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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?

The concept of “fair market value” is fundamental to the valuation of business interests, and is the definition that has been accepted by our highest courts. Fair market value is generally defined as follows:

The highest price available in an open and unrestricted market between informed and prudent parties, acting at arm’s length and under no compulsion to act, expressed in terms of cash.

The definition of fair market value has several key elements, all of which have been addressed by the Courts. In this newsletter, we discuss one of these key elements, that is, the concept of “informed and prudent parties” and the impact thereon by the existence of insider information about a business.

Most of the time, business valuations prepared for matrimonial litigation are prepared notionally, in other words, a live transaction is not being contemplated. In a notional valuation prepared under the definition of fair market value, it is assumed that the notional vendor and notional purchaser

are informed and prudent parties. The relevant questions for valuation purposes therefore are:

- 1) How much prudence should the notional vendor and purchaser be assumed to have?
- 2) How much knowledge should the notional vendor and purchaser be assumed to have?

Although the degree of the participants' prudence has not been tested by the Courts, the extent to which they are informed was first tested in the English Court of Appeal case *Hinchcliffe v. Crabtree* 1971 2 All. E.R. In *Hinchcliffe*, negotiations were taking place on the valuation date with respect to the takeover of a public company, whose shares on that date had a trading price of the equivalent of about \$85. Because news of the takeover was not public, the argument was made that the shares should be valued at the ultimate takeover price, which was the equivalent of about \$200. On the valuation date, the only parties that had knowledge of this information were the investment advisor to the company and his insider client shareholders. The argument was made that if the owner of the shares wanted to sell them on the valuation date, he would have been compelled to disclose information about the takeover offer to the purchaser, thereby causing the price to be bid up to the takeover price. The Court of Appeal held that there was no evidence that such information would have been available to purchasers in the open market, and, accordingly the argument for the higher value was not accepted.

In *National System of Baking of Alberta Limited v. The Queen* 1978 DTC 6018, taxpayers who owned shares in a public company argued that their shares should be valued higher than the public market price for tax purposes because 1) the shares were thinly traded, 2) they had information prior to the valuation date of a pending takeover and 3) an actual takeover bid took place shortly after the valuation date, driving the stock price from \$85 to \$200. The Court fixed the value at about \$93 based on the average closing price of the stock for the ten week period prior to the valuation date, and paid no attention to the post-valuation date impact on the takeover bid. In the finding, the Court stated that there was no reason for departure from the ordinary functioning of the open market in determining the fair market value, as it remained the best indicator available. The Federal Court of Appeal upheld the decision of the lower Court.

At least in *Hinchcliffe* and *National System of Baking of Alberta*, it was assumed that neither the vendor nor the purchaser had perfect knowledge – only the knowledge that can reasonably be expected to be present in a normal open marketplace. Next month, we will examine the debate about insider trading in a more recent case, as well as the appropriateness of valuing employee stock options under the generally accepted approach when the owner is privy to insider information.

This newsletter is intended to highlight areas where professional assistance may be required. It is not intended to substitute for proper professional planning. The professionals at Marmer Penner Inc. will be pleased to assist you with any matters that arise. Please feel free to visit our website at www.marmerpenner.com.