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Marmer Penner Inc. Newsletter

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Can Insider Information Known Only to One Party Be Considered In a Valuation? (Part II)

Last month, we reviewed the appropriateness of using insider information known only to one party in a valuation by examining the well known tax cases *Hinchcliffe v. Crabtree* 1971 2 *All. E.R* and *National System of Baking of Alberta Limited v. The Queen* 1978 DTC 6018.

More recently, the appropriateness of considering insider trading was debated in *LeVan v. LeVan* 2006 CanLII 31020 (ON S.C.), a case better known for the legal issues pertaining to marriage contracts. In *LeVan*, the husband and his direct family owned multiple voting shares in a publicly traded company such that the family controlled 87% of the votes on the date of separation. The remaining 13% of the votes were widely held by the public and were traded on both the Toronto and Nasdaq stock exchanges. The public company was a manufacturer of exhaust manifolds for the major automobile manufacturers. Historically, the company had three major customers: General Motors, Ford and Chrysler. Several months prior to the date of separation (in or around April 2003), Ford notified the company that it was not going to renew its contract with the company and that it was going to move its business to a Chinese competitor. This knowledge was not public on the date of separation (October 2003). The valuator for the wife calculated the value of the husband's interest on the date of separation by multiplying the public market share

price by the number of shares that were directly or indirectly held by him. The valuator for the husband disputed the approach taken by the wife's valuator, and argued that a valuation based on the share price was inappropriate given the significant insider information that existed on the valuation date that would likely impact the share price if it was made public. Furthermore, the husband argued that, as an insider with material insider information, he was precluded from selling his shares because he was subject to a "blackout window" under securities law. However, an en bloc valuation of the public company was not prepared on behalf of the husband, because it was his position that he was not required to prepare one under the marriage contract. Because the Court set aside the marriage contract, the only evidence before it was the calculation of value based on the share price. Furthermore, the Court found that the wife's valuator was not provided with the necessary information and access to management required to do an en bloc valuation. Accordingly the Court accepted the value based on the share price, notwithstanding the insider information that was present on the date of separation.

Although the findings in *LeVan* relied on the public trading price, it did so at least partially because that is all the Court had to rely on - time will tell if a different case with similar facts distinguishes between the use of the share price to calculate the value of a business interest and an en bloc approach to value when there is significant insider information that is present on the valuation date.

Another yet-to-be-litigated issue is the appropriateness of valuing employee stock options using the generally accepted *Black-Scholes* formula, when the owner of the employee stock options is privy to insider information. For employee stock options, the relevant definition of value is "value-to-owner", which is defined as follows:

> *The economic advantage to the owner regardless of a property's transferable nature, or, the measure of loss to the owner if the property was removed rather than what an arm's length party would pay for that asset.*

In *Ross v. Ross* 2006 CanLII 41401 (ON C.A.), the Court of Appeal endorsed the use of the *Black-Scholes* formula in valuing employee stock options, which is appropriate as long as the owner of the employee stock options is not privy to significant insider information. Is the use of *Black-Scholes* appropriate otherwise?

An implicit assumption in the use of the *Black-Scholes* formula is that its user only has access to the public information that is available on the date that the options are being valued. Since stock options are granted to CEO's and insiders, who are often privy to information that is not public, the use of the *Black-Scholes* formula for all cases may not be appropriate. If the owner of the employee stock options is privy to significant insider information on the relevant valuation date, it is possible for the "value-to-owner" to be higher or lower than the value that the *Black-Scholes* formula would predict. Given the frequency with which employee stock options are awarded to senior employees who are typically privy to insider information, it is somewhat surprising that this issue has not yet been considered by the Courts. Time will tell if the Court, given the right set of facts to consider, will distinguish between a *Black-Scholes* based valuation and some other approach when the owner of the employee stock options is privy to significant insider information on the valuation date.