

Valuations and limitations of liability

SPEAKERS



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19:11

Valuation disputes present various challenges—many of which can be mitigated through effective contracting at the outset of business agreement.

In this video, Torys litigators [Andrew Bernstein](#), [Gillian Dingle](#) and [Jeremy Opolsky](#) explain how businesses can work to prevent valuation disputes, and streamline the process as much as possible when valuation disputes arise.

We discuss:

- How to draft contracts with valuation mechanisms to mitigate dispute risk
- How to efficiently manage valuation disputes when they happen
- Models to assess value in the context of a dispute

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Video transcript



Andrew Bernstein (00:07): Today's topic is valuation disputes. I'm Andrew Bernstein from Torys' Litigation Department. And I'm joined by two of my colleagues, Gillian Dingle and Jeremy Opolsky.

Andrew Bernstein (00:23): Okay, so let's get right into it. Gill, what is a valuation dispute and is it really just a dispute of a valuation?

Gillian Dingle (00:29): So the short answer is, yes. It is a dispute about valuation. We call them by different names. Sometimes it's valuation, sometimes it's appraisal, sometimes it can even be a damages assessment. But in effect, what we're talking about today and with valuation disputes in general, is any time that there is an asset, a business, a thing that is difficult to value and can and must be valued, you have the possibility of a valuation dispute. Most commonly, we see this in the valuation of a private business or shares of that business because these things are typically illiquid and tough to wrap a valuation around. But there are other things, Jeremy, I think that you could value.

Andrew Bernstein (01:12): Okay. Jeremy, Gill says that when you value stuff, you value an asset, a business or a thing. So she talked about businesses. Let's talk about assets and things.

Jeremy Opolsky (01:22): And things? Well really, Andrew, anything that is illiquid, anything that doesn't have a ready value attached to it on a given date can be valued and can give rise to a valuation dispute. So some examples of things that can give rise to valuation disputes include most commonly real estate, art is also a big one, livestock we've seen in some cases, jewelry, even wine, which I would call the most liquid of illiquid assets.

Andrew Bernstein (01:49): You've been saving that one, huh? Cellaring. I should say cellaring that one.

Jeremy Opolsky (01:56): Gets better with age—but in a dissent proceeding with share valuations, you might actually have a dispute over the value of a liquid asset, discussing whether the value of means different things to different people based on the valuation date, based on the specific circumstances. So really, if you have a dispute that is based on assets as opposed to a fixed damages in money, you need a valuation for it.

Andrew Bernstein (02:26): And Gill, is there a taxonomy of valuations in disputes? Is there categories we should think about or know about?

Gillian Dingle (02:31): There is a taxonomy. So generally speaking, valuation disputes arise in two different ways. Number one, a statutory framework that provides for something to be valued. And so the valuation of shares from an oppression proceeding or through shareholder dissent rights, those are all statutory valuation remedies, but commonly we also see valuation provisions in contract. And so there may be a contract dispute about how to value an asset that's governed by the contractual relationship between the parties.

Andrew Bernstein (03:06): Okay. So let's start with those contractual disputes. Jeremy, do you want to kick us off?

Jeremy Opolsky (03:12): Sure. In contractual separation provisions, which is where we most commonly see these, where parties have a right to separate or call or put shares. There needs to be a mechanism for that valuation and how well the valuation provisions are drafted will define how the dispute unfolds. Poorly-drafted valuation provisions can lead to complex and expensive disputes where the parties don't, at the beginning of the process have an issue in drafting the contract, turn their minds to how the valuation dispute will unfold.

Andrew Bernstein (03:45): Okay. Well, spoken like a litigator, we always blame the solicitors who actually drafted the contracts for the problems we're having now. But realistically, it's really hard to anticipate everything that might come up.

Andrew Bernstein (03:59): Gill, what would you flag as the most important issues to think about when you're drafting a contract that has a valuation mechanism?

Gillian Dingle (04:07): So some of the things we see in our ex-post disputes about valuation are things like the valuation date, does the contract contemplate specifically when the asset or the business is going to be valued? It is also important for the agreement to set out how the valuation is actually going to occur. You've got your court process, arbitration—court and arbitration generally are similar, both will likely involve expert evidence and a third-party decision maker who is going to hear legal argument as well as that expert evidence to land on a value. But there is a third mechanism which is appointing an expert as the valuator. So depending on the asset, this could be an accountant, for example, a professional business valuator. And in that circumstance, what you're really doing is putting your information, packaging it up, putting it to the decision maker. And then the decision maker isn't fussing

with the law as we would, but is just looking at the asset and saying, based on the information that I've received, this is the value, and that's probably the most streamlined process. A couple of other things to think about in your drafting phase are: what is the process for valuation and how specifically do you want to spell it out in your agreement, access to information about the particular asset this is a point that Jeremy is going to touch on but generally speaking if the asset is a thing, getting access to information about that thing may not be that difficult but if it's a business that's still operating, there may be some more challenges there, and then ultimately the contract may set out and you might want to provide for what happens if the parties disagree about the valuation outcome, which unfortunately can occur. Do you want to have second valuation? Best two out of three? Do you want to have an appeal? What sort of dispute resolution mechanism do you want to put in place for that outcome? And then I think the last point, and this is something where we litigators will often weigh into our solicitor colleagues, is make sure that you're setting in enough time to work through the valuation dispute. 60 days is probably a bare minimum for a reasonably complex asset to be valued. And so you don't want to find yourself in a situation where the contract provides that the dispute is going to be resolved in two weeks and nobody really has wrapped their mind around what the value of the asset actually might be.

Andrew Bernstein (06:34): Yeah, it's a good idea generally, I think, to show these clauses to a litigator who will at least tell you if what you're proposing is realistic.

Andrew Bernstein (06:46): So Jeremy, Gill's talked about some really important procedural issues, I want to get to a more substantive issue. Value can very much be in the eyes of the beholder. Value can mean a lot of different things to a lot of different people. You know, my family photos are very valuable to me, but most people wouldn't pay anything for them. So do you want to talk about how to define the word value in a contract and what issues come up?

Jeremy Opolsky (07:12): Sure, Andrew. Without taking the bait on the value of your family photos.

Andrew Bernstein (07:15): They're lovely, they're delightful.

Gillian Dingle (07:17): Or the value is in the eye of the beholder.

Jeremy Opolsky (07:20): That's right. Moving on, the most important distinction of value or one of the most important distinctions of value, Andrew, is the definition or measure of value itself. Because you're right, price and value are similar, but not always the same definitions. And there are different ways to consider value because value to whom, and when, and what circumstances are important parts of considering what price would be paid. So the most common definition of value is known as fair market value, which is the usual base measure of value. It's employed especially in the tax context a lot. And the definition is, and I'll just read it here, fair market value is normally the highest price expressed in dollars—that's Canadian currency—the property would bring in an open and unrestricted market—so no compulsion—between a willing buyer and willing seller who are both knowledgeable, informed and prudent, and who are acting independently of another. Basically, what two arm's length buyers and sellers would pay. That is one measure of value. But—and we'll talk about this a little more later, you promise? We'll talk about this a little bit later—that will often in the valuation of a business lead to a minority discount for a minority holding. So another measure of value, which we'll discuss is fair value, or fair market value defined to exclude a minority discount, which can turn the dial a lot on the ultimate value that's paid for shares. There, the question will be: What is the ultimate value of the minority shares with or without minority discount?

Andrew Bernstein (09:03): Gill, we're kind of past the drafting stage, aren't we good? And then we're on to the dispute stage. So a client calls you and says, "I have this valuation dispute, here's the contract". What's the first thing we do? What how do we think about these things?

Gillian Dingle (09:22): So the first thing to do is to go back to the contract and review the areas that are likely to map on to the valuation dispute that you're having. The contract, if drafted well and thoughtfully upfront, as we are sure will be the case, usually will outline the areas of dispute pretty clearly. If the contract is perhaps unwritten or there was just an understanding between the parties without framing it out, then the dispute is probably going to be a bit more fuzzy because once the litigators get involved, there's a lot more scope for arguing over who intended what.

Andrew Bernstein (09:59): Jeremy what are some other issues that come up when those disputes start?

Jeremy Opolsky (10:03): Well, Gill had read my mind of what I would talk about: flag the issue of access to information, which is really important when you're valuing these assets. And instead of "access to information", let's call it "access to information or the assets themselves", because you need to ensure that if your client or you

personally do not have possession of the asset or control of the business, that a minority are not controlling or not possessing owner, has access to the information about that asset, especially if that information is held by current officers or shareholders who are adverse to you. So you want to consider all aspects of that information. Talking to potential valuers as to what they would need. Physical assets are the easiest to understand. You need access to them, right? If you want to value a horse, you need to see the horse. But real estate, you need to go in. The appraisal standards require the appraiser to go into the asset, to the house or building, or onto the greenfield to assess what conditions it's in, cause that will affect value. For a company you'll want to see forecast. You'll want to see confidential financial information that go beyond your bare rights as a minority shareholder to access under the OBCA or a comparable corporate statute. The more information, the better. But it's not just the amount of information, it's how quickly you can get that information and how timely or current that information is. Doing a valuation in October, based on December 31st, last year ends' figures may or may not give you an accurate valuation for that date.

Andrew Bernstein (11:42): Okay. Gill, what other issues would you flag at the outset of a dispute?

Gillian Dingle (11:47): So, valuation disputes are typically expert-heavy disputes.

Andrew Bernstein (11:53): Especially if there's a horse involved.

Gillian Dingle (11:54): Well, yes! If you're going to value a horse, you need an expert to tell you how to value that horse's pedigree. If you're going to value Jeremy's favourite illiquid, liquid asset, you need an expert to help you on that. And realistically, when you're dealing with a business valuation, for example, you're going to have an expert who is going to opine on the revenue that's likely to be generated by the business or use one of the other standard metrics. And that generally involves modelling. That generally involves assumptions. And so you are going to want to get pretty deeply involved in the fine details of the assumptions that are being made, the calculation that is being done by the expert, because the other side is going to be doing the exact same thing on their side and is going to be looking for ways to poke holes at the assumptions that are being made. And to Jeremy's earlier point, the lag of time between financials and valuation date is a perfect example of that because if you haven't taken a look at how to true-up that financial position, then that's an assumption that may not bear out once the facts are actually carefully examined.

Andrew Bernstein (13:11): Jeremy, you promised—I wrote it down—you promised you would get back into the question of fair value and fair market value. Now's your time.

Jeremy Opolsky (13:20): Nothing would make me happier.

Andrew Bernstein (13:21): I know, I know. I'm a little scared, but I know.

Gillian Dingle (12:23): High bar, high bar.

Jeremy Opolsky (13:25): So there really are, once you're in dispute, two questions at a high level that you should ask. The first is, does a minority discount apply? What measure of value are you in? Are you in fair market value or are you in fair value or something else? In much of the oppression case law, fair value is the proper determination if there is a buyout order. And the idea, at again very high level, is an oppressor should not be able to take advantage of his or her wrong by sticking the minority discount on the minority shareholder. But in the balance of disputes, minority discounts can and do apply in the absence of a contractual protection, otherwise. And that can be large. It can mean significant amounts of money to the minority shareholder. So the second is, if you have a minority discount or the threat of a minority discount, what is it? How large is that discount? The theory behind this is, what would a willing buyer, an arm's length buyer pay for owning the minority interest in a corporation where the discount therefore reflects the lack of control and the lack of marketability over the business and its assets? And those are two different ways of exploring the idea of a minority discount and often they're aggregated. A discount for lack of control accounts for the fact that a minority shareholder often cannot control the business strategy, executive or officer hiring business direction, and all those things go to value. But they also lack control to create liquidity. They can't control the timing or the amount of the dividends, and they also can't control when there is a liquidity event, either a sale of the entire company, or a IPO or other going public event. The second consideration is a discount from lack of marketability because it's harder to sell or can be harder to sell a minority stake and take longer. And that amount of time and effort can result in a lower value. Even the fluctuations in value between the time you want to sell and the time you do sell can impede the value itself, measured by complex modelling and options considerations.

Andrew Bernstein (15:40): There's been a lot of references to modelling. My modelling career ended a long time ago, but when we talk about modelling, what are we talking about the experts doing here?

Gillian Dingle (15:52): We are not talking about playdough modelling, which is my modelling experience, what we're talking about is it really depends on the assets. So let's stick, for example, with if you're dealing with a business and you will need an expert's help to determine what the appropriate modelling, what the appropriate methodology even is to value a business. You might use an income method, that would be more appropriate for a business that has a long income track record so it's easy to actually look at and measure. You might use a discount rate, that might be more appropriate for a newer business or one that doesn't have a long operating history. But you're going to need some expert help to figure out which is the appropriate model to actually choose. And then once you've chosen your appropriate modelling structure and you may use more than one, there are a variety of assumptions. So when we're talking the income method, what is your budgeting assumption? What is your forecasting assumption? Are those assumptions reasonable? Bearing in mind that, again, the other side is going to be looking at them and testing them with the very same lens. Are the individuals who are putting these assumptions together if they're management, again, are they reasonable? Can they be tested? Are they too optimistic, given the macro-economic circumstances? There can be fights over the discount rate. There can be fights over the weighted average cost of capital. These are all things that two very smart experts may disagree about. And so thought has to go into what are the particular assumptions being made that are driving these calculations? And then on the other hand, you can also use a market strategy. So taking a look at comparable companies, again, if we're talking about a business, comparable public companies and what is their value, and there the focus tends to be on whether the comparables are actually good comparables. Do they measure well in terms of size, in terms of revenue, in terms of geographic location to the particular business that you're trying to value? And if they don't, how has that been accounted for in the valuation calculation?

Andrew Bernstein (18:03): Got it. Okay. So it sounds like there's a lot of Excel spreadsheets in your future if you're going to be involved in one of these disputes.

Gillian Dingle (18:09): Yes.

Andrew Bernstein (18:14): Okay. Jeremy, we are at the end. Can you sum up for us briefly?

Jeremy Opolsky (18:19): Sure. So in a closely-held business or other situation with illiquid or unique assets, valuation disputes are almost inevitable, and they're complicated, and they're hard, and I've heard valuers tell me that valuation is often more an art than a science. So when you are entering into agreements, if you can plan for how a valuation dispute or disagreement about value will play out, you will save time and money. And if you can plan for an efficient, streamlined approach, balanced of course, against adequate protections for fairness, you may thank yourself at the end of the day because what you don't want is you don't want valuation disputes to become more value-destructive than they have to be.

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