Discounts for Lack of Marketability and Fair Value

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The issue of standard of value is always at the forefront in conducting work in the business valuation arena. In those circumstances where a non-controlling equity owner is alleging abuse at the hands of the controlling equity owners, it is common that such non-controlling owner seeks equitable resolution based upon the value of his or her ownership interest, immediately prior to the alleged harmful acts. In most cases, that value is determined using a "fair value" standard of value.

In assessing the critical impact that proper application of discounts, and/or premiums, may have in a fair value determination, valuators often turn to legal decisions rendered by triers of fact. This guidance is especially relevant in jurisdictions where fair value is the appropriate standard of value but where legislative statutes fail to adequately define the meaning of that term in the particular jurisdiction where the answer is required.

In a recent decision of the Supreme Court of the State of New York, *Zelouf International Corp. vs. Zelouf,* 2014 N.Y. Slip Op 51462(U)[Sup. Ct., N.Y. County (Oct. 6, 2014), in a 31-page opinion authored by Justice Shirley Werner Kornreich, the Court ruled very specifically against the application of a discount for lack of marketability in a fair value case. The courts in that state have allowed the application of a discount for lack of marketability in fair value decisions but as the *Zelouf* decision notes, that discount is not mandatory and may not apply given any set of particular facts.

By way of background, the dispute was between three shareholders in a corporation formed in 1984. The parties to the litigation included a shareholder who had inherited a 45 percent interest from his father upon his death in 2004 and who had previously held a 5 percent interest. In total, this shareholder held a 50 percent interest. A brother of the decedent held another 25 percent and the final ownership interest of 25 percent was held by a second brother of the decedent who became incapacitated in the course of events, causing a shift in the ownership of the interest to the brother's spouse, Nahal. The resulting litigation was the corporation, Zelouf International, against Nahal.

Zelouf International was a textile business that operated as a "middleman of sorts between fabric manufacturers and garment manufacturers." The litigation was a long-term series of filings and legal challenges, transpiring for "more than a decade."

While a number of technical issues were addressed within the decision, the focus here is on the discount for lack of marketability and the propriety of using such an adjustment in the determination of fair value.

The genesis of the issue of utilizing a discount for lack of marketability in this case began with a decision in 2013 by all parties to engage an independent neutral business valuator to prepare a business valuation to be used by the parties as part of a mediation process. Prior to reaching a resolution under such a process, however, the two shareholders managing the company elected to pursue a "freeze-out" merger transaction. To accomplish this transaction, a new corporation was formed to facilitate the buyout of Nahal's shares and limiting her ability to legally pursue her derivative claims. The merger was approved by the Court on the agreed stipulation that the derivative claims filed by Nahal could be resolved in conjunction with the valuation proceeding, which would allow additional damages if she were successful in asserting those claims.

The Court was exceedingly complimentary to the independent valuator, and his report, finding it "comprehensive and reliable" and the work undertaken for this purpose, and all parties agreed that the report prepared as a result of his analysis would serve as the starting point for the fair value analysis.

Considering all three valuation approaches, the independent expert ultimately "determined that the only meaningful and reliable valuation methodology in this case was the Income-Based Approach." Under this approach, he selected the capitalized future returns method. The resulting conclusion of value was considered by

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the independent valuator to be "the price that would be received to sell (Old Zelouf International) in an orderly transaction between market participants." The company was valued as a going concern under the assumption that its earnings would continue into perpetuity.

The independent valuator determined the fair value of the entire company on a controlling, marketable basis at $8.9M. At legal counsel's request, he also prepared a second computation, incorporating a discount for lack of marketability at 30 percent, reducing the fair value under this alternative computation to $6.2M. Importantly, the independent valuator added language in his report that noted, "typically, a [DLOM] is usually only applicable for valuations of minority interests in closely-held companies under the assumption that a controlling owner would be able to force the sale of a company."

The Court did not render any decision on the level of discount (30 percent) applicable to the company value as a whole, because the court "agrees" with the independent valuator's view that a DLOM should not be applied.

Of course, the petitioners took exception, arguing that the state's (New York's) law requires a DLOM. The judge's decision notes that "no New York case stands for the proposition that a DLOM must be applied to a closely-held company."

The Court decision further notes that, "the idea of a DLOM is that, since the company as a whole can be difficult to sell (e.g., buyers of closely-held companies in niche businesses are not as plentiful as buyers of publicly traded corporations), a frozen-out, minority shareholder should recover less to reflect this fact. While it is surely true that it would have been difficult to sell Old ZIC […] the rationale for generally applying a DLOM is inapplicable to Old ZIC" (Zelouf International).

The Court's finding that a DLOM is not applicable is predicated upon a judgmental finding that, "The company, without Nahal and her family, will always remain under the control of the Zelouf family. This makes the company's illiquidity irrelevant, mooting the concern for which a DLOM accounts." It further found, "If the other Zelouf family members will never pay a price for the company's theoretical illiquidity, then there is nothing 'fair' about artificially depressing Nahal's recovery due to a hypothetical sale that will never occur."

The decision has generated much discussion within the business valuation community. The primary source of consternation centers on the meaning of the term "hypothetical" transaction. It is difficult to envision any determination of value without consideration of its value "in exchange." As such, there is no way to conclude on value without first assessing the hypothetical risks that surround the company that would likely be considered by a hypothetical buyer in a transaction, actual or hypothetical.

It is not surprising, then, that the controlling shareholders immediately filed motions to modify and/or vacate portions of the Court's decision. Clearly, traditional thinking in many court applications have addressed and allowed the application of such a discount.

The Court came back with a follow-up ruling on December 22, 2014 answering the motions with a reinforcement of the language from its earlier decision rendered on October 6, 2014. In this decision, the Court adds further cloudiness to the matter, however, noting that,

> In effect, applying a DLOM here would be the economic equivalent of imposing a minority discount—that is, Nahal realising less for her shares because she is being forced to sell while [the other part(ies)] gets to realize their full value by staying in control. It is well settled that minority discounts are not permitted under New York law... Indeed, it is the tension between the application of a DLOM, which is done in most cases, but is not *legally required,* and the practical effect of a DLOM here serving as a minority discount, repugnant to New York courts and *never allowed*, that drive's the Court's ruling.

The Court further notes that it is "*not* holding that a DLOM is necessarily legally inappropriate in valuations of closely held companies.[…] Rather, in this case, under the unique set of facts set forth in the Decision, applying a DLOM is unfair."

A contrasting view can be obtained by looking to *Ferolito v. AriZona Beverages,* USA LLC, 2014 N.Y. Misc. LEXIS 4709 (October 14, 2014). As the date indicates, this case was decided just eight days after *Zelouf.* In this case, the Court found that there are a number of issues relating to the sale of shareholder capital stock that merit the application of a DLOM.

In this case, the subject company was AriZona, a national bottler and distributor of iced tea products. Founded in the early 1990s, the two equal shareholders had a falling out. It was agreed that one of the original shareholders would remain actively involved in the management of the business while the remaining shareholder would take a more passive role. At approximately the same time that these decisions were made, both shareholders executed a shareholders'/owners' agreement limiting the transferability of their respective ownership shares.

After a failure of the plaintiff shareholder in the case to sell his shares to an outside buyer, he sued for dissolution of the company. This was followed by the defendant shareholder's decision to enter into a buyout transaction. Both hired experts and the Court determination of the value of the plaintiff's 50 percent ownership interest was based on information provided by both experts.

With respect to the issue of DLOMs and the propriety of applying such a discount, the plaintiff's expert argued for no DLOM, while the defen-

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dant's shareholder's expert argued for a 35 percent DLOM. The Court generally sided with the defendant's shareholder's expert due to the fact that the shareholders'/owners' agreement limited free transferability. In addition, specific to this case, the facts illustrated that the shareholder's ownership interests in the company were not easily transferred, as established by a previously tried and failed potential transaction with a viable buyer. The Court did decide to lower the DLOM to 20 percent.

It is noteworthy that the Court took *Zelouf* into consideration in rendering its decision but distinguished the facts from those in this case. The Court indicated that unlike the hypothetical liquidity risk associated with *Zelouf,* there was evidence of liquidity issues for interests in AriZona based on the stalled negotiations for the sale of the company, failure of the shareholder to sell his interests, and the restrictions on transfers from the owners' agreement.

The resultant take-away from these cases is the ongoing struggle the New York trial courts (and others) face in interpreting fair value and the applicability of DLOMs in these cases. The technical justification for the application of a DLOM requires reconciliation with overall economic reasonableness required by the court's mandate to achieve an overall fairness to harmed parties in its dealings in these matters.

Whether the application of the DLOM will be found to be an appropriate reduction in fair value determinations should be predominantly based on the facts and circumstances attendant to the subject ownership interest under valuation. This is not different from the driving mechanics behind determining DLOMs for any other purpose, including fair market value determinations. While the decisions noted in this article are precedential only in the state of New York, a careful read can provide a great deal of insight into applying these discounts in other jurisdictions. ᘓ