



Insights

Indiana Supreme Court Affirms Freedom of Contract Principles in Closely Held Company Valuation Case: Choose Your Words Carefully

February 2, 2021

By: Robert A. Greising and Virginia A. Talley

On January 28, 2021, the Indiana Supreme Court affirmed freedom of contract principles and upheld discounts of over thirty percent in the fair market valuation of shares in a dispute over the buyback provision in a shareholder agreement among all of the shareholders of a closely held company. In *Hartman v. BigInch Fabricators & Construction Holding Company, Inc.*, No. 20S-PL-618, 2021 WL 325883 (Ind. Jan. 28, 2021), the Supreme Court unanimously held that the plain language of the shareholder agreement contemplated the fair market valuation of the selling shareholder's shares and that a third-party appraiser could apply minority and marketability discounts in the valuation of those shares. The Supreme Court rejected the plaintiff's claims that the discounts should not have been applied.

This case underscores the importance of carefully choosing the words to describe the exit values in a "buy-sell" agreement. The parties can freely negotiate those terms and will be held to the bargain they struck.

Background of the Case

In 2006, all shareholders of BigInch Fabricators & Construction Holding Company, Inc. ("BigInch"), including Blake Hartman ("Hartman"), agreed to be bound by a contract containing a buyback clause. In the event a shareholder was involuntarily terminated, the buyback clause required BigInch to repurchase that shareholder's shares at "appraised market value," as determined by a third-party valuation company applying commonly accepted accounting principles. Prior to his termination, Hartman was an officer and director of BigInch.

Hartman's involuntary termination in 2018 triggered an obligation of BigInch to purchase his shares. BigInch hired a third-party appraiser to determine the fair market value of Hartman's shares. In conducting the valuation, the appraiser discounted Hartman's shares for their lack of marketability and lack of controlling interest in BigInch, decreasing the total value of Hartman's shares by over \$1 million. Hartman sought a declaratory judgment that the marketability and minority discounts applied were improper because the buyback provision of the shareholder agreement did not contemplate a "fair market value" standard. Rather, Hartman argued that his shares should be valued at "market value" and that such discounts did not apply to the closed-market sale of his shares.

Court Rulings

The trial court entered judgment for BigInch based on the language of the buyback clause, but the Indiana Court of Appeals reversed, holding that marketability and minority discounts could not apply to a closed-market sale. However, the Supreme Court sided with BigInch and vacated the Court of Appeals' decision. In so doing,



the Supreme Court distinguished the case law upon which Hartman relied to support his arguments and held that there is no “blanket rule” that such discounts do not apply to closed-market transactions. The key consideration for the Supreme Court focused on the shareholders’ agreement to value the shares at their “appraised market value.” The Supreme Court then found that the term “market value” plainly and unambiguously refers to, and has historically been used interchangeably with, “fair market value.” As a result, because a fair market valuation of shares includes appropriate discounts and because the Supreme Court found that valuation terms contemplated by the shareholder agreement were equivalent to “fair market value,” the value of Hartman’s shares could be discounted for lack of marketability and minority status.

In a prior case, *Wenzel v. Hopper & Galliher, P.C.*, 779 N.E.2d (Ind. Ct. App. 2002), the Indiana Court of Appeals had declined to apply such discounts to the closed-market sale of shares. The *Wenzel* case focused on a determination of “fair value” in connection with a statutory valuation process. The Court of Appeals in *Wenzel* refused to apply discounts when determining “fair value” in order to avoid a windfall to the continuing majority interests. In contrast, *Hartman* differed because it involved a contract among the parties that clearly reflects an agreed upon basis for valuing the shares to be acquired, namely the shares’ “market value.”

The Supreme Court also recognized that, in extraordinary cases, a contract’s plain language need not be enforced where such enforcement would lead to some absurdity or inconsistency with the rest of the agreement. In the case under consideration, however, interpreting the shareholder agreement to allow marketability and minority discounts leads to a result that was clearly contemplated by the plain language of the shareholder agreement. As the Supreme Court noted, “all of the company’s shareholders agreed years ago to be equally bound by the agreement’s terms . . .” and “the plain and unambiguous language of the shareholder agreement calls for BigInch to pay Hartman the fair market value of his shares.”

Takeaways

Hartman affirms long-standing freedom of contract principles in Indiana, which permit parties to set values and value methodologies for shares in agreements with buyback provisions. Further, this case affirms that a market value standard includes marketability and minority discounts and that such fair market discounts can apply to the closed-market sale of shares when agreed by the parties.

In an arm’s length shareholder situation, a contract’s provisions for valuing shares will govern. Parties have wide flexibility in setting up buyback provisions and formulas for share valuation, and parties should thoughtfully evaluate and clearly define the terms for buyback provisions used in operating agreements, buy-sell agreements, option agreements, and the like. The parties can use a market value concept that would allow applicable discounts to be considered, but they can just as easily agree for shares to be valued on an enterprise basis without discount. Indeed, *Hartman* seems to support an ability to parse the valuation process even more discretely and to allow agreements to use different values and discounts or premiums in different circumstances as the parties see fit.

Hartman also suggests that parties may want to revisit their valuation provisions currently in play. The dispute over the subject agreement, which was put in place in 2006, did not arise until 2018. Thus, *Hartman* reinforces the notion that even agreements long in the tooth will be enforced as representative of the intent of the parties.

We note that the Supreme Court allowed other precedent to stand, though effectively distinguished by its holdings in *Hartman*. This case appears to not overrule statutory appraisal processes or other public policy considerations. Also, other scenarios involving valuations, such as transfers among related parties for estate tax or gift tax purposes, may not fall within the Supreme Court’s holding.

As demonstrated by the approximate one-third discount applied to Hartman’s shares in this case, valuation methods can have significant impacts on the value of one’s shares and cry out for careful word-crafting when



preparing agreements with valuation provisions.

If you have any questions regarding contents found in this alert, please contact **Robert A. Greising**, or **Virginia A. Talley**.

Disclaimer. The contents of this article should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult with counsel concerning your situation and specific legal questions you may have.