtain appropriate external advice from an independent expert in the form of a fair and reasonable opinion and regulation 90 provides that the offeree regulated company in section 112 (proposals to dispose of all or greater part of assets of undertaking) and section 113 (proposals for amalgamation or merger) fundamental transactions shall retain an independent expert if the Panel so requires. Section 114 also requires the company to retain an independent expert to compile a report stating all prescribed information relevant to the value of the securities affected by the proposed arrangement.²¹⁷ The independent expert's fair and reasonable opinion and report is intended to provide an added safeguard to minority shareholders against an unfair offer price. Obviously such an opinion and report will be acknowledged by a court in a

²¹³ Discussed in paragraph 5.3 below.

²¹⁴ Wertheimer op cit note 45 at 618.

²¹⁵ Which enquiry this dissertation shall consider in paragraph 5.2 below.

²¹⁶ Section 118(1)(b) of the Companies Act, 2008. Private companies are also subject to the Takeover Regulations if 10% of the issued securities of the company have been transferred, other than by transfer between or among related or inter-related persons, within the period of 24 months immediately before the date of the affected transaction (section 118(1)(c)). The Panel, however, usually is willing to exempt an offeror to an affected transaction if the target is a private company on the basis of the grounds in section 119(6)(a) - (c).

²¹⁷ Sections 114(2) and 114(3)(a).

section 164(14) application. It is telling that regulation 90(4) provides that an independent expert's valuation of the offeree regulated company must be performed in accordance with "generally accepted valuation approaches and methods in use in the market from time to time", including:

- a) "capitalisation, income or cash flow approach which relies on the "value-in-use" principle and requires determination of the present value of future cash flows over the useful life of the asset or business;
- b) comparative or market approach that relies on the principle of "willing buyer, willing seller" and requires that the amount obtainable from the sale of an asset or undertaking is determined as if in an arm's-length transaction; and
- c) cost approach that relies on historical amounts spent on the asset or undertaking."

It is significant that regulation 90(4) requires an independent expert to use the DCF method, a relative or market approach and a cost approach to determine the value of the company.

It is also worth mentioning that following the introduction of the Companies Act 2008 it has become standard practice in affected transactions for the offeror to make its offer subject to the suspensive condition that less than 5% of the shareholders exercise appraisal rights, such condition being capable of waiver by the offeror. The purpose of such a condition is to obviate the risk of dissenting shareholders frustrating the transaction through the exercise of appraisal rights and challenging the company's offer in court; it having been acknowledged that judicial appraisal is open to abuse by minority shareholders, who may initiate appraisal proceedings only to accept the company's offer on or before the court's determination of fair value.²¹⁸ An example of such a suspensive condition can be found in the scheme of arrangement proposed to Avusa Limited shareholders in 2012, which made the scheme conditional on not more than 5% of the Avusa Limited shareholders exercising their appraisal rights in terms of section 164(7) of the Companies Act 2008:

"within 30 Business Days following the general meeting, [...] provided that, in the event that Avusa shareholders give notice objecting to the Scheme as contemplated in section 164(3) of the Companies Act and/or vote against the resolutions proposed at the general

²¹⁸ Cassim op cit note 9 at 805 - 806.

meeting in respect of no more than 5% of the Avusa shares, this condition shall be deemed to have been fulfilled at the time of the general meeting."²¹⁹

The use of this suspensive condition has yet to be challenged under the anti-avoidance, exemptions and substantial compliance provisions of section 6 of the Companies Act 2008. It is arguable that the prevalence of this suspensive condition in fundamental transactions post 1 May 2011 may be the reason why there are no reported decisions of section 164 judicial appraisals of publicly-held shares.

Lastly, if market price is to be the sole basis of valuation, the timing of the valuation or the time period considered will be crucial. Fortunately, the Companies Act 2008 is unequivocal on the timing of share valuations. Section 164(16) stipulates that "the fair value must be determined as at the date on which, and time immediately before, the company adopted the relevant resolution". In the context of a market valuation, the phrase "time immediately before" appears to indicate that the closing price of shares on the date of the announcement is not conclusive if the announcement was made before market close. This requirement would also seem to exclude market valuations based on average prices of the shares in question.

5.2 Unlisted shares

Given that there is no easily accessible objective indicator of the value of a private company's shares, it is suggested that the determination of their fair value for purposes of appraisal proceedings is likely to be a contentious matter.

In view of the points made throughout this dissertation, the choice of valuation method applied by a court in a section 164 appraisal will depend largely on the circumstances surrounding the triggering action. Practically, this will be dependent on the evidence which is tendered by the parties for purposes of the section 164(14) application.

There are, however, a number of common threads in the reported cases on court appraisals that one can draw upon for guidance. First, the market value method, while persuasive, is susceptible to a host of unpredictable circumstances which tends to exclude it as a sole valuation method. Second, exclusive reliance on the net asset value of a company should also be avoided, unless the company is in serious financial

²¹⁹ Paragraph 6.2.4 of the Avusa Limited circular issued to Avusa Limited Shareholders on 18 July 2012 available at www.timesmedia.co.za/wp-content/.../AVUSA-CIRCULAR-FINAL.pdf

distress. Third, the prices obtained in the sale of similar businesses of a similar size to the company under consideration are persuasive indicators of fair value. Fourth, relative valuation methods such as the earnings multiple approach are useful provided there are analogous companies to be used as references and that the applicable industry is not positioned at a historical high or low point in its business cycle. Fifth, the Delaware block method or a variation thereof should not be used as it has been effectively discredited as a valuation method.²²⁰ Lastly, judging by international financial norms regarding share valuation and the legal sentiment emanating from the Delaware courts,²²¹ it would appear that the discounted cash flow method is likely to be favoured by the court and court-appointed valuers in the valuation of the dissenters' shares, provided there is no legitimate cause to value the company on a liquidation basis.

It is anticipated, however, that more than one valuation method will be used by expert valuers when presenting evidence of "fair value" to a court in order to corroborate the valuers' findings. For instance, the earnings multiple approach could be used as a sanity check on a DCF valuation.

It is submitted that the valuation methods and principles in relation to voluntary or compulsory sales agreed to by the dissenting shareholders and the company in shareholders agreements, or which are provided for in the Memorandum of Incorporation, are not to be used for purposes of determining fair value.

Finally, it is submitted that the most important decision to be made in determining fair value will be whether to apply a minority discount. Dissenting shareholders who have invested in the company without an expectation of control may be deserving of a minority discount. On the other hand, a minority shareholding in a quasi partnership is more likely to avoid the minority discount in section 164 court appraisals. However, as this study will indicate below, the purpose of the appraisal remedy will be a significant consideration in assessing the appropriateness of minority discounts or marketability discounts in section 164 share appraisals. Notably, given that the valuation is unlikely to factor in gains or potential gains arising from the fundamental transaction, it would be inappropriate for the dissenting shareholders to be awarded a share in the control premium that accrues to the new controlling shareholder in certain fundamental transactions.

²²⁰ See commentary in paragraph 3.2.5 above.

²²¹ See paragraphs 3 & 4 above.

5.3 The purpose of the remedy and its effect on valuation

It is submitted that the purpose of the appraisal remedy will be a fundamental consideration in section 164 court appraisals. As this study will explain below, the purpose of the appraisal remedy may affect the manner in which the court applies valuation principles, in particular, minority discounts, lack of marketability discounts and control premiums. Accordingly, I submit that it will be necessary for a court to distinguish the purpose of the appraisal remedy in each situation of judicial appraisal in order to justify its valuation.

Where the purpose of the appraisal remedy is to permit a dissenting shareholder to exit the company solely because the fundamentally-changed company does not accord with the dissenting shareholder's original investment, it could be said that section 164 serves a liquidity function. In this scenario a section 164 court valuation does not follow from a finding of prejudice or risk of prejudice. Instead, the appraisal remedy provides a mechanical, morally-neutral process to allow a minority shareholder to exit a company that has changed direction against his will. Moreover, the appraisal remedy ensures that the minority will not be prejudiced should he wish to exit, by guaranteeing a fair price for his shares. In this sense the appraisal remedy is seen as the trade-off for giving the company more flexibility to pass the resolution giving rise to the triggering action.

Where there is a risk of wrongful conduct by insiders or controlling shareholder(s) in a triggering action or where the triggering action results in the minority shareholders being forced to sell their shares or their rights being significantly diluted against their will, the appraisal remedy can serve a more protective purpose. It does so by acting as a safety net, ensuring that minority shareholders will always receive fair value, notwithstanding the wrongful or prejudicial conduct of other actors. This safety net can operate to discourage insiders or controlling shareholders from acting wrongfully in relation to triggering actions and minimise the risk of prejudice to minority shareholders who may be significantly diluted or squeezed-out as a result of the triggering action. If Delaware case law is any indication, we are likely to see the appraisal remedy used for the purpose of protecting dissenting minority shareholders in fundamental acquisitions where the dissenting minority shareholders are forced, against their will, to sell all or some of their shares to a purchaser pursuant to a resolution passed by the majority of shareholders.

It is worth noting that section 164(15)(c)(ii) requires the court to determine a fair value in respect of the shares of all the dissenting shareholders. Accordingly, there will be no scope for the court to examine the particular circumstances of each of the dissenting shareholders. If inequitable conduct is to influence the valuation it will have to affect the dissenters generally.

Where the purpose of the appraisal remedy is simply to provide a liquidity function, the established case law on court valuations under section 252 and section 440K of the Companies Act 1973 is likely to be unpersuasive, given that those valuations were performed in response to actual or potential prejudice.²²² Inversely, it is submitted that the established rules developed and applied in section 252 and section 440K judicial appraisals are likely to be instructive when the purpose of an appraisal remedy is to protect minorities.

With respect, I do not agree with the contention of Cassim²²³ that the factors and considerations applicable to court valuations under section 252 and section 440K of the Companies Act 1973 cannot be applied to court valuations under the appraisal remedy because the former do not involve a willing seller. It is possible that the appraisal remedy may be used in situations where a dissenting shareholder is forced to sell all or some of his shares against his will pursuant to a triggering action. For example, schemes of arrangement in terms of section 114 and mergers under section 113 that involve an offer for a portion or the entire issued share capital not already held by the offeror will, if approved by the shareholders, result in the dissenting shareholders being forced to sell their shares to the offeror against their will. In these situations the appraisal remedy is relied upon to ensure that a fair price is obtained for the dissenter's shares. In short, the dissenting shareholder is still being forced out against his will but may rely on the appraisal remedy to correct the offer consideration to the extent it is unfair.

Moreover, section 252 share appraisals were used to remedy the position of the minority shareholder who suffered prejudice at the hands of the company or a person related to the company. It is submitted that parallels can be drawn between the aims of these different appraisal proceedings.

²²² Cassim op cit note 9 at 809 para 16.13.5.

²²³ Ibid. See also Cassim MF op cit note 23 at 168.

If the appraisal remedy serves a protective function a court is likely to refrain from applying a minority discount or marketability discount to a dissenter's shares. Failure to accord a minority shareholder the full proportionate value of his shares would impose a penalty for lack of control and could potentially enrich the majority shareholders who would reap a windfall from the appraisal.²²⁴ This clearly would be unacceptable in situations where a minority deserves to be protected, such as those situations where the dissenting shareholder is forced to sell his shares against his will or his rights are at risk of being diminished or adversely affected as a result of a triggering action. As was seen in the section 252 and section 440K decisions, a minority discount is inappropriate where the minority shareholder has been forced out or was materially prejudiced by the behaviour of the company.

On the other hand, if the application of the appraisal remedy is solely to provide liquidity (in the absence of a risk of wrongful conduct or prejudice), the application of a minority discount or marketability discount to the relevant shares may be appropriate, as the appraisal remedy in this context is simply aiming to replicate a realistic market for the shares.

5.4 Problems with expert valuers

One of the primary difficulties that will face a court in section 164 appraisal proceedings is having to navigate the opinions of different expert valuers to reach a fair value of the dissenters' shares. It has been recognised that the expert valuations put forward by each party in appraisal proceedings are prone to partiality given that expert valuers are hired to produce a valuation complimentary to their client's case. This lack of impartiality can be blamed for divergent outcomes even when the same methodologies are applied by the expert valuers.²²⁵ A good example is the manner in which the choice of future cash flow assumptions can produce radically different valuations under the DCF valuation method. Experts' testimony is likely to diverge even further where different valuation methodologies are applied.

This concern was echoed in US judgment of *MPM Enterprises, Inc v Gilbert*²²⁶, which noted the following:

²²⁴ *Cavalier Oil Corp v Harnett* supra note 194 at 1145.

²²⁵ *Idem* at 630.

²²⁶ No. 14416, 709 A.2d 663 Del Ch Lexis 141 (1997).

One might expect the experts' desire to convince the Court of the reasonableness and validity of their assumptions and financial models would produce a somewhat narrow range of values, clearly and concisely supported, despite the individual parties' obvious conflicting incentives. Unfortunately [...] one should not put much faith in that expectation, at least when faced with appraisal experts in this Court.

The more credible opinion of the various opinions submitted by expert valuers is likely to be accepted by the court as reflecting "fair value". But a court is not bound to choose between expert valuations. A court could justifiably construct its own valuation based on the experts' testimony. The key to this dilemma may be for the court to appoint an independent valuer to value the shares. Indeed, section 164(15)(c)(iii)(aa) grants the court the discretion to appoint one or more appraisers to assist it in determining the fair value in respect of the shares.

A court must nevertheless guard against placing too much reliance on the independent expert's testimony.²²⁷ The responsibility to determine fair value is the court's alone and cannot be delegated. Moreover, the court must be mindful that appointed experts will ratchet up the costs of the application and may extend the duration of the proceedings unnecessarily.²²⁸ Thus a court-appointed independent expert may not always be appropriate in section 164 appraisal proceedings and the powers in section 164(15)(c)(iii)(aa) must be exercised with due regard to the rights and justifiable expectations of the parties to the appraisal proceedings.

6. Conclusion

With the introduction of any new statutory legal mechanism into our law there is always going to be a degree of uncertainty as to how it will be interpreted and applied by the courts. The purpose of this dissertation is to investigate and consider the sources that are likely to influence the courts in determining the fair value of dissenters' shares in appraisal proceedings.

It is submitted that the courts are expected to rely on the significant wellspring of case law from Delaware, especially in the context of fundamental transactions. As a result, earnings valuation methods are likely to take a pre-eminent position in the valuation of dissenters' shares. Other valuation methods, or a combination of valuation methods,

²²⁷ Wertheimer op cit note 45 at 701.

²²⁸ Ibid.

may be applied should the circumstances of the case demand them, provided always that they meet the requirement of being generally considered acceptable in the financial community and otherwise admissible in court. In particular, stock market prices will be a reliable indicator of the value of listed public company shares but will not be conclusive evidence of the shares' true value and may need to be adjusted upwards to take into account the minority discount inherent in the listed share price.

Further, it is submitted that the court's interpretation of the purpose of the appraisal remedy is likely to influence the application of valuation methods and principles by the court. The purpose of the appraisal remedy will also determine whether it is appropriate to rely on past South African judgements involving judicial appraisals. It is suggested that to the extent that the triggering action involves the risk of inequitable conduct or the prejudice of minority shareholders, the decisions of our courts in share valuations under section 252 and section 440K applications under the Companies Act 1973 may provide valuable assistance to courts in appraisal proceedings under section 164. Furthermore, the wealth of case law in the United Kingdom in respect of the corresponding sections of United Kingdom Companies Acts, past and present, should also prove to be a useful repository. It is submitted that the application of minority discounts, in particular, will depend on the purpose of the appraisal remedy.

Finally, it is submitted that the expense of initiating and proceeding with a judicial appraisal is likely to affect the use of the appraisal remedy by minority shareholders. In respect of fundamental transactions involving offer consideration, there is also the risk that the court appraisal could be stalled by the company, leaving the dissenting shareholder empty-handed for the period in question whilst the non-dissenting shareholders receive the offer consideration. Given these drawbacks and other uncertainties highlighted in this dissertation, it is submitted that dissenting shareholders are likely to discount the "fair value" of their shares to take into account the risk that the court valuation will not meet their expectations, leading them to accept an offer from the company that meets or exceeds their own discounted valuation of their shares.

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Title of thesis:

THE APPRAISAL REMEDY AND THE DETERMINATION OF FAIR VALUE BY THE COURTS

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Abstract of thesis

This paper examines the different share valuation methods and principles likely to be used by a court in determining the fair value of dissenting shareholders' shares in appraisal proceedings in terms of section 164(14) of the Companies Act 2008. It is submitted that the valuation principles and methods used by the courts will affect the operation of the triggering actions contemplated in subsections 164(2)(a) - (b).

It is proposed that section 164 court appraisals are likely to be guided by the valuation methods and principles developed in section 252 and section 440K court appraisals under the Companies Act 1973, as well as by the decisions of the courts in the state of Delaware relating to share valuations under the appraisal remedy. It is further proposed that the purpose ascribed to the appraisal remedy will influence the application of these valuation methods and principles.

Key terms:

Section 164; Companies Act 2008; appraisal remedy; purpose of appraisal remedy; court appraisals; judicial appraisals; court valuations; share valuation methods; section 252; Sammel v President Brand Gold Mining Co Limited; section 440K; Companies Act 1973; Delaware Corporation Law; Weinberger v UOP.