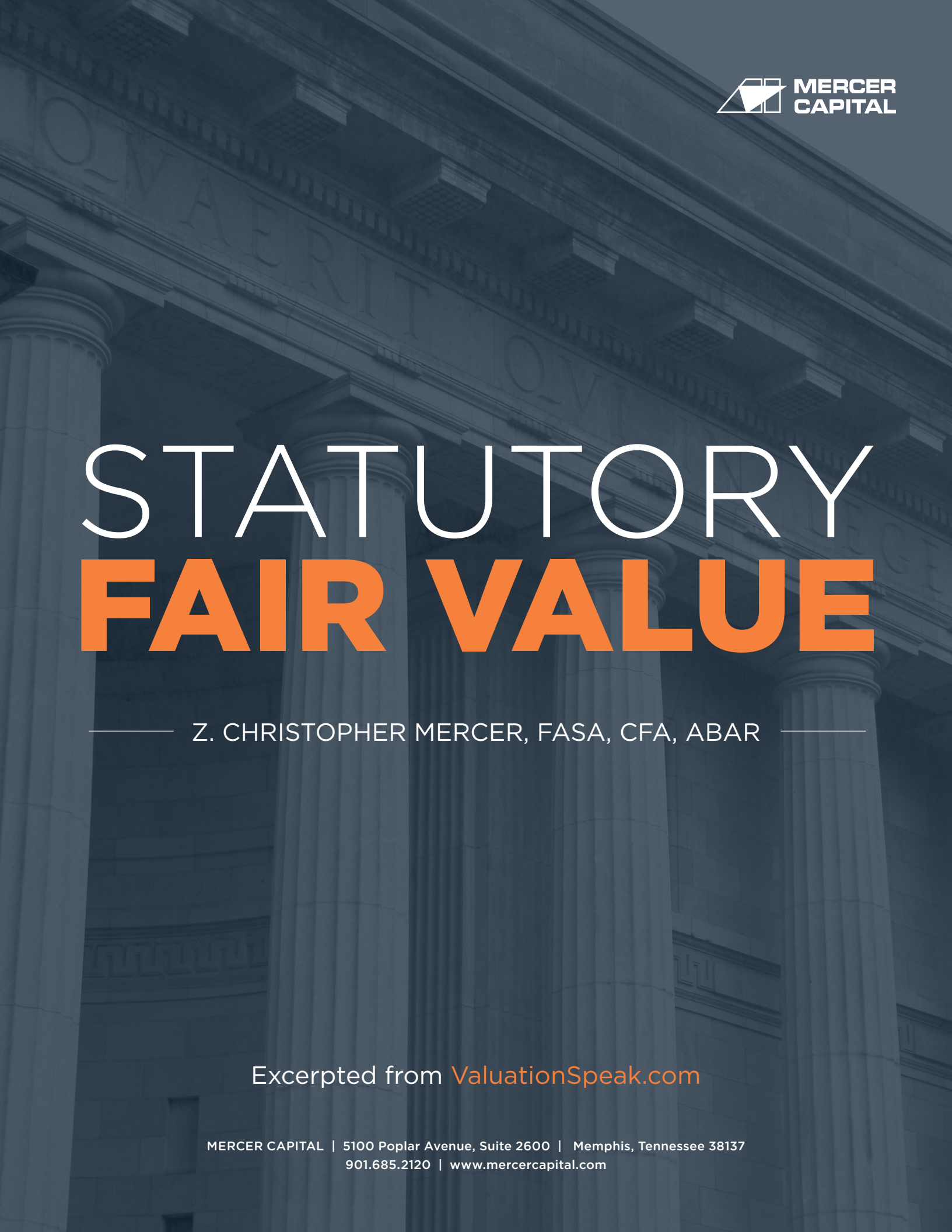

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STATUTORY FAIR VALUE

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Excerpted from ValuationSpeak.com

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This e-book consists of a series of posts originally published on the blog Valuation Speak between February 2011 and January 2012.
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STATUTORY FAIR VALUE
An Introduction

February 21, 2011

Statutory "fair value" is the standard of value for valuation in the dissenters' rights and shareholder oppression statutes of the majority of states. I have testified on the fair value of equity interests at deposition and/or trial in 15 states over the last 30 years. I speak as a business appraiser and a business man. I have no legal opinions. (I do hope the ones I have are not illegal.)

At the outset of this series of posts on statutory fair value, let me be clear: I am agnostic with respect to what fair value should be in any particular state. That is a matter of statutory decision-making and judicial interpretation. As a business appraiser, what I hope is that the collective (statutory and judicial) definitions of fair value are clear and able to be expressed in the context of valuation theory and practice.

In my experience, disagreements over the applicability (or not) of certain valuation premiums or discounts provide the source of significant differences of opinion between counsel for dissenting shareholders and, unfortunately, between business appraisers. Because fair value is ultimately a legal concept, appraisers should consult with counsel regarding their legal interpretation of fair value in each jurisdiction.

About half of all public companies in the United States are domiciled in Delaware — in large part because of favorable corporation laws and the responsiveness of the Delaware Court of Chancery. As we begin our discussion of fair value, we look at the statutory definition in Delaware. Fair value is defined in Delaware Code Annotated Section 262(h) as (with parenthetical numbers and emphasis added):

> After the Court determines the stockholders entitled to an appraisal, the appraisal proceeding shall be conducted in accordance with the rules of the Court of Chancery, including any rules specifically governing appraisal proceedings. Through such proceeding **(1) the Court shall determine the fair value of the shares (2) exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation,** together with interest, if any, to be paid upon the amount determined to be the fair value. **(3) In determining such fair value, the Court shall take into account all relevant factors…**

From this statutory definition, we know that the Court of Chancery will determine fair value according to its rules. We know that fair value shall be determined "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation." Finally, we know that "the Court shall take into account all relevant factors" in fair value determinations in Delaware.

As a business appraiser, the first thing I see is that fair value in Delaware is a concept that does not give benefit to potential value arising from statutory mergers or combinations for effected shareholders. Appraisers would need further guidance from counsel in order to assure that they meet the requirements of fair value as defined.

The next thing to note is that the Court will consider "all relevant factors." In business appraisal, we typically consider "all relevant factors" that influence a valuation situation. The language is familiar. Revenue Ruling 59-60 at Section 4.01 states (emphasis added):

> It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well **as all relevant factors affecting the fair market value**, should be considered. The following factors, although not all- inclusive are fundamental and require careful analysis in each case:

Section 4.01 goes on to list eight well-known factors that should be considered in fair market value determinations, including the nature of the business, its history and outlook, and its earning capacity.

Fair market value is an objective, arms' length standard of value and is defined in Section 2.02 of Revenue Ruling 59-50. The parties are hypothetical, willingly negotiate, are independent of each other, have reasonable knowledge of the facts of an investment, are under no compulsion to transact, and have the financial capacity to engage in hypothetical transactions.

Fair Market Value is a Willing Buyer, Willing Seller Concept

The standard of fair market value is mentioned here because it is referenced (albeit indirectly) in the statutory definition of fair value in Delaware. The statutory right to dissent arises in a number of situations involving sales, consolidations, recapitalizations or other actions on the part of controllers of corporations that effect minority owners. Fair value is also the statutory standard of value in cases of shareholder oppression in many states.

But take the fairly common cases of a squeeze-out merger or a reverse stock split. The effect of either transaction is to attempt to force minority shareholders to receive the consideration offered by the controllers. If the right to dissent is triggered, affected owners can dissent to the transaction and petition the courts in their states to determine the fair value of their shares.

Fair Value in Such Situations Is a Willing Buyer, Unwilling Seller Concept

Fair market value is an objective standard. Fair value, on the other hand, is an equitable standard. Equitable is defined in Your-Dictionary.com as: "Fair, under widely held moral principles, often embodied in court precedents; or referring to a remedy available in a court of equity."

A "court of equity" is defined in Wikipedia.com (footnotes omitted) as:

> … a court that is authorized to apply principles of equity, as opposed to law, to cases brought before it.
>
> These courts began with petitions to the Lord Chancellor of England. Equity courts "handled lawsuits and petitions requesting remedies other than damages, such as writs, injunctions, and specific performance." Most were eventually "merged with courts of law."
>
> United States bankruptcy courts are the one example of federal courts which operate as courts of equity. Some common law jurisdictions–such as the U.S. states of Delaware, Mississippi, New Jersey, South Carolina, and Tennessee–preserve the distinctions between law and equity and between courts of law and courts of equity.

The point of this seeming diversion to talk about fair market value, equity and courts of equity is to illustrate that there is potential tension between objective valuation standards and the standard of fair value as it might be interpreted based on equitable considerations by a court.

As a business appraiser, I can provide objective valuation evidence to a court in a fair value proceeding.

As a business appraiser, I cannot consider equitable issues in providing valuation evidence unless instructed by a court.

We will see that fair value is intertwined with concepts of fair market value and equity, which can be highly confusing for participants in fair value proceedings and for business appraisers as well.

As a business appraisal expert, Delaware's statutory definition of fair value provides little effective guidance as to what kind of value fair value should be. Delaware is a state with a rich history of cases involving fair value determinations. Delaware's judicial guidance, as we will see, can be confusing when viewed through the objective lenses of fair market value and valuation and finance theory. This observation is more or less true in the majority of states.

We begin a journey to talk about statutory fair value. Before we talk about any cases, in Delaware or elsewhere, it is critical to follow this introduction with a discussion of key valuation concepts that underlie both fair market value and fair value.

In our next post on the topic, we will begin our valuation and finance introduction with a discussion of the Discounted Cash Flow Model, or the discounted cash flow method, or simply, DCF. There is a reason for beginning here. As we will see, the DCF method is of primary importance in fair value determinations in Delaware.

STATUTORY FAIR VALUE

Discounted Cash Flow (DCF) Method

February 24, 2011

We continue our discussion of statutory fair value with an outline of the discounted cash flow (DCF) model (or method). The DCF valuation method is a core method within the Income Approach to Value (with the other two approaches being the Asset Approach and the Market Approach).

One objective of this series of posts on statutory fair value is to outline sufficient valuation and finance theory so we can begin to examine cases, i.e., judicial interpretations of what fair value means. With the proper background, we will be able to understand and to interpret what the courts have said in the context of valuation theory.

Most judges are not trained in valuation, which is understandable. They make decisions regarding valuation based on economic evidence presented to them by business appraisers. Unfortunately, the valuation evidence presented in courts is often conflicting, unclear and simply wrong from a theoretical viewpoint. The fact is, as we will see, there are a number of "bad" fair value decisions, where "bad" reflects the fact that they do not reflect current valuation theory or practice. Quite often, "bad" fair value decisions are the result of "bad" valuation evidence.

In addition, regardless of the quality of valuation evidence presented, judicial guidance is not always definitive, and reasonable legal interpretations by counsel can lead to differing conclusions about what constitutes fair value in a jurisdiction. For example, I have been criticized for applying a marketability discount in a fair value case in one state where counsel gave me that instruction. I have been criticized in another for not taking minority interest and marketability discounts. It took a decision by that state's Supreme Court to resolve the issue.

As I mentioned in the first article in this series, it is not the appraiser's job to determine what kind of value fair value should be. That is for the courts to decide. I hope that this series will, over time, provide assistance to appraisers, counsel for parties in statutory fair value matters, and to the judges in the courts where future decisions will be made.

The following discussion of the discounted cash flow method is excerpted in part and modified in part from Chapter 1 of *Business Valuation: An Integrated Theory Second Edition*, which I co-authored with Travis W. Harms.

The Value of a Business Defined

The value of a business enterprise can be described as:

- The value today (i.e., in *cash-equivalent terms*)
- of all expected future cash flows (or benefits) of the business
- forecasted or estimated over an indefinite time period (i.e., *into perpetuity*)
- that have been *discounted to the present* (expressed in terms of *present value* dollars) at an appropriate *discount rate* (which takes into consideration the riskiness of the projected cash flows of the business relative to alternative investments).

The valuation and finance literature consistently confirm this conceptual definition of the value of a business enterprise. In order to value a business, therefore, we need the following:

1. A forecast of all expected future cash flows or benefits to be derived from ownership of the business; and,
2. An appropriate discount rate with which to discount the cash flows to the present.

This conceptual definition of business value can be defined symbolically in the following equation:

$$\text{Value} = V_0 = \left(\frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} + \frac{CF_4}{(1+r)^4} + \ldots + \frac{CF_n}{(1+r)^n} \right)$$

Where:

- $\mathbf{V_o}$ is the value of the equity of a business today.
- $\mathbf{CF_1}$ to $\mathbf{CF_n}$ represent the expected cash flows (or benefits) to be derived for periods 1 to n. The discounted cash flow model is based on time periods of time of equal length. Because forecasts are often made on an annual basis in practice, we use the terms "periods" and "years" almost interchangeably for purposes of this theoretical discussion.
- ***r*** is the discount rate that converts future dollars of CF into present dollars of value.

The equation above is the basic discounted cash flow (DCF) model. To employ the model in this form, however, the analyst must make a forecast of all the relevant cash flows into the indefinite future. For clarity, the cash flows or earnings discussed in this chapter are the net earnings and net cash flows of the enterprise or the business as a whole. V_0 is the value of the equity of the enterprise, or the present value of the expected cash flows to the owners of the equity of the enterprise.

The Gordon Model

In his 1962 finance text, *The Investment, Financing, and Valuation of the Corporation*, Myron J. Gordon showed that under the appropriate assumptions, the DCF equation is equivalent to the simplified equation shown below:

$$V_0 = \frac{CF_1}{r - g}$$

The Gordon Model initially dealt with dividends, hence it has been called the Gordon Dividend Model, or the Gordon Growth Model. The Gordon Model has become so generalized that it reflects what can be called the generalized valuation model. In practice, CF_1 often represents the estimate of earnings for the next period so we can generalize and refer to the cash flow measure as Earnings. The expression (r – g) is known as the capitalization rate (see "Glossary," ASA *Business Valuation Standards* (Washington, DC: American Society of Appraisers, 2005), p.21.) And the expression (1 /(r – g)) is a multiple of earnings. So the Gordon Model is consistent with the general valuation model:

$$\text{Value} = \text{Earnings} \times \text{Multiple}$$

These factors are so familiar that appraisers sometimes forget their source. Earnings in the generalized valuation model must be clearly defined and the "multiple" must be appropriate for the defined measure of earnings. These comments could be based on common sense, and they are. However, as will be shown, they are also theoretically sound.

For the DCF model and the Gordon Model to be equivalent, the following conditions must hold:

- $\boldsymbol{CF_1}$ is the measure of *expected cash flow* for the next period (sometimes derived as (CF_0 x (1 + g)) or otherwise derived specifically).
- Cash flows must grow at the constant rate of ***g*** into perpetuity.
- All cash flows must be: 1) distributed to owners; or, 2) reinvested in the enterprise at the discount rate, ***r***.

The discount rate, ***r***, must be the appropriate discount rate for the selected measure of cash flow, ***CF***. In the real world, businesses make reinvestments and accept the returns of these investments, some of which will exceed ***r*** and some of which may be less than ***r***. This model assumes that all reinvestments will achieve a return of ***r***.

By comparing the DCF model equation with the Gordon model equation, we see two ways to estimate the value of an enterprise. The next equation restates the DCF model to reflect constant growth and relates it to the Gordon Model.

$$V_0 = \left(\frac{CF_0(1+g)}{(1+r)^1} + \frac{CF_0(1+g)^2}{(1+r)^2} + \ldots + \frac{CF_0(1+g)^n}{(1+r)^n} \right) = \frac{CF_1}{r - g}$$

- The left portion of the equation illustrates a forecast of cash flows at a constant rate into perpetuity, discounted to the present at the discount rate ***r***.
- With appropriate algebraic manipulation, the left portion of the equation reduces to the Gordon Model, which is shown at the right above.

Two-Stage DCF Model

Recall the conditions that must hold for equivalency of the DCF and Gordon Models to be equivalent expressions. In practice, these conditions may limit the strict application of either expression.

- Application of the DCF model as in the first equation requires a discrete forecast to time period *n*, or effectively into perpetuity. Few forecasts extend reliably beyond five or 10 years in practice.

- Application of the Gordon Model requires that the estimate of next year's cash flow grow into perpetuity at a constant rate of ***g***. This condition may not be consistent with an analyst's expectations regarding near-term cash flow growth, which may be significantly different from longer-term expectations for growth.

In practice, these two limitations are overcome by use of a "two-stage" DCF model that combines elements of the perpetuity DCF model and the Gordon Model. The two-stage DCF model is presented below, and consists of the following two sets of forecast cash flows:

$$V_0 = \left(\frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} + \ldots + \frac{CF_f}{(1+r)^f} \right) + \left(\frac{CF_{f+1}/(r-g)}{(1+r)^f} \right)$$

Present Value of Interim Cash Flows (PVICF) Using this portion of the basic DCF model, the analyst is not constrained by the requirement of constantly growing cash flows during the finite forecast period ending with Year f. This part of the equation is the present value of interim cash flows through the finite forecast period ending with Year f, or PVICF.

Present Value of the Terminal Value (PVTV) Using the Gordon Model, all cash flows are capitalized after Year f, assuming cash flows are growing from that point at the constant rate of g. This portion of the equation therefore represents the present value of $CF_{f+1} = CF_f \times (1 + g)$

- ***Interim Cash Flows (for finite period ending in Year f).*** While accurate predictions regarding the future are certainly elusive, diligent analysts can often prepare reasonable forecasts of near-term financial results for most businesses. The left side of the equation depicts the Present Value of Interim Cash Flows (PVICF).

- ***Terminal Value (all remaining cash flows after Year f).*** Following the discrete forecast period, the two-stage DCF model reverts to the Gordon Model, as the accuracy of the analyst's discrete financial forecast wanes, and violation of the constant-growth condition becomes less significant. When discounted to the present from the end of year f, the Present Value of the Terminal Value (PVTV) is obtained.

Appraisers using the two-stage DCF model typically employ discrete forecast periods ranging from about three to 10 years or so, followed by application of the Gordon Model as shown in Equation 1-4. Alternatively, in practice, many appraisers and market participants use a market-based method that applies current market multiples to the forecasted cash flow for Year f or Year f-plus-1. This alternative practice, if employed with reasonable multiples from the public marketplace, should not be considered unusual or incorrect.

DCF, the Gordon Model and Public Security Valuation

Thus far, we have been speaking about the DCF Model and the Gordon Model. Both of these are valuation models employed when using the income approach to valuation. The other commonly used valuation approach used in valuing profitable business enterprises is the market approach. Under the market approach, comparisons are made with valuation metrics of a subject company and the similar metrics of similar, or "guideline companies."

We know that we can estimate value using a single period income capitalization method, i.e., the Gordon Model, for a public or private company. If expected earnings are $1.00 per share, the (constant) growth in earnings is 5.0%, and the discount rate is 15.0%, then the indicated value is $10.00 per share ($1.00 / (15% minus 5%).

In the context of a publicly traded stock, we can specify the Gordon Model as follows:

$$P_o = \frac{D_1}{r - g_d}$$

The price of a publicly traded stock today reflects the present value of all expected future dividends. Ignoring for a moment the possibility of share repurchases by the company, the receipt of dividends represents the only return the shareholders, will receive from ownership of the stock – other than a sale of stock in the public market, where all expected future dividends are continuously capitalized in the market price. We derive the price/earnings multiple by dividing both sides of the equation by earnings for the coming year (E_1).

$$P_o/E_1 = \frac{D_1/E_1}{r - g_d}$$

Recognize that the expression (D_1/E_v) is the dividend payout ratio, or DPO.

$$P_o/E_1 = \frac{DPO}{r - g_d}$$

Now, assume that DPO equals 100%, or 1.0. Therefore, the P/E of Equation 1-12 is (1/(r–g)). This should clarify that valuation analysts, who typically derive earnings multiples as (1/(r-g)), are making an implied assumption that all earnings of the company will be distributed, i.e., that the DPO = 100%.

Now, assume that we observe that the market price for a public company is $10.00 per share (for convenience and comparability to the private company example above). Expected earnings are $1.00 per share as indicated by the consensus of analysts' estimates. The Price/Earnings ratio, or multiple, is 10.0x ($10.00 price / $1.00 expected earnings).

With the Gordon Model and the income approach, we use analyst-derived estimates of expected earnings (CF_1 or E_1) and the analyst's estimate of the discount rate (r). Using the equation above and assuming a DPO of 100% (or 1.0), we can now derive the discount rate for the public company, or r, which is 15.0% (P/E = E / (r – g). Given P/E = 10.0, g = 5.0% and DPO = 1.0, solve for r).

At its simplest, in a perfect world, analysts will develop the very same indications of value using income methods (the DCF model or the Gordon Model) and market approach methods (using guideline public companies as the basis for applying multiples to earnings).

Relationship of the DCF Method to Fair Value

The DCF method is a commonly used valuation method, particularly when valuing sizable companies where management routinely prepares forecasts of future financial performance. For example, the DCF method would appear to be the favored valuation method for valuations presented to the Delaware Court of Chancery.

Even when the Gordon Model is used as a single period income capitalization method, there is an implicit forecast of future performance.

Conclusion

In next post, we will discuss what is called the levels of value chart. This chart as it has been developed over the last twenty years or so by valuation writers (including the present writer) can be used to illustrate the various "kinds of value" that courts might consider to be fair value as they interpret fair value statutes in the various states.

Following the initial discussion of levels of value, we will then use the Gordon Model, and implicitly, the DCF method, to define what I refer to as the marketable minority level of value. This is the level at which public companies trade in normal and active markets. It is also one level at which appraisers develop valuation indications. Along the way, we'll discuss the relationship between the DCF method and valuation by reference to what are called guideline public companies.

After a number of additional posts where we address valuation theory, we will begin to look at some fair value cases. I believe that the investment in background will pay dividends in our collective understanding of statutory fair value in any particular jurisdiction as well as similarities and differences among and between the various states.

STATUTORY FAIR VALUE

Traditional Level of Value Chart

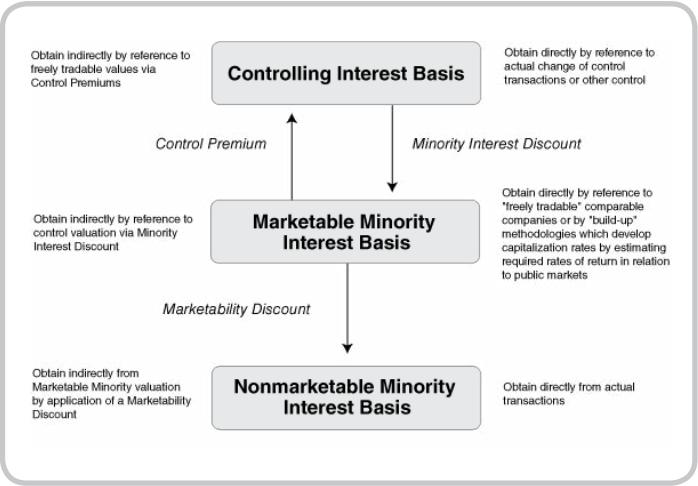
March 16, 2011

We started our discussion of statutory fair value with an introduction and followed that with a discussion of the DCF valuation method. We now turn to the levels of value charts that are at the heart of every valuation decision made in statutory fair value determinations, either by judicially or by appraisers.

The "Traditional" Levels of Value Chart

The "traditional" levels of value chart has three levels: the control level, the marketable minority (or "as-if freely traded") level, and the nonmarketable minority level. As we will see, there are two key valuation discounts and one premium that enable "movement" between levels on the chart.

While the valuation concepts of control, freely traded and nonmarketable minority have been around for several decades, they were not formally published in a chart until 1990. Since the publication of the original charts, appraisers have worked on the concepts and attempted to refine them. Interestingly, it is this process of learning and refinement that has contributed to confusion over what "fair value" means in the statutory fair value world.



The three-level chart shows the three conceptual levels of value noted above. It also shows conceptual premiums and discounts that enable appraisers (and courts) to move from one level to another.

The Marketable Minority Level of Value is the Benchmark Level

The benchmark level is the marketable minority level of value, or the middle level in the chart above. Conceptually, it represents the pricing of the equity of an enterprise if (for a public company) or as if (for a nonpublic company) there were a free and active public market for the shares.

In Discounted Cash Flow Method, we indicated the Gordon Model is a single equation representation of public securities pricing. We'll come back to this as our discussion progresses. For now, note the following:

- Many large, high market capitalization public companies have free and active markets for their shares.
- Other public companies have less active markets.
- Privately owned companies lack markets.

Nevertheless, we use the conceptual marketable minority level of value when attempting to provide value indications for all three: large-cap publics, smaller, more thinly traded publics, as well as private companies.

Note that the term, marketable minority level of value implies that this valuation concept is a minority concept, i.e., one that lacks control. However, public companies are "valued" at this level.

For example, it is routine to refer to the market price of a public company multiplied by its shares outstanding as the market capitalization of its equity.

Said another way, *the market cap of equity is an indication of the value of a business enterprise*, and not merely of a small minority interest in the enterprise. For that reason, I (and others) refer to the marketable minority level of value as an *enterprise level of value.* This distinction will become important as we proceed with the discussion of the underpinnings of statutory fair value.

The Control Level of Value

The conceptual level of value above the benchmark marketable minority level is the control level of value. We will learn that "control" has multiple meanings (including financial, synergistic, and strategic), but for now, we stick with the single term. The control level of value represents pricing as if entire companies (or controlling interests in them) are sold.

We move from the marketable minority level of value to the control level of value through the application of a conceptual control premium. When public companies are sold, "control premiums" are typically paid by the acquirers. A control premium represents the percentage difference between the price actually paid for a company, say $14 per share, and the price at which it was trading prior to the announcement of an acquisition, say $10 per share. In this case, the control premium would be 40% ($14/$10 minus 1.0).

Market participants have been studying control premiums for years. The Factset Mergerstat® /BVR Control Premium Study™ is the most prominent such study at this time.

Sometimes, the control level of value can be observed directly, as when public companies and private companies are acquired and valuation metrics become available. So the levels of value chart provides for moving from the observable control level back down to the marketable minority level. As seen in the chart above, the conceptual minority interest discount has been used to facilitate this movement.

The minority interest discount eliminates the so-called value of control (as reflected in the control premium) by deflating a control price by the amount of the actual or conceptual control premium. So in the example above, the minority interest discount, as measured in the movement from the $14 per share control price to the $10 per share marketable minority price, is 28.6% (or 1 – (1/(1+40%)).

The 40% control premium in our example is the numerical equivalent of the 28.6% minority interest discount. Historically, control premium data (averages and medians) have been used by appraisers as a basis to estimate minority interest discounts. There is now substantial agreement among business appraisers that control premiums measure, in addition to any value that may be directly attributable to control, the added benefits of expected acquirer synergies or other strategic benefits.

This evolution in thinking regarding valuation premiums and discounts (and the levels of value) has created growing confusion in the statutory fair value arena.

The Nonmarketable Minority Level of Value

The lowest level on the traditional levels of value chart is called the nonmarketable minority level of value. This level of value represents the conceptual value of illiquid (nonmarketable) minority interests of private companies (i.e., entities that lack markets for their shares).

It has long been accepted that minority interests in private companies are worth less, perhaps even substantially less, than controlling interests. What have not been clearly understood are the reasons for differences in value between minority and controlling interests of businesses.

Appraisers have typically moved from the marketable minority level of value to the nonmarketable minority level of value through the application of a conceptual discount called the marketability discount. That has been my term of preference for many years, but others refer to the same discount as the discount for lack of marketability (DLOM).

If, as in our example above, the marketable minority level of value is $10 per share for a company, and a transaction in a minority block occurs at $7.50 per share, then the marketability discount is 25% (1 – ($7.50/$10)).

The concept of valuation discounts related to lack of marketability has been studied in the public securities markets since the 1960s. A good overview of available market evidence (i.e., restricted stock studies and pre-IPO studies) is found in my book, *Business Valuation: An Integrated Theory Second Edition* (with Travis Harms). These studies of market evidence fall into two categories, restricted stock studies and pre-IPO studies.

Appraisers and courts have used and misused these studies for years. The misuse of available evidence has contributed to confusion in the statutory fair value arena.

Conclusion

In our next post on Statutory Fair Value, we will dispel some of the confusion regarding the traditional levels of value chart as we proceed with our discussion of statutory fair value in the context of modern business valuation theory and practice.

STATUTORY FAIR VALUE

Proportionate Interest in a Going Concern

March 17, 2011

There have been three posts thus far in this series on Statutory Fair Value. The first post introduced the topic of statutory fair value and provided the statutory definition of fair value in Delaware.

Fair value is defined in Delaware Code Annotated Section 262(h) as (with parenthetical numbers and emphasis added):

> After the Court determines the stockholders entitled to an appraisal, the appraisal proceeding shall be conducted in accordance with the rules of the Court of Chancery, including any rules specifically governing appraisal proceedings. Through such proceeding (1) the Court shall determine the fair value of the shares (2) exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value. (3) In determining such fair value, the Court shall take into account all relevant factors…

We pointed out that this definition was less than crystal clear from the viewpoint of turning it into clearly understandable concepts of valuation.

In the second post, we introduced the discounted cash flow model and the Gordon Model to begin the discussion of understandable concepts of valuation. And in the third post, we discussed the traditional levels of value that appraisers (and courts) use when trying to make determinations of statutory fair value. We also linked the benchmark, marketable minority level of value with the Gordon Model and the DCF method.

In this fourth post, I'd like to pose the first of three questions or issues that arise with statutory fair value determinations that simply cannot be addressed with the valuation concepts discussed thus far. In raising the issues, we will not yet attempt to address them. However, it is necessary to understand what the questions are as we continue our quest to understand statutory fair value.

1. What is the (value of) a "proportionate interest in a going concern?" This terminology (or similar) pervades cases in many jurisdictions, so it is an important question.

2. What is an "implicit minority discount?" This concept has been appearing in Delaware cases for some years, is confusing, and conflicts with concepts of financial control versus strategic control.

3. What is the basis for applying a marketability discount to otherwise controlling interest fair value determinations in New York? This question is important for New York and for all jurisdictions that look in that direction for guidance.

What is the Proportionate Interest in a Going Concern?

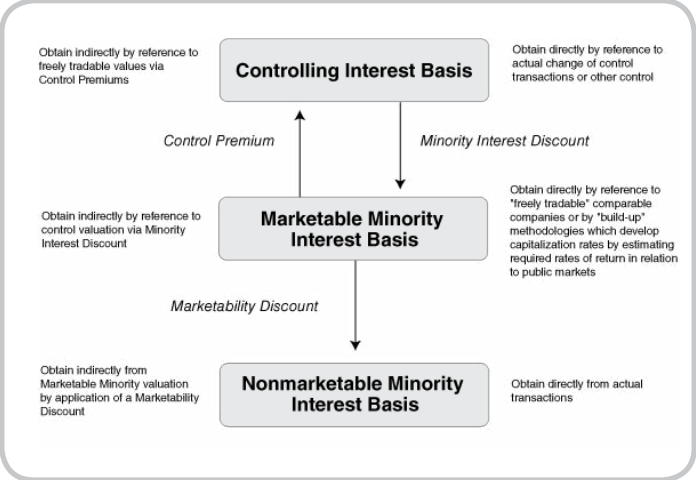
In *Trye-Continental vs. Battye* (1950 Del. LEXIS 2), we read:

> The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder's proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger. In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into the fixing of value. Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but must

be considered by the agency fixing the value. The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. **By value of the stockholder's proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger.** In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into the fixing of value. Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but must be considered by the agency fixing the value. (emphasis added)

One problem with guidance like this relating to the value of a proportionate interest in a going concern is that it introduces new terms like "true or intrinsic value." The cited case is more than 50 years old, but the concept of the proportionate interest in a going concern appears in many, more recent cases.

Recall the traditional levels of value chart.



A primary issue with the concept of the proportionate interest in a going concern is that it is unclear, on the traditional levels of value chart, whether the concept refers to the marketable minority level of value or the control level of value. Both levels are enterprise concepts and reflect "going concern" value (except, of course, in liquidation). This lack of clarity creates confusion for appraisers and for courts in statutory fair value determinations.

Further, the mention of true, or intrinsic value, raises questions regarding yet another standard of value called investment value. Investment value can be thought of as value to a particular owner or investor.

The crux of the problem with the term "proportionate interest in a going concern" is that it can mean different things to different people. Appraisers can put in the position of having to guess what the term means. If the term could refer to the control value or the marketable minority value of a business (see the chart above), the choice of which level will have a potentially significant impact on any determination of statutory fair value.

Some appraisers apparently take positions on matters like this. My practice, if there is potential for differing economic interpretations, is to provide indications at both levels. In the alternative, I request a specific legal interpretation from counsel and provide my determination of statutory fair value at counsel's concluded level and in reliance on counsel's legal interpretation.

I understand that courts are often making equitable determinations of fair value. But if the courts in various jurisdictions desire to obtain competent and understandable valuation guidance from business appraisers, they will, ultimately, have to express fair value determinations in understandable economic terms. For the courts to do this, however, requires that the economic evidence presented to them is understandable and consistent with financial and valuation theory and practice.

Conclusion

Our quest in this statutory fair value series is to develop understandable valuation guidance and terminology. With such guidance, appraisers and courts will be able to focus on reasonable valuation concepts in statutory fair value determinations, rather than fighting over confusing and theoretically incorrect concepts and terminology.

In the next post in this series, we will address the concept of the implicit minority discount that has recently emerged in Delaware statutory fair value cases.

STATUTORY FAIR VALUE

The Implicit Minority Discount

March 21, 2011

In the last post, we talked about the concept of the proportionate share of the value of a going concern that has deep roots in Delaware statutory fair value case law. In Delaware, where the discounted cash flow method is the favored valuation method, the proportionate interest in a going concern is defined by the net present value of the expected future cash flows of a business.

A 2007 article, "The Short and Puzzling Life of the 'Implicit Minority Discount' in Delaware Appraisal Law appearing in the *University of Pennsylvania Law Review*" (written by two professors, Lawrence Hamermesh and Michael Wachter) points out the second problem (with respect to the traditional levels of value).

Recall that the first problem is that of a proportionate interest in a going concern and the third is the marketability discount that appears relative to otherwise controlling interest values in New York case law.

The article notes:

> As sometimes happens in rapidly developing bodies of law, however, a doctrinal weed sprung up in the late 1990s in what was otherwise a largely harmonious, well-tended garden of finance and law. In a rapid succession of cases over a period of less than ten years, there developed what is now known in the Delaware case law as the "implicit minority discount," or "IMD"…

The Hamermesh/Wachter article then describes the IMD:

> The financial/empirical assertion of the IMD is quite simple: no matter how liquid and informed the financial markets may be, all publicly traded shares persistently and continuously trade in the market at a substantial discount relative to their proportionate share of the value of the corporation. This discount, it is said, arises because the stock prices on national securities markets represent "minority" positions, and minority positions trade at a discount to the value of the company's equity. The consequence of the IMD in appraisal proceedings is limited in scope, but substantial in scale: in applying a valuation technique (known as "comparable company analysis, or "CCA") that estimates subject company value by reference to market trading multiples observed in shares of comparable publicly traded firms, the result must be adjusted upward by adding a premium to offset the "implicit minority discount" asserted to exist in the comparable companies' share prices. In the last several years, the size of this upward adjustment (and the supposed discount that it "corrects") has been routinely fixed, even without supporting expert testimony, at 30%.

Interestingly, the Delaware chancellors have relied primarily on works of Dr. Shannon P. Pratt and, believe it or not, me, in reaching their conclusions regarding the IMD. The primary texts relied upon have been the third edition of Pratt's *Valuing a Business*, published in 1996, and on my 1992 text, Valuing Financial Institutions.

Never mind that both Shannon and I have modified our positions on the routine application of control premiums when using the comparable company method (actually, the appropriate name is the Guideline Public Company Method).

Gilbert Matthews, a business appraiser with extensive experience in statutory fair value matters, addressed this fact in his 2008 article in the *Business Valuation Review* (fee to download), "Misuse of Control Premiums in Delaware Appraisals." Matthews wrote about Pratt:

> In 2001, Pratt further clarified his position in *Business Valuaiton Discounts and Premiums.* After an extensive discussion of various articles and seminars regarding the issue of whether market prices reflect control value, Pratt quoted extensively from [Mark] Lee's incisive 2001 article and then concluded, "In any case, it is obvious that, given the current state of the debate, one must be

> extremely cautious about applying a control premium to public market values to determine a control level of value.
>
> However, as late as 2005 in the Andaloro decision, the Court continued to cite Pratt's 1996 book in support of an adjustment for IMD…

And now, it gets personal. Matthews continued:

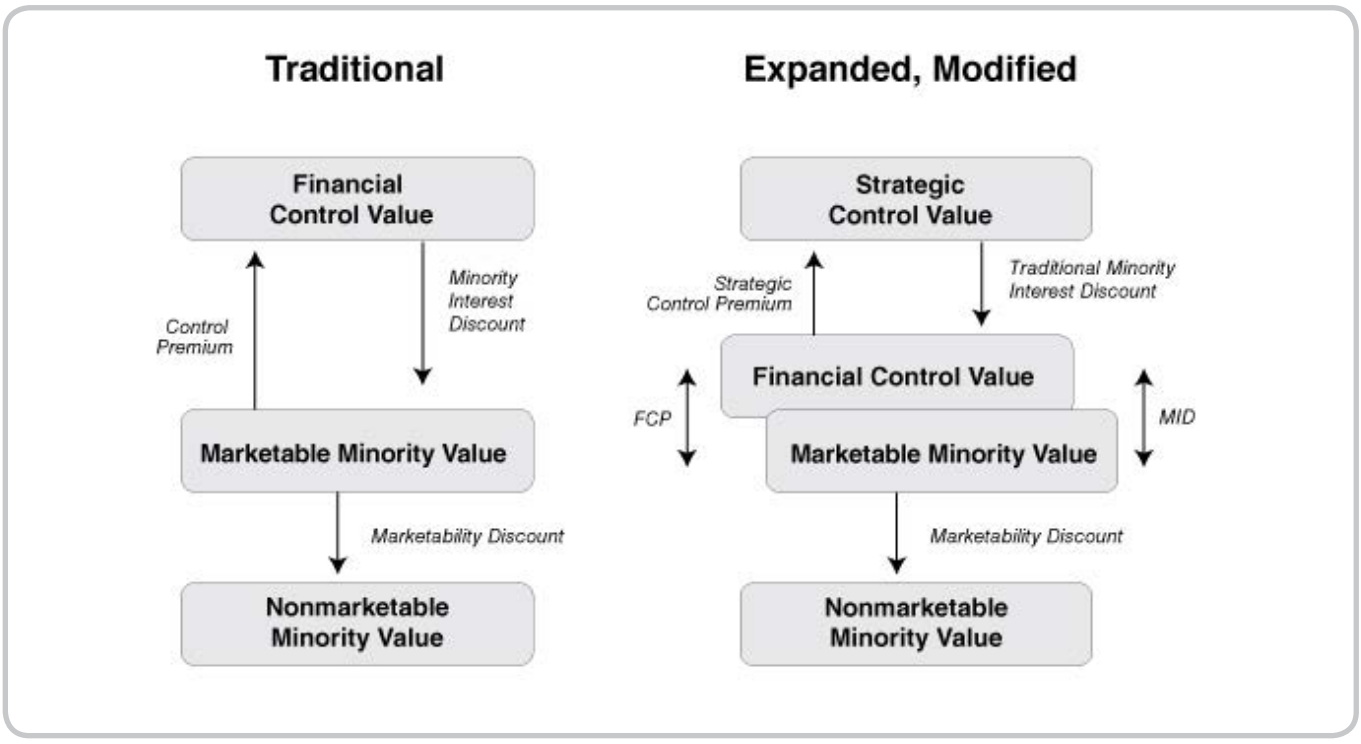
> Mercer was also coming to the conclusion that market prices are often close to control value. He addressed the issue directly in 2004 [and long before that in speeches] in the important 1st Edition of *The Integrated Theory of Business Valuation*. After having disagreed with [Eric] Nath in the early 1990s, he conceded that Nath had been right, and that the financial control premium (the difference between Financial Control Value and Marketable Minority Value) could be zero. Mercer's 2004 book included a modified levels-of-value diagram (see Figure 2) that showed Marketable Minority Value overlapping Financial Control Value. He uses that model to make the point that unless there are cash flow-driven differences between the enterprise's financial control value and its marketable minority value, there will no (or very little) minority interest discounts.

The Figure 2 referred to in the quote is the updated (or modified) level of value chart on the right side of the included chart below.

It should be clear that if economic reality is best described by the modified (four levels) chart on the right, then it would be difficult to address the issue of the implicit minority interest discount with the traditional (three levels) chart. Also, a 30% swing in value is a pretty large difference in any statutory fair value price determination.

Matthews is correct in noting that I refer to the need to discuss cash flow-driven differences to discuss the levels of value. That is the linchpin concept behind the first book cited and also *Business Valuation: An Integrated Theory Second Edition*, which is the second edition of the 2004 book cited by Matthews (and co-authored by Travis Harms).

As this series on statutory fair value continues, we will specifically address the cash flow-driven differences that underlie the integrated theory of business valuation. We will define each of the levels of value in terms of expected cash flow, risk and growth, just as we concluded in the second post on the discounted cash flow method.



STATUTORY FAIR VALUE

Applicability of Marketability Discounts in New York

March 24, 2011

In the last two posts in this series, we have addressed two of at least three issues that are not easily addressed in the context of the traditional levels of value concepts in statutory fair value determinations.

1. Determining the proportionate interest in a going concern
2. The applicability of "implicit minority discounts" in Delaware fair value determinations

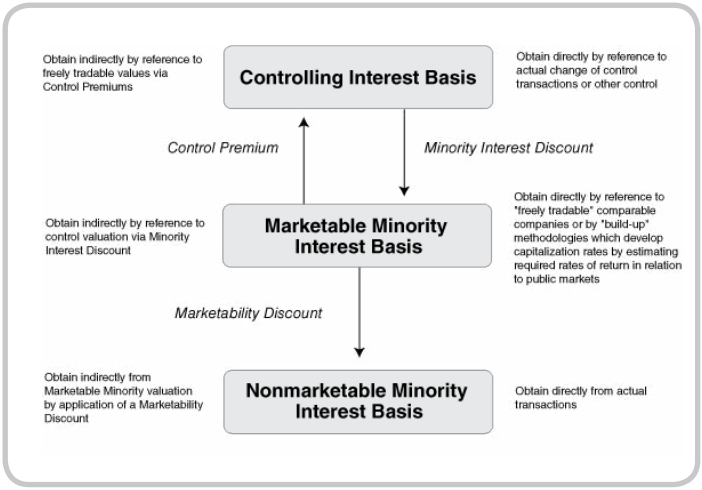
This post begins to address a third issue, that of the applicability of marketability discounts in statutory fair value determinations in New York.

We begin with a summary of the current situation by Peter Mahler, writer of the New York Business Divorce Blog, in a post about a recent case *Cole v. Macklowe*:

> The rules for the two most important valuation discounts in New York statutory "fair value" (FV) proceedings, such as shareholder oppression and dissenting shareholder cases, are well established: the discount for lack of marketability (DLOM) is in; the minority discount a/k/a discount for lack of control (DLOC) is out. DLOM applies because it reflects the additional time and risk of selling even a controlling, nonmarketable interest in a closely held business as compared to publicly traded shares. In contrast, the reasoning goes, if DLOC were applied in FV proceedings the majority shareholders would receive a windfall that would encourage squeeze-out and unfairly deprive minority shareholders of their proportionate interest in the venture as a going concern.
>
> As I've previously written here and here, the exclusion of DLOC in FV appraisals is the principal distinguishing feature from the "fair market value" (FMV) standard used in matrimonial, gift and estate tax matters where, premised on a hypothetical arm's-length transaction under which neither buyer nor seller is under any compulsion to buy or sell, both discounts generally apply. The two discounts, individually and certainly when combined, can substantially reduce the value of an interest in a closely held business entity. (Links in original post)

Having stated this current overview of New York statutory fair value law, Mr. Mahler then goes on to discuss *Cole v. Macklowe*, an apparent exception (and subject to appeal) to the rote applicability of a marketability discount in an otherwise controlling interest valuation.

Once again, we look at the traditional, three-level levels of value chart that gives rise to much confusion in the statutory fair value world.



At its simplest, the marketability discount is applicable to the marketable minority level of value. It is that conceptual valuation discount that accounts for the additional risks and (likely) lower expected cash flows attributable to illiquid minority interests rather than to an enterprise. Two observations are appropriate here:

- The marketable minority level of value is an enterprise level of value. Value indications are developed based on the capitalization (or discounting) of 100% of enterprise cash flows. Some say that the level is, nevertheless, minority. However, since 100% of the enterprise cash flows are capitalized into the current price for public (and, as-if for private) companies, no discounting from that level for lack of marketability or otherwise is appropriate in fair market value (or fair value) determinations at that level. See the further discussion below.

- The control level of value on the chart also represents the capitalization (or discounting) o 100% of the cash flows of an enterprise. However, the control level cash flows may be different than at the marketable minority level if others think they can run the company better (and adjust existing cash flows) or differently (and adjust existing or synergistic cash flows).

Looking back at the chart, it is clear that the marketability discount relates to the marketable minority level of value. Market evidence of the lower typical pricing of public securities whose liquidity is impaired is found in numerous restricted stock studies. In the third post in this series, we learned:

> It has long been accepted that minority interests in private companies are worth less, perhaps even substantially less, than controlling interests. What have not been clearly understood are the reasons for differences in value between minority and controlling interests of businesses.
>
> Appraisers have typically moved from the marketable minority level of value to the nonmarketable minority level of value through the application of a conceptual discount called the marketability discount. That has been my term of preference for many years, but others refer to the same discount as the discount for lack of marketability (DLOM).
>
> If, as in our example above, the marketable minority level of value is $10 per share for a company, and a transaction in a minority block occurs at $7.50 per share, then the marketability discount is 25% (1 – ($7.50/$10)).
>
> The concept of valuation discounts related to lack of marketability has been studied in the public securities markets since the 1960s. A good overview of available market evidence (i.e., restricted stock studies and pre-IPO studies) is found in my book, *Business Valuation: An Integrated Theory Second Edition* (with Travis Harms). These studies of market evidence fall into two categories, restricted stock studies and pre-IPO studies.

In the remainder of this post, we will address the issue in light of levels of value charts. In future posts, we will refine our discussion of expected cash flow, risk, and growth to further elaborate on this question and the proportionate interest in a going concern and the implicit minority discount questions as well.

The logic for the application of a marketability discount to an otherwise controlling interest is repeated from above:

> DLOM applies because it reflects the additional time and risk of selling even a controlling, nonmarketable interest in a closely held business as compared to publicly traded shares.

This is the stated logic (as summarized by Mr. Mahler) and it is consistent with what I have seen in my experience in statutory fair value matters in New York, as well. While the issue may be well-settled, it is also well-debated in New York statutory fair value cases because the logic is simply incorrect. In light of the three-level chart above, it should be clear that there is no marketability discount applicable at the controlling interest level of value.

No valuation discount or premium has any meaning unless the base from which it is taken or to which it is applied is defined. The marketability discount has meaning because it applies to the marketable minority level of value and reduces value for lower expected cash flows and greater risk normally associated with holding illiquid minority interests.

It is incorrect, both theoretically and practically, to apply a marketability discount to a controlling interest in a business. The market information (i.e., restricted stock studies) has no bearing on controlling interests. Yet, it is the restricted stock studies (and pre-IPO studies) that have been cited to justify marketability discounts to controlling interests in New York fair value determinations.

There are no studies that provide market evidence of the lack of marketability for controlling interests in companies. It is true that public securities can be sold and cash received in settlement three days later. That is the institutional framework in which interests in public companies are sold.

It is also true that it generally takes considerable time to sell entire companies. However, it is appropriate to compare this time with the three day settlement period for public security transactions. I first wrote an article on this topic in June 1994 in the *Business Valuation Review*. The logic was developed further as we developed the integrated theory of business valuation.

Thanks to the magic of Google, readers can look inside the overs of *Business Valuation: An Integrated Theory Second Edition* on this topic.

A New York Hypothetical Example

In New York, the application of a marketability discount to otherwise controlling interests is particularly interesting. A number of the cases in which the issue has arisen have related to asset holding companies. Many of the thousands of apartment buildings, office buildings and other rental properties in New York City have been placed into corporate or partnership form. A number of those corporate entities have been involved in statutory fair value or shareholder oppression disputes.

Consider that a corporation whose primary assets, other than cash, are apartment buildings in New York City. In a statutory fair value matter, the apartment buildings would normally be appraised individually by qualified real estate appraisers. Assume for purposes of this example that two qualified real estate appraisers reached conclusions within three percent of each other, an immaterial amount that is resolvable between the parties or certainly by a court.

Now consider that two business appraisers are retained by the company and the dissenting shareholders, respectively, to value the stock in the company, and that the real estate values are stipulated by the parties.

- Both appraisers have an identical net asset value. There is no dispute over the value of cash, any other assets and the few liabilities on the balance sheet.
- No other valuation issues relating to the valuation of the company, e.g., embedded capital gains or other off-balance sheet liabilities, were identified by either appraiser.
- Both business appraisers conclude that net asset value is $20.0 million
- One appraiser applied no marketability discount, so her conclusion of the fair value of the company was $20 million.
- The other business appraiser applied a discount for lack of marketability of 30%, consistent with case law, citing restricted stock studies as the basis, so his conclusion of fair value was $14 million.

What is a judge to do? In a similar case that has not yet been decided (and where there were also other valuation issues), I made arguments like above regarding the inapplicability of the DLOM, or marketability discount to an otherwise control valuation. I also pointed out, after reading the appraisal reports of two groups of real estate appraisers, that "time to market" was an integral assumption in both groups of appraisals.

"Time to market" was the expected exposure time that preceded the valuation date of the reports that was assumed to have already occurred prior to the valuation date.

If the time to market had already been considered, how then would it make sense to apply an additional and arbitrary DLOM to the corporation's fair value for, effectively, the time to market the corporation (which consisted almost entirely of the properties) which had already been considered by the real estate appraiser.

The Real New York Case at Hand

Mr. Mahler reports the following about *Cole v. Macklowe*:

> The application of discounts, Justice Diamond therefore concludes, does not turn on statutory constraints. "Rather, the issue turns on whether the policy concerns underlying the ban on the use of discounts are present in this case." Those concerns are present in Cole, Justice Diamond finds, based on four factors:
>
> 1. Macklowe's repudiation of Cole's equity interests "is clearly analogous" to oppressive majority shareholder conduct intended to limit or preclude minority ownership rights, thereby implicating the statutory objective in oppression cases of obtaining a "fair appraisal remedy."
> 2. The use of discounts would "reward" Macklowe by limiting the damages payable by him arising from his own misconduct.
> 3. As in *Vick*, the unavailability of discounts is "particularly apt" since the business assets consist of real estate, and their application would deprive Cole of what the value of his interests would have been had each of the designated properties been sold on the open market.
> 4. The use of discounts would result in a "windfall" to Macklowe by virtue of his "consolidating or increasing his ownership and control of the properties," as opposed to a sale to a third party who gains no right to control or manage the entity.
>
> "Accordingly," Justice Diamond decrees, "Macklowe's request for leave to present expert testimony regarding the applicability of minority and marketability discounts is hereby denied."

In correspondence with Mr. Mahler, he noted that to date, there is little case authority in New York to justify the use of DLOM in statutory fair value cases. That guidance came in *Matter of Blake* (1985), in which we find the following:

> With regard to the discount applied by the **referee** and approved by Special Term, we believe that that discount should be reduced from 40% to 25%. Said discount should only reflect the lack of marketability of petitioner's shares in the closely held corporation. No discount should be applied simply because the interest to be valued represents a minority interest in the corporation.
>
> Business Corporation Law § 1104-a was enacted for the protection of minority shareholders, and the corporation should therefore not receive a windfall in the form of a discount because it elected to purchase the minority interest pursuant to Business Corporation Law § **1118**. Thus, a minority interest in closely held corporate stock should not be discounted solely because it is a minority interest (see, *Brown v Allied Corrugated Box Co.*, 91 Cal App 3d 477, 154 Cal Rptr 170; *Woodward v Quigley*, 257 Iowa 1077, 133 NW2d 38; but see, *Perlman v Permonite Mfg. Co.*, 568 F Supp 222, 230-232, *affd* 734 F.2d 1283; *Moore v New Ammest*, 6 Kan App 2d 461, 474-475, 630 P2d 167, 177).

> However, a discount recognizing the lack of marketability of the shares of **Blake** Agency, Inc., is appropriate, and, under the circumstances of this case, the amount of the discount should be 25%. A discount for lack of marketability is properly factored into the equation because the shares of a closely held corporation cannot be readily sold on a public market. Such a discount bears no relation to the fact that the petitioner's shares in the corporation represent a minority interest (see, e.g., Haynsworth, *Valuation of Business Interests*, 33 Mercer L Rev 457, 489-90; Lyons & Whitman, *Valuing Closely Held Corporations and Publicly Traded Securities with Limited Marketability: Approaches to Allowable Discounts from Gross Values*, 33 Bus Law 2213; cf. *Ford v Courier-Journal Job Print. Co.*, 639 SW2d 553 [Ky App])

There is not much guidance here. Looking at the *Ford v. Courier-Journal* case cited above, though, the evidence cited to justify a 25% marketability discount is definitely based on restricted stock (minority) transactions of public companies:

After a careful examination of the total assets, and even a consideration of the Stevens sale, which occurred after the statutory date of December 20, 1978, the appraisers arrived at a net asset value of $165.00 a share. They then applied what they termed a "marketability discount" in the following language:

> *556 The final step is to address the question of marketability. C-J Job Printing is not a public company and a closely held stock is considerably less attractive to an investor than a similar stock with access to the public marketplace. This difference is normally expressed in terms of a marketability discount applied to its "if-public" price. **These discounts, in general, range between 20 and 50 per cent and reflect both the nature of the public market** (which was generally unreceptive to new issues at the valuation date) and the characteristics of the subject company (in this case a small regional business with no express desire to go public). (Emphasis added)

The evidence cited pertained to restricted stock studies in existence in the late 1970s or early l1980s. The valuation date above was in 1978 and the opinion was rendered in 1982. A great deal has happened in the world of valuation since then that is not reflected in the current application of a marketability discount in statutory fair value determinations in New York.

Conclusion

As stated in the first post in this series, I am agnostic with respect to what courts in any jurisdiction call fair value. The various courts are called upon to make equitable determinations and this can be a difficult process.

What I am concerned about, however, is the fact that courts provide valuation guidance in the process of making their statutory fair value determinations. If that *valuation guidance* is unclear, or if it is based on inadequate or inappropriate market evidence, then the stage is set for future disputes in fair value determinations.

STATUTORY FAIR VALUE

An Introduction to An Integrated Theory of Business Valuation

April 7, 2011

The Gordon Model

The Gordon Model is a single-period income capitalization model that provides a summary interpretation of how securities are valued in the public markets.

$$V_0 = \frac{CF_1}{r - g}$$

The basic formulation of the Gordon Model defines the value of a business or interest as next period's expected cash flow divided by an appropriate discount rate less the expected growth rate of the specified cash flow. As we discussed earlier in this series, this formula is a summary of the discounted cash flow method of valuation under the following conditions:

- The cash flows are expected to grow at the constant rate of g, and
- All cash flows are distributed to shareholders or are reinvested in the firm at the discount rate, r.

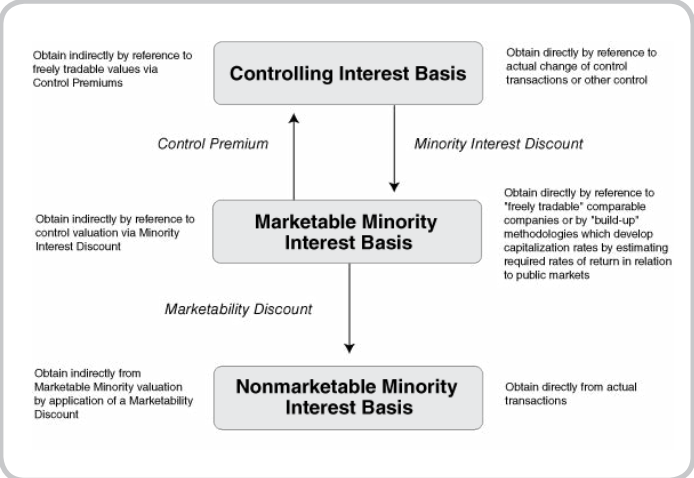
The discounted cash flow model as summarized by the Gordon Model provides an ideal basis for discussing what we call an integrated theory of business valuation, which is fully developed in my book (with Travis W. Harms), *Business Valuation: An Integrated Theory (2nd Edition).*

Early Views of the Levels of Value

The so-called levels of value chart first appeared in the valuation literature some time around 1990 (for more information, see *Business Valuation: An Integrated Theory (2nd Edition)*). However, the general concepts embodied in the chart were known by appraisers (and courts) prior to that time. Even today, virtually all discussions regarding levels of value in the valuation literature are very general, lacking any compelling logic or rationale regarding the factors giving rise to value differences at each level.

The early levels of value chart showed three conceptual levels.

The chart is so important to an understanding of valuation concepts that analysts at Mercer Capital have included it or an evolving version with four levels (see future posts) in virtually every valuation report since about 1992.



Statutory Fair Value and an Integrated Theory of Business Valuation

Guided by the discussion in *Business Valuation: An Integrated Theory (2nd Edition)*, we will begin a process of integrating the

Gordon Model with a discussion of how the markets value companies as we continue in the statutory fair value series. And, we will frame this discussion within the conceptual framework of the levels of value.

The end game is to create a theoretical framework and vocabulary with which we can talk about the valuation concepts that arise in statutory fair value determinations. As we proceed with developing an integrated theory of business valuation, we will:

- Provide a conceptual description of each three level, levels of value on the levels of value chart above in the context of the Gordon Model.
- Develop the four level, levels of value chart previously shown in earlier posts in this series.
- Use the components of the Gordon Model to define the conceptual adjustments between the levels of value, the control premium (and its inverse, the minority interest discount) and the marketability discount.
- Reconcile the resulting integrated valuation model to observed pricing behavior in the market for public securities (the marketable minority level), the market for entire companies (the controlling interest level(s) of value), and the market for illiquid, minority interests in private enterprises (the nonmarketable minority level of value).
- Use the integrated theory of business valuation to discuss statutory fair value concepts such as the implicit minority discount, the use of a marketability discount in statutory fair value determinations in New York, and other concepts of value that appear in historical and emerging cases relating to statutory fair value.

We Will Begin with the Marketable Minority Level of Value

Remember, no valuation premium has any meaning unless the base to which it is applied is specified. And no valuation discount has any meaning unless the base from which it is taken is specified.

The marketable minority interest level of value is the middle level in the three level, levels of value chart above. It is the base from which marketability discounts are applied and to which control premiums are added. As such, an understanding of what this level of value is becomes pivotal to our developing understanding of valuation concepts.

With these objectives in mind, we proceed with the development of the integrated theory of business valuation and with our discussion of statutory fair value.

The next post in this series will discuss the benchmark level of value known as the marketable minority interest.

STATUTORY FAIR VALUE

The Marketable Minority Level of Value

April 15, 2011

In the second post in this series on statutory fair value, we provided background information on the Gordon Model. This model is a single-period income capitalization model that summarizes the way securities are valued in the public markets. The Gordon Model is shown again as a beginning point for discussing of the Integrated Theory of Business Valuation.

$$V_0 = \frac{CF_1}{r - g}$$

The basic formulation of the Gordon Model defines the value of a business or interest as the next period's expected cash flow divided by an appropriate discount rate less the expected growth rate of the specified cash flow. As we have previously shown, this formula is a summary of the discounted cash flow method of valuation under the following conditions:

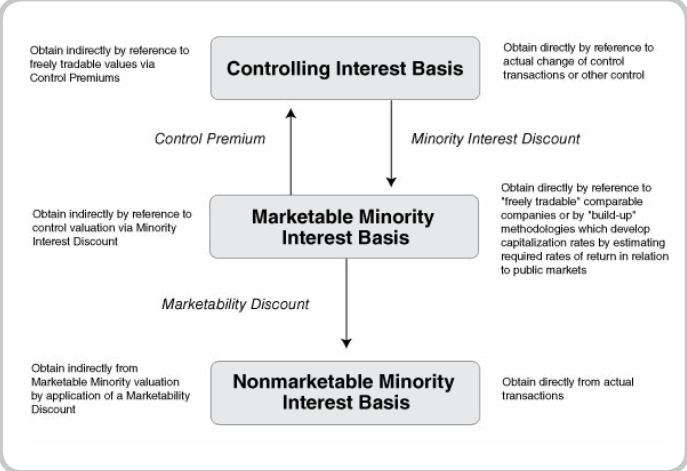
- The flows are expected to grow at the constant rate of g, and
- All cash flows are distributed to shareholders or are reinvested in the firm at the discount rate, r.

The discounted cash flow model as summarized by the Gordon Model provides an ideal basis for the Integrated Theory of Business Valuation. As a reminder, this series of posts is based on my book (With Travis Harms), *Business Valuation: An Integrated Theory, Second Edition.*

Early Views of the Levels of Value

The so-called levels of value chart first appeared in the valuation literature in 1990. However, the general concepts embodied in the chart were known by appraisers (and courts) prior to that time. Even today, most discussions regarding levels of value in the valuation literature are very general, and lacking any compelling logic or rationale regarding the factors giving rise to value differences at each level.

The early levels of value chart showed three conceptual levels, as indicated below. The chart is so important to an understanding of valuation concepts that analysts at Mercer Capital have included it, or an evolving version with four levels (see past and future posts) in virtually every valuation report since about 1992.



We, like most appraisers in the 1990s, assumed the existence of the conceptual adjustments referred to as the control premium, the minority interest discount, and the marketability discount. We relied on market evidence from control premium studies to help ascertain the magnitude of control premiums (and minority interest discounts). And we relied on certain benchmark studies, the so-called Pre-IPO Studies and the Restricted Stock Studies, as the basis for estimating the magnitude of marketability discounts.

Such reliance contributed then, and unfortunately, continues to do so today, to a failure to understand the basis for the valuation premiums and discounts being estimated.

One purpose of this series of posts is to integrate the Gordon Model (and how the markets value companies) and the conceptual framework of the levels of value. In so doing, we will discuss an integrated theory of business valuation, which will help as we continue our discussion of statutory fair value. We will proceed to:

- Provide a conceptual description of each level of value in the context of the Gordon Model.
- Use the components of the Gordon Model to define the conceptual adjustments between the levels of value, the control premium (and its inverse, the minority interest discount) and the marketability discount.
- Reconcile the resulting integrated valuation model to observed pricing behavior in the market for public securities (the marketable minority level), the market for entire companies (the controlling interest level(s) of value), and the market for illiquid, minority interests in private enterprises (the nonmarketable minority level of value).
- Begin a discussion of this conceptual framework in the context of statutory fair value generally.
- Discuss specific statutory fair value cases and issues in the context of an integrated theory of business valuation.

With this background, we will develop the marketable minority interest level of value, or the middle level in the three-level chart, as the benchmark level of value from which other levels of value are developed and can be understood.

The Marketable Minority Interest Level of Value

The Gordon Model provides a shorthand representation of the value of public securities at the marketable minority interest level of value. For privately owned enterprises, it indicates the same level of value (the "as-if-freely-traded" level). In developing the Integrated Theory, we use the Gordon Model to analyze how the levels of value relate to each other. To do so, we introduce a symbolic notation to designate which elements of the model relate to each level of value.

The following equation introduces conceptual math for the benchmark level of value – the marketable minority value.

$$V_{mm} = \frac{CF_{e(mm)}}{R_{mm} - G_{mm}}$$

We just described the marketable minority level of value as the "benchmark" level of value. The marketable minority level of value is the benchmark to which control premiums are added to derive controlling interest indications of value, and from which marketability discounts are subtracted to reach the nonmarketable minority level of value.

The components of the equation above are defined as follows:

- $\mathbf{V_{mm}}$ represents the market value of the equity a company at the marketable minority level of value, whether public or private. This is the benchmark, observable value for public securities. The as-if-freely-traded value for private enterprises is a *hypothetical value*. By definition, it is not observable for nonmarketable interests of private enterprises since there are no active, public markets for the shares. Appraisers develop indications of value at the marketable minority level as a first step in determining other levels of value. Such indications of value are developed either by direct reference to the public securities markets (using the guideline public company method), or indirectly, using the Adjusted Capital Asset Pricing Model or other build-up methods.
- $\mathbf{CF_{e(mm)}}$ is the expected cash flow of the enterprise at the marketable minority level (for the next period). The marketable minority level of cash flow reflects enterprise earnings, "normalized" for unusual or non-recurring events and having an expense structure that is market-based, at least in terms of owner/key shareholder compensation. Public companies attempt to keep investors focused on their "normalized" earnings. Many public companies, for example, disclose *pro forma earnings*, or earnings after adjusting for unusual or nonrecurring (and sometimes not so non-recurring) items. The concept of normalizing adjustments is so important and so misunderstood that the next post will be devoted to it. At this point, I ask readers to accept this assumption and then consider the more detailed treatment when we get to it.
- $\mathbf{R_{mm}}$ is the discount rate at the marketable minority level of value. While it is not directly observable, it can be inferred from public pricing or estimated using the Capital Asset Pricing Model or other models. For private companies, R_{mm} is most often estimated using one of several build-up approaches.
- $\mathbf{G_{mm}}$ is the expected growth rate of core earnings for the enterprise under the assumption that all earnings are distributed to shareholders. However, earnings are often reinvested in businesses. It is the compounding effect of reinvested earnings that enables a company to grow its *reported earnings (and value)* at rates (g*) in excess of its *underlying core earnings growth rate*. So, G_{mm} is not equal to the expected growth rate of earnings published by stock analysts for public companies. The *analysts'* g (g*) includes the compounding effect of the reinvestment of cash flows on the expected growth of earnings.

	Conceptual Math	Relationships	Value Implications
Marketable Minority Value	$\frac{CF_{e(mm)}}{R_{mm} - G_{mm}}$	$G_v = R_{mm}$ - Div Yld	V_{mm} is benchmark for other levels

At this point, we can begin to connect the mathematics of valuation theory with the conceptual levels of value chart. The marketable minority level of value is the conceptual value from which other levels of value are derived. The figure above presents the conceptual math of the marketable minority level of value.

We refer to the marketable minority level of value as an *enterprise level* of value. We do so because $CF_{e(mm)}$ is defined as the cash flow of the enterprise. All the shareholders of a publicly traded enterprise, controlling or minority, share the benefit of all of its cash flows (as they are capitalized in the public stock markets every day). The importance of this definition will become clear as the remaining mathematical relationships of the conceptual levels of value are built.

The conceptual math of the marketable minority level indicates that, as we have discussed previously, value is a function of expected cash flows (next period and expected growth) and risk.

The figure shows an important relationship regarding the expected growth in value in the middle column. The Gordon Model is a dividend discount model. $CF_{e(mm)}$ is the expected cash flow available for distribution.

- Expected returns to shareholders come in two forms, distributions, or dividend yield, and capital gains. Dividends provide current income, and reinvested earnings provide the potential for future growth in value and for capital gains.

- If there are no dividends, then $CF_{e(mm)}$ is equal to the net income of an enterprise. Intuitively, that is why the long-term growth rate used in the Gordon Model is typically fairly low, quite often in the low to mid single digits. If all earnings are distributed, growth is limited to inflation and productivity increases. Owners get substantial current returns and limited expected capital gains. If all earnings are paid out to shareholders, then the expected growth in value is the long-term growth of core earnings.

- If some earnings are retained to finance growth, then two things occur. First, owners get a current return in the form of current dividends and a portion of expected returns relates to the more rapid growth (than long term core growth) because of the compounding effect (at the discount rate) of reinvested earnings.

- The point is that expectations for growth in value of an enterprise are related to a company's distribution policy (or, alternatively, its earnings retention policy). If all earnings are retained in the enterprise, the expected growth in value is the discount rate. If all earnings are distributed, the expected growth in value is the long-term core (slow) growth in earnings. For distribution policies in between 0% and 100%, the expected growth in value is discount rate (R_{mm}) minus the dividend yield. This is true because shareholders expect to get their expected return either in the form of dividends or capital gains (and are assumed to be indifferent between the two forms of return).

Finally, the right side of the figure above indicates that the Gordon Model provides value at the marketable minority level.

We will continue to build the Integrated Theory from the base found in the figure above.

The marketable minority level of value is that level to which appraisers have almost automatically applied control premiums to develop controlling interest indications of value. It is also the level from which appraisers have subtracted marketability discounts to derive indications of value at the nonmarketable minority level of value.

Refer again to the levels of value chart above. The control premium and the marketability discount are conceptual adjustments enabling appraisers to relate the marketable minority level of value with the controlling interest level (control premium) and the nonmarketable minority level (marketability discount). The minority interest discount also relates the controlling interest and marketable minority levels.

As pointed out clearly by numerous writers, including me, no valuation premium or discount has meaning unless we understand the base to which it is applied. The ASA Business Valuation Standards (BVS VII Valuation Discounts and Premiums) states:

II. The concepts of discounts and premiums

A. A discount has no meaning until the conceptual basis underlying the base value to which it is applied is defined.

B. A premium has no meaning until the conceptual basis underlying the base value to which it is applied is defined.

C. A discount or premium is warranted when characteristics affecting the value of the subject interest differ sufficiently from those inherent in the base value to which the discount or premium is applied.

D. A discount or premium quantifies an adjustment to account for differences in characteristics affecting the value of the subject interest relative to the base value to which it is compared.

The marketable minority value is the benchmark level of value for the enterprise in the Integrated Theory of Business Valuation. It is the "conceptual base" to which marketability discounts and control premiums are applied. We need to understand what this conceptual base is, and importantly, what it is not.

A review of the valuation literature prior to the latter part of the 1990s yields little insight into the theoretical basis for applying the well-known conceptual premiums and discounts. Practically, appraisers applied control premiums because they were frequently observed when public companies changed control. And marketability discounts were applied because it was observed that restricted stocks of public companies traded at prices lower than their freely traded counterparts.

Only in recent years have appraisers begun to understand and to articulate why control premiums and restricted stock discounts exist, and consequently, to understand the theoretical basis for their existence. The Integrated Theory explains the why behind the generally accepted valuation premiums and discounts.

Conclusion

Statutory fair value for interests in businesses is judicially determined in the various states, usually with assistance from business appraisers. However, courts cannot render clear judicial guidance in the absence of clear valuation evidence.

In the next post, we will talk about normalizing adjustments before proceeding with our investigation of the control level(s) of value.

STATUTORY FAIR VALUE

An Introduction to Normalizing Adjustments

April 18, 2011

We used the Gordon Model to develop a "basic valuation equation" in an earlier post in this series on statutory fair value. Everyone who is familiar with business value in an way understands this equation:

Value = Earnings x Multiple

This generalized valuation model and the integrated theory of business valuation that I have written about (*Business Valuation: An Integrated Theory, 2nd Edition* with Travis W. Harms) suggest that value indications should be developed by estimating appropriate indications of earning power and a reasonable valuation multiple.

It follows that appraisers may need to consider potential adjustments to both earnings and the multiple in order to develop appropriate indications of value.

- **Normalizing Adjustments.** The next couple of posts will explore normalizing adjustments to develop private company earnings that correspond with the valuation multiples of guideline companies to yield marketable minority indications of value.
- **Control Adjustments.** We will also consider earnings adjustments that relate to the other enterprise levels of value, namely, the financial control and strategic control levels of value. A fundamental insight arising from the integrated theory of business valuation is that the discount rate applicable to individual private companies should remain (approximately) the same for the various enterprise levels of value. Control adjustments yield a measure of enterprise earnings appropriate to the control levels of value.
- **Fundamental Adjustments.** Fundamental adjustments relate appropriate private company valuation multiples to the median or average multiples of guideline company groups. Fundamental adjustments account for differences in risk and expected growth for private companies relative to selected guideline companies. We postpone treatment of fundamental adjustments for possible treatment later.

This post and the next one (or two) lay the theoretical foundation for these adjustments commonly applied in valuation practice.

The Marketable Minority Level of Value

In our previous post, we developed mathematical expressions for the marketable minority level of value. In future posts, we will develop the other levels of value in similar fashion. For now, however, we need to discuss normalizing adjustments to facilitate understanding of the other levels of value.

Cash flow of the enterprise at the marketable minority level is represented by $CF_{e(mm)}$.

This cash flow is assumed to be normalized to approximate that of comparable well-run public companies. Otherwise, if there were, for example, excessive compensation or other discretionary expenditures of an ongoing, egregious nature, there would be pressure from shareholders (or potential acquirers) for the earnings stream to be normalized.

To foreshadow the nonmarketable minority level, which is discussed below, the marketable minority level of value is determined, in part, by capitalizing the cash flow of the enterprise ($CF_{e(mm)}$).

The Nonmarketable Minority Level of Value

The nonmarketable minority level of value is determined by capitalizing (or discounting) a different set of cash flows – only those cash flows directly available to minority shareholders. We know that the Gordon Model assumes full distribution of earnings (or alternatively, the reinvestment of earnings in the enterprise at the discount rate). In a sense, distribution policy does not matter for public companies. Regardless of whether earnings are distributed or retained (or a combination), shareholders of public companies have access to the capitalized value of all future cash flows through the mechanism of the public securities markets.

Owners of illiquid interests have no ready market for their shares, and obtain only those cash flows that are distributed if and when they are, together with a terminal cash flow upon exit.

Cash flow to minority shareholders can be equal to, but not greater than, the cash flows of the enterprise at the marketable minority level. Cash flows can be less for two reasons. In the extreme case, assume there are no distributions. The cash flow available to owners of an illiquid interest is comprised of a future terminal cash flow. The absence of cash flow and the risk of holding the interest over a likely uncertain holding period warrant a diminution in value.

Another reason for a potential diminution in value pertains to the potential for agency costs, or non pro rata distributions to selected shareholders. Agency costs also include excess perquisites and other discretionary expenditures. Some appraisers seem to think that these expenses should not be normalized in valuations of minority interests. This treatment is inconsistent with the theory that to value an illiquid interest we must first value the enterprise. That is precisely the theory summarized in the levels of value charts themselves.

It should be clear that agency would be normalized, so that the resulting enterprise cash flows approximate the expected enterprise cash flows (assuming any nonrecurring items in historical earnings have been eliminated). We classify adjustments for both agency costs and nonrecurring items as normalizing adjustments.

Control Adjustments

As we move up the levels of value chart from the marketable minority level to the levels of financial control and strategic control, we see that it is possible that a controlling shareholder may make adjustments to expected cash flows based on the expected ability to run the existing enterprise better (financial control), or to modify or manage the enterprise differently (strategic control). Such adjustments are control adjustments, and increase value if such adjustments would normally be negotiated between buyers and sellers. In other words control adjustments are those that, if appropriate, increase enterprise cash flow above that of the (normalized) marketable minority level.

Conclusion

In the next post(s), we will discuss two types of normalizing adjustments as well as two types of control adjustments. Then, with this understanding, we will proceed to develop the other levels of value in a fashion as in the figure above.

To remind readers, this series of posts on statutory fair value relies heavily on my book (with Travis W. Harms) *Business Valuation: An Integrated Theory, 2nd Edition.*

STATUTORY FAIR VALUE

Normalizing Adjustments Continued

April 20, 2011

We continue the discussion of normalizing adjustments, which are important adjustments in valuation analyses generally, and potentially critical in statutory fair value determinations.

Two Types of Income Statement Adjustments

Having described the general nature of normalizing adjustments and control adjustments, we now turn to their proper application.

- With **normalizing adjustments**, we attempt to adjust private company earnings to a reasonably well run, public company equivalent basis. Normalizing adjustments can be further divided into two types to facilitate discussion and understanding. Normalizing adjustments are not control adjustments.

- **Control adjustments** modify normalized private company earnings to reflect 1) the operational improvements anticipated by the typical financial buyer; and 2) synergies or strategies of particular buyers. Control adjustments can also be divided into two types. We will discuss control adjustments in a subsequent post.

This nomenclature for income statement adjustments is fairly new. Many appraisers do not distinguish between normalizing and control adjustments or between types of normalizing and control adjustments. This failure by some appraisers to distinguish between two significantly different types of adjustments lends to confusion on the parts of users of valuation reports and courts.

The specific vocabulary presented in these posts facilitates understanding of income statement adjustments, and clarifies the nature of and reasons for income statement adjustments.

Income Statement Adjustments and the Relevant Discount Rate

The importance of distinguishing between types of income statement adjustments becomes apparent when we discuss the discount rates applicable to derived earnings. The discount rate or capitalization rate applied to a particular measure of earnings must be appropriate for that measure, whether net income, pre-tax income, debt free net income or another level of the income statement.

As suggested in a recent post, the CAPM/ACAPM (the Adjusted Capital Asset Pricing Model which I have written about since 1989 and which is discussed in Chapter 6 of *Business Valuation: An Integrated Theory Second Edition*) discount rate applies to either the net income or net cash flows of business enterprises (and relates to the nature — dividend discount — of the Gordon Model). The discount rate does not change with changes in distribution, or dividend-payout, policies.

There has also been considerable discussion in recent years regarding whether discounted cash flow valuation models yield minority interest or controlling interest indications of value. The two major schools of thought are as follows:

1. The CAPM/ACAPM discount rate is applicable to the net income (or net cash flow) of a business enterprise, and therefore yields a marketable minority indication of value. As a result, control premiums are properly applied to value indications at this level to derive a controlling interest conclusion of value.

2. Appraisers often make control adjustments in developing their projections for DCF methods. If the income stream is "control adjusted," the resulting valuation indication is at the controlling interest level. As a result, no additional control premium is appropriate, and a minority interest

discount might be applied to derive a marketable minority value indication.

Appraisers have debated these two viewpoints for years. Depending on the adjustments made, either approach might yield similar results. However, the issue has been a source of confusion, and the debate has found a forum in the Tax Court. A number of recent appraisals submitted to the court have been scrutinized over the very issue of whether a DCF model yields a minority interest or a controlling interest valuation.

Dr. Shannon P. Pratt and others, including myself, have suggested that in DCF methods, the value of control is generally developed by adjusting the numerator (the projected cash flows). The following quote from Pratt's Cost of Capital, 1st Edition (pp. 127-128) illustrates the consensus:

> The discount rate is meant to represent the underlying risk of a particular industry or line of business. There may be instances in which a majority shareholder can acquire a company and improve its cash flows, but that would not necessarily have an impact on the general risk level of the cash flows generated by that company.
>
> In applying the income approach to valuation, adjustments for minority or controlling interest value should be made to the projected cash flows of the subject company instead of to the discount rate. Adjusting the expected cash flows better measures the potential impact a controlling party may have while not overstating or understating the actual risk associated with a particular line of business.

While the above quote is found in a chapter dealing with discount rates, note the suggestion that control adjustments would be made to the marketable minority level of cash flows. If such adjustments are made, the indicated value would exceed the marketable minority level, and reflect on the controlling interest levels on the conceptual chart.

Properly distinguishing between normalizing and control adjustments in the context of the integrated theory of business valuation should bring clarity to this issue.

Normalizing Adjustments to the Income Statement

Normalizing adjustments modify the income statement of a private company to reveal a "public equivalent" income stream. If such adjustments are not made, the resulting indication of value is something other than a marketable minority value. Resulting values would there or not be "as-if freely traded" (see below).

For appraisers using benchmark analysis to determine marketability discounts, this would be disastrous, since the restricted stock studies are based on freely traded (marketable minority) stock prices.

Note that, in creating a public equivalent for a private company, the subject company need not have all of the characteristics of potential IPO candidates. Another name given to the marketable minority level of value is "as-if freely traded." This terminology emphasizes that earnings are being normalized to where they would be as if the company were public. The framework does not require that a company be public or even that it have the potential to become public.

A new vocabulary is needed to clarify the nature of normalizing income statement adjustments. As noted earlier, there are two types of normalizing adjustments. Being very original, we call them Type 1 and Type 2.

- **Type 1 Normalizing Adjustments**. These adjustments eliminate one-time gains or losses, other unusual items, discontinued business operations, expenses of non-operating assets, and the like. Every appraiser employs such income statement adjustments in the process of adjusting (normalizing) historical income statements. Regardless of the name given to them, there is virtually universal acceptance that Type 1 Normalizing Adjustments are appropriate.

- **Type 2 Normalizing Adjustments.** These adjustments normalize officer/owner compensation and other discretionary expenses that would not exist in a reasonably well-run, publicly traded company. Type 2 Normalizing Adjustments should not be confused with control adjustments or Type 1 Normalizing Adjustments.

These adjustments reveal the income stream that is the source of potential value for the minority investor. Normalizing adjustments also reveal the base income stream available to the controlling interest buyer who may be able to further enhance that income stream.

Appraisers should not be confused by the fact that minority shareholders of private companies lack the control to make normalizing adjustments. Some have argued that because minority shareholders lack the ability to change, for example, things like excess owner compensation, normalizing adjustments should not be made in minority interest appraisals. **This position is simply incorrect,** although it is enduring among appraisers.

Minority shareholders of public companies also lack control. However, they expect normalized operations. If management of a public company receives egregious salaries, or fails to reasonably manage expenses, minority shareholders of the public company will invest their money elsewhere. And the market value of such companies normally reflects this lack of investor interest exposing incumbent management to the threat of hostile takeover (followed shortly thereafter by unemployment).

Shareholders of nonmarketable minority interests generally lack this ability to "take my money and run." **These considerations have no impact on the underlying value of the enterprise.** Rather, they reduce the value of the interest in the enterprise in relationship to its pro rata share of enterprise value. This diminution of value must be

considered separately from, but in conjunction with, the valuation of the enterprise.

Statutory Fair Value and Normalizing Adjustments

Normalizing adjustments can be important in statutory fair value determinations. If excess owner compensation is considered part of how a company is operated, then controllers of corporations have the control to artificially lower "fair value" and at the same time, benefit from the reduction in the form of non pro rata distributions.

That may be "fair" in some jurisdictions, and part of the "operational reality" of a business. However, normal appraisal procedure would call for normalization of earnings prior to determining enterprise value.

Conclusion

This discussion on normalization adjustments could provide useful information to courts in their determinations of statutory fair value. Judges should make equitable decisions in light of relevant valuation theory and practice.

To remind readers, this series of posts on statutory fair value relies heavily on my book (with Travis W. Harms) *Business Valuation: An Integrated Theory, 2nd Edition.*

STATUTORY FAIR VALUE

Normalizing Adjustments Illustrated

April 25, 2011

In the last two posts, we introduced the concept of normalizing adjustments to the income statements of businesses as an essential element in the development of valuation indications at the marketable minority level of value (or as-if-freely-traded). While some appraisers still disagree regarding the applicability of Type 2 Normalizing Adjustments, we find the arguments supporting their use compelling. Consider the illustrative example to the right.

ABC, Inc. Normalizing Adjustments ($000's)	Reported	Normalizing Adjustments Type 1 Non-Recurring Items	Type 2 Normalize to Public Equivalent	Normalized
Sales	$10,000	$0	$0	$10,000
COGS	$5,800	$0	$0	$5,800
Gross Profit	$4,200	$0	$0	$4,200
Litigation Settlement	$200	($200)	$0	$0
Selling (Cousin Joe)	$800	$0	($100)	$700
G&A (Cousin Al)	$1,600	$0	($100)	$1,500
Owner Comp (Big Daddy)	$900	$0	($600)	$300
Chalet (Big Daddy's Vacation Home)	$400	$0	($200)	$200
	$3,900	($200)	($1,000)	$2,700
Operating Profit	$300			$1,500
Operating Margin (No debt)	3.0%			15.0%

In the figure, ABC, Inc. is a company reporting sales of $10 million and operating profit of $300,000. Assume that we are appraising ABC and are now considering normalizing adjustments. There is one Type 1, or unusual, non-recurring, normalizing adjustment to be made in this particular appraisal. There are also several Type 2 normalizing adjustments that relate to the owner and the controlling shareholder of the business.

Type 1 Normalizing Adjustment (Non-Recurring Items)

- The company settled a lawsuit regarding damages when one of its vehicles was in an accident. The settlement, inclusive of attorneys' fees, was $200,000 in the most recent year. Expenses associated with the lawsuit are eliminated from operating expenses.

Type 2 Normalizing Adjustments (Agency Costs and Other Discretionary Expenses)

- Our examination of selling expenses reveals that Cousin Joe is on the payroll at $100,000 per year and he is not doing anything for the good of the business. An adjustment is clearly called for regarding Cousin Joe. His compensation must be eliminated in order to see the "as-if-freely-traded" income stream.
- In the Administrative Department, Cousin Al comes to work every day, but it is clear that the department is being run by someone else and that Cousin Al is not productive. We adjust by removing his $100,000 salary.
- Big Daddy takes a substantial salary out of the business. Based on a salary survey, earnings should be adjusted by $600,000 for his excess compensation to lower the expense to a normal, market level of compensation.
- Finally the business owns a chalet for Big Daddy's vacation needs, which costs the company about $200,000 a year. Expenses associated with Big Daddy's vacation home are adjusted accordingly.

Summing the Type 1 and Type 2 adjustments, adjustments to operating expenses of $1.2 million have been identified. These

adjustments raise the adjusted operating profit to the level expected were this company publicly traded (even though it likely never will be). The normalized operating margin is 15%.

Before proceeding to examine control adjustments, we should carry the discussion of normalizing adjustments a step further in order to address any lingering concerns. Some appraisers remain convinced that Type 2 Normalizing Adjustments are really control adjustments and that they should not be made when valuing minority interests.

Why, they ask, should we not value the minority interest directly and forego making Type 2 Normalizing Adjustments? Consider that if we do not make these adjustments:

- The resulting earnings stream is not comparable to those of public companies (or "as if freely traded").
- A discount rate based on guideline company analysis would not be appropriate and the resulting value indication would not be at the marketable minority level.
- Marketability discounts referencing restricted stock and pre-IPO transactions involving public companies would be inappropriate if relevant Type 2 Normalizing Adjustments are not made. The various restricted stock and pre-IPO studies are based on marketable minority values and the resulting, non-normalized base would not be at the marketable minority level.
- There is an implicit assumption that the shareholder will never realize his or her pro rata share of the value of the enterprise. In the alternative, there is no basis to estimate what that future terminal value might be. There would be no basis, for example, to estimate the expected growth in value of the enterprise over any relevant expected holding period, since the base marketable minority value is not specified.

Absent making appropriate Type 2 Normalizing Adjustments, an appraiser cannot assure users that his or her conclusion is at the nonmarketable minority level of value, which is typically the objective of minority interest appraisals.

The bottom line is that failure to make Type 2 Normalizing Adjustments when valuing nonmarketable minority interests provides neither the appropriate theoretical nor practical bases for valuation conclusions.

Normalizing Adjustments and Statutory Fair Value

This series of posts involving an integrated theory of business valuation is being applied to statutory fair value determinations, not determinations of fair market value at the nonmarketable minority level of value. So why spend time on them? Let's begin to address the question with a few assumptions:

- For simplicity, assume that ABC, Inc. has no debt and that the appropriate valuation multiple to determine its equity value is 5x.
- Assume further that ABC, Inc. is engaging in a transaction, the effect of which is to "squeeze-out" a 10% owner who is not related to Big Daddy. The shareholder appropriately perfected his right to dissent in accordance with the laws of the state and has dissented and is asking for the fair value of his shares.

ABC, Inc. hired an appraiser who made no normalizing adjustments. This appraiser determined the fair value of the company to be $1.5 million (5 x $300 thousand of operating profit), and the 10% owner's interest at $150 thousand.

The shareholder hired another appraiser (who has read and studied *Business Valuation: An Integrated Theory, Second Edition*). This appraiser made the normalizing adjustments in the table above and capitalized adjusted operating profit of $1.5 million. Her conclusion of fair value was $7.5 million (5 x $1.5 million), and her conclusion of the fair value of the 10% interest was, accordingly, $750 thousand.

The matter is now at trial for an appropriate determination of fair value. In this jurisdiction, it is clear that no minority interest or marketability discounts are applicable. So, what is the fair value of the 10% interest in ABC, Inc.: $150 thousand, $750 thousand, or something in between?

You be the judge.

Having put you in the position of judge for our illustration, how would you begin to resolve the problem and articulate a clear valuation rationale if you lacked the vocabulary and understanding that we are developing in this series on statutory fair value? It would be difficult, indeed.

Conclusion

It should be clear that absent the understanding and vocabulary presented above and in the previous posts, anything you said about your conclusion would likely lack clarity *from a valuation perspective.* Again, let me say that I am not questioning the equitable decisions that real judges have to make. But I do hope we are beginning to create an ability to articulate conclusions in clear and consistent valuation terms.

In a coming post, we'll address what we call *control adjustments,* which are distinctly different from normalizing adjustments. Then, after wrapping up our discussion of these conceptual valuation adjustments, we will turn back to the evolving discussion regarding levels of value with a sharper ability to talk about what each of the levels of value mean.

STATUTORY FAIR VALUE

Control Adjustments

May 10, 2011

We have discussed normalizing adjustments, and we now move to control adjustments to the income statement.

As we move up the levels of value chart from the marketable minority level to the levels of financial control and strategic control, we see that it is possible that a controlling shareholder may make adjustments to expected cash flows based on the expected ability to run the existing enterprise better (financial control), or to modify or manage the enterprise differently (strategic control).

Such adjustments are control adjustments, and increase value if such adjustments would normally be negotiated between buyers and sellers.

In other words control adjustments are those that, if appropriate, increase enterprise cash flow above that of the (normalized) marketable minority level.

Normalizing and Control Adjustments Applied

Having described the general nature of normalizing adjustments and control adjustments, let us examine their proper application.

- **Normalizing adjustments** adjust private company earnings to a reasonably well run, public company equivalent basis. Normalizing adjustments can be divided into two types to facilitate discussion and understanding. Normalizing adjustments are not control adjustments. In the last post, we derived normalized operating profit of $1.5 million for ABC, Inc., after making normalizing adjustments for nonrecurring items and excess owner benefits. This placed normalized earnings on a public-equivalent basis (as shown in the left column in the table below).
- **Control adjustments** modify normalized private company earnings to reflect 1) the operational improvements anticipated by the typical financial buyer; and 2) synergies or strategies of particular buyers. Control adjustments can also be divided into two types.

Many Business Appraisers Do Not Distinguish Between These Two Different Types of Adjustments

This nomenclature for income statement adjustments is fairly new. Many appraisers do not distinguish between normalizing and control adjustments or between types of normalizing and control adjustments. This failure by some appraisers to distinguish between two significantly different types of adjustments leads to confusion on the parts of users of valuation reports and courts.

Financial Control Adjustments Defined

Financial control adjustments modify private company earnings for the economies or efficiencies available to the typical *financial buyer,* but are not applicable to the marketable minority basis of value.

Financial Control Adjustments In Practice

Prospective financial control buyers may consider adjustments to the income statement that can improve the normalized earnings stream. In other words, financial control adjustments are appropriate if the typical buyer could expect to manage the existing company better.

We live in an expectational world. If a prospective financial buyer reasonably believes that a particular change will improve earnings

and/or growth, that buyer may be willing to share a portion of that benefit with the seller. If there are other purchasers with similar expectations, market value may be bid up shifting a significant portion of that benefit to the seller. For example, financial control adjustments might be reflected in a negotiation or in an appraisal at the controlling interest level if the indicated economies or growth prospects are generally available to multiple buyers and bidding competition transfers those benefits to the seller.

Financial Control Adjustments – An Example

Assume that ABC, Inc. reports selling costs of $700,000, or 7% of sales. Selling costs for the most efficient companies in the industry run on the order of 5.5% of sales, so there is a potential benefit of $150,000 from a reorganization or restructuring of the selling process.

Recognizing this potential, financial and/or strategic buyers may consider adjusting the income statement for such expected benefits. Such an adjustment – the potential increase in earning power by as much as $150,000 - would be a financial control adjustment.

ABC's earnings, after appropriate normalizing adjustments, increased from $300,000 to $1,500,000, and the operating margin increased from 3.0% to 15.0%.

With the consideration of financial control adjustments, expected operating income increases by an additional $150,000 to $1,650,000, or to 16.5%.

As it turns out, ABC, Inc. is actually a very profitable company and can likely be even more profitable under control of new buyers as shown in the figure below.

ABC, Inc. Control Adjustments ($000's)	**As if Publicly Traded**	**Financial Control**	
	Normalized	**Type 1 Control**	**As Adjusted Type 1**
Sales	$10,000	$0	$10,000
COGS	$5,800	$0	$5,800
Gross Profit	$4,200	$0	$4,200
Litigation Settlement	$0	$0	$0
Selling	$700	($150)	$550
G&A	$1,500	$0	$1,500
Owner Comp	$300	$0	$300
Chalet	$200	$0	$200
	$2,700	($150)	$2,550
Operating Profit	$1,500		$1,650
Operating Margin (No debt)	15.0%		16.5%

Strategic Control Adjustments Defined

Strategic control adjustments modify private company earnings for the potential strategic synergies/benefits available to a particular *strategic buyer.* Therefore, strategic control adjustments reflect changes stemming from an expected interaction between the subject company and other assets in the strategic buyer's portfolio.

Strategic Control Adjustments In Practice

Strategic benefits may arise from several sources, including consolidation of general and administrative expenses, lower costs of goods sold because of higher volume purchasing, benefits from horizontal or vertical integration, the ability to achieve lower financing costs, and others.

Strategic buyers do not contemplate operating the acquired business on a stand-alone basis, but rather in conjunction with other businesses currently owned (or expected to be acquired).

Strategic buyers may also seek beachheads in an industry, thinking it cheaper to "pay up" by anticipating future synergies rather than to build from scratch. Other considerations include the preemption of other competitors from obtaining a certain "space."

Strategic Control Adjustments – An Example

With ABC, Inc., one or more strategic buyers might reasonably believe that their larger purchasing volumes could lower cost of goods sold by $200,000, and that a consolidation of general and administrative expenses could eliminate an additional $250,000 of expenses.

So the strategic buyer is looking not at the $300,000 of reported earnings for ABC, Inc., or at the $1,500,000 of reported earnings as normalized, or even at the $1,650,000 given financial control adjustments, but potentially at $2,100,000, with strategic control adjustments, as shown in the figure at the top of the next page.

Additional Thoughts on Normalizing Owner/Management Compensation

We see the importance of differentiating between normalizing and control adjustments.

Normalizing adjustments adjust for unusual and non-recurring items. Unless adjustments are also made to normalize owner/management compensation, the underlying value of an enterprise may be missed entirely.

ABC, Inc. Control Adjustments ($000's)	As if Publicly Traded	Financial Control		Strategic Control	
	Normalized	Type 1 Control	As Adjusted Type 1	Type 2 Control	As Adjusted Type 2
Sales	$10,000	$0	$10,000	*$0*	$10,000
COGS	$5,800	$0	$5,800	*($200)*	$5,600
Gross Profit	$4,200	$0	$4,200	*$200*	$4,400
Litigation Settlement	$0	$0	$0	*$0*	$0
Selling	$700	($150)	$550	*$0*	$550
G&A	$1,500	$0	$1,500	*($250)*	$1,250
Owner Comp	$300	$0	$300	*$0*	$300
Chalet	$200	$0	$200	*$0*	$200
	$2,700	($150)	$2,550	*($250)*	$2,300
Operating Profit	$1,500		$1,650		$2,100
Operating Margin (No debt)	15.0%		16.5%		21.0%

The enterprise itself is not worth less because an owner takes compensation in the form of non pro-rata bonuses than if she pays herself a market wage and distributes earnings on a pro-rata basis (or reinvests to the benefit of all owners).

- To the extent that excess owner/manager compensation reduces shareholder distributions, this can impact value to individual shareholders' interests.

- To the extent that excess owner/manager compensation (or, for example, the mere accumulation of non-operating assets) reduce future growth opportunities, the expected future value of the business may be impacted and therefore, the present value of illiquid minority interests may be reduced.

Control and Normalizing Adjustments and Statutory Fair Value

It is important to recognize that normalizing and control adjustments are the ways in which appraisers "peel back the onion" and understand underlying business (enterprise) value at given points in time.

In the context of our ongoing discussion of statutory fair value, recall the guidance of *Beway* (*Matter of Friedman [Beway Realty Corp.]*, 87 NY2d 161) that suggests that minority discounts should not be taken because it would provide benefit to the controllers of a corporation in excess of that available (fair value) to minority owners.

The failure to normalize earnings for excess owner compensation, for example, would be analogous to imposing a disguised minority discount, which would be contrary to judicial and statutory guidance.

Normalizing and control adjustments influence the transparency of expected cash flows of businesses. Value is all about expected cash flow, its growth, and risk.

Shortly, we'll begin to circle back more specifically and talk about the cash flow implications of normalizing and control adjustments in the context of the levels of value.

STATUTORY FAIR VALUE

Potential Impacts of Income Statement Adjustments on Value

May 12, 2011

Income statement adjustments (normalizing and control) are critically important in providing estimates of earnings for capitalization using methods under either the income or market approaches to valuation, as well as for providing a base level of earnings from which to forecast when using discounted future benefits methods.

Appraiser judgment is obviously required in the assessment of potential income statement adjustments.

Hopefully, the vocabulary and analysis outlined in this series on statutory fair value, are beginning to highlight the importance of income statement adjustments and the judgments made in developing them.

The figure on the next page summarizes an analysis of each of the measures of ABC, Inc.'s operating income that we discussed in previous posts.

Each level of adjusted earnings is capitalized using a pre-tax multiple of 5.0x. As previously discussed, we assume for now that the enterprise discount rate does not change across categories of investors. We also assume a common outlook for expected growth in earnings for purposes of this illustrative discussion.

Enterprise-level values are developed at the respective levels of value and premiums or discounts to the marketable minority value are presented. Marketability discounts are applied to the "as reported" and normalized marketable minority values.

We make the following observations from the figure:

- If the objective of an appraisal is to develop an indication at the nonmarketable minority level of value, appraisers who fail to normalize in situations similar to the above have little chance to develop a reasonable indication of value. In the present case, the capitalization of reported operating income yields a result that is 20% of the appropriate nonmarketable minority value ($1,500,000 vs. $7,500,000). In other words, failure to normalize earnings suggests that nonmarketable minority investors will be burdened by the identified agency costs indefinitely.
- The application of typical marketability discounts based on benchmark analysis only exacerbates the problem noted above.
- The example illustrates that it is quite possible for different types of buyers to see different income potential – to them – when examining the same company.
- It is important to distinguish between the types of adjustments in order to understand the level of the income stream being developed. For example, if it is unlikely that there are any strategic buyers for a particular company, including strategic control adjustments would overstate value.
- A corollary to the above is that the blind application of a so-called typical control premium of 40% or so to an indication of value derived using a normalized income stream would tend to result in overvaluation if no competition among strategic buyers is expected for the property.
- Wide variations in value indications can result between appraisers at the nonmarketable minority level based on assumptions made regarding appropriate normalizing and control adjustments to enterprise earnings.
- It is inappropriate to apply a control premium to a value indication that considers financial or strategic control adjustments – such a premium is already embedded in the capitalized value. The application of a control premium in cases where no control adjustments are made implies that such benefits do exist and that, in the case of fair market value, typical buyers are willing to pay for them. The blind application of a control premium simply cries out for the kind of analysis suggested in these posts to determine the appropriate

	Types of Income Statement Adjustments and Levels of Value			
	As Reported	**"Public Equivalent" Normalized**	**Financial Control**	**Strategic Control**
Operating Income *Net Adjustments*	**$300,000** *none*	**$300,000** *$1,200,000*	**$1,500,000** *$150,000*	**$1,650,000** *$450,000*
Adjusted Operating Income *Implied Operating Margins*	**$300,000** *3.00%*	**$1,500,000** *15.00%*	**$1,650,000** *16.50%*	**$2,100,000** *21.00%*
Types of Adjustments Considered	*None*	*Type 1 Normalizing* *Type 2 Normalizing*	*Type 1 Control*	*Type 2 Control*
Assumed Multiple of Operating Income *(No Debt; Discount Rate Remains Unchanged)*	**5.0**	**5.0**	**5.0**	**5.0**
Implied Value Indications *Implied Level of Value*	**$1,500,000** *unknown*	**$7,500,000** *Marketable Minority*	**$8,250,000** *Financial Control*	**$10,500,000** *Strategic Control*
Implied Differences Over/Under Normalized	*-80.0%*	*"Public Equivalent"*	*10.0%* *"Financial Control" Premium*	*40.0%* *"Strategic Control" Premium*
Implied Multiples of Normalized	*1.00x*	*5.00x*	*5.50x*	*7.0x*
Assumed Marketability Discount	**35.00%** *"Typical Benchmark"*	**60.00%** *Based on QMDM*		
Nonmarketable Minority Indications	**$975,000**	**$3,000,000**		
Implied Multiples of "Public Equivalent" Normalized Comments	0.65x Clearly unreliable Masks underlying value of enterprise Crux of the problem is the failure to consider appropriate normalizing adjustments	2.0x Large marketability discount reflects the agency costs (i.e., foregone cash flows to minority shareholders) of Big AI and time to expected liquidity	Analysis provides logical explanation for a fairly wide range of observed control premiums as well as for the attractiveness of finding competing strategic buyers when a company is being sold. Absent a market with competing strategic buyers, there would appear to be little rationale for large control premiums over normalized (marketable minority) levels of value.	

earnings at the appropriate level of value for each appraisal. For example, the strategic control value of $10,500,000 could be developed as indicated or by applying a 40% control premium to the marketable minority value of $7,500,000. In either cases, there is an assumption that a total of $600,000 in combined financial and strategic control adjustments is available.

- Further when using discounted future benefits methods, no control premium is applicable to value indications developed based on forecasts that included financial or strategic control adjustments. If the forecast does not include control adjustments to income, it may be proper to consider the application of an appropriate control premium. However, that premium should relate to the expectation of benefits that buyers would pay for – else, it could lead to overvaluation (or undervaluation).

Control Premiums and Fair (Market) Value

Combining the practical analysis of our discussion to date with the conceptual analysis of the levels of value chart, we now consider several questions business appraisers should ponder when developing controlling interest value indications under the standard of fair market value. Recall that statutory fair value is usually defined as the functional equivalent of fair market value at a particular level of value.

Are the typical buyers financial buyers?

- The appraiser may need to evaluate the market for similar enterprises to ascertain the nature of the so-called typical buyers in a fair market value determination.
- Financial buyers may believe they can improve the earnings stream, and this belief may be reflected in the pricing.
- If there are no cash flow improvements available, there may be little or no premium to the marketable minority value (i.e., to the value developed using normalized cash flows).

Are the typical buyers strategic buyers?

- Again, the appraiser may need to evaluate the market for similar enterprises to ascertain the nature of typical buyers.
- Strategic buyers may believe they can alter and improve the earnings stream, and may reflect this belief in pricing, particularly if there are other strategic buyers who may be in competition for the same property.
- Strategic buyers may pay a premium in excess of that available to typical financial buyers, however, as previously noted, a rational strategic buyer will willingly pay no more than necessary to win the deal from the next most capable strategic buyer.
- Consideration of strategic buyers may be irrelevant in the context of fair market value determinations. For example, if there are no strategic buyers in a particular market, it would likely not be appropriate to consider a control premium based on strategic cash flows incorporating the effect of strategic control adjustments. Alternatively, if the likely buyers are strategic, for example, in consolidating industries, it may be appropriate to consider potential strategic control adjustments in the context of a fair market value determination. Once again, appraisers must make appropriate judgments in the

context of their overall analysis of a subject enterprise and the likely market for the subject enterprise.

What accounts for control premiums?

- The appraiser may consider appropriate premiums over marketable minority value, but such control premiums are not automatic. Appraisers must make appropriate judgments in the context of fair market value appraisals.

- A buyer's desire to "get a deal done" can cause the price offered to increase, resulting in a larger observed premium. If this occurs, there may be elements of compulsion involved in establishing the price limiting the relevance of such transactions in the determination of fair market value.

- Irrational buyers can pay any price that they can afford to pay, but this provides poor support for assessing fair market value.

- The first element above relates to fair market value determinations; however, elements of compulsion and irrationality should not be considered in fair market value determinations according to the very definition of fair market value.

Appraisers have their work cut out for them in developing opinions of statutory fair value or fair market value. With this discussion of normalizing and control adjustments, and a first look at the relationship between control premiums and such adjustments, we will return to the development of the integrated theory in the context of the levels of value that was begun in An Introduction to an *Integrated Theory of Business Valuation.*

STATUTORY FAIR VALUE

The Benchmark Marketable Minority Level of Value

June 3, 2011

In the second post in this series on statutory fair value, we provided background information on the Gordon Model. Portions of that post are reprinted here as background information.

The Gordon Model is a single-period income capitalization model that summarizes the way securities are valued in the public markets, and is a beginning point for continuing our discussion of an integrated theory of business valuation.

$$V_0 = \frac{CF_1}{r - g}$$

The basic formulation of the Gordon Model defines the value of a business or interest as the next period's expected cash flow divided by an appropriate discount rate less the expected growth rate of the specified cash flow. As we have previously shown, this formula is a summary of the discounted cash flow method of valuation under the following conditions:

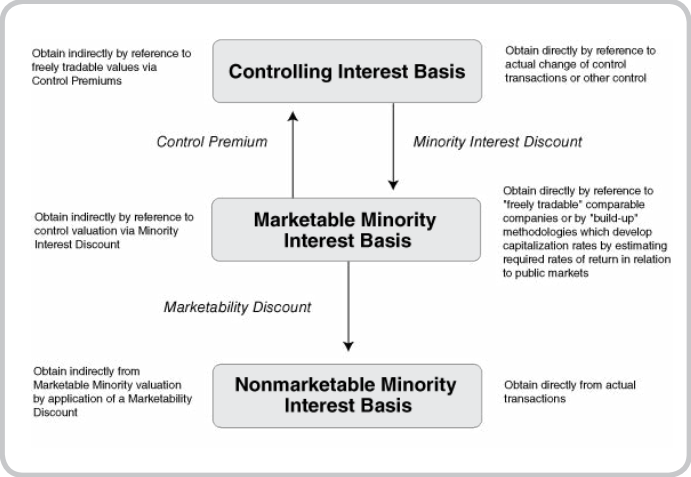
- The cash flows are expected to grow at the constant rate of g, and
- All cash flows are distributed to shareholders or are reinvested in the firm at the discount rate, r.

The discounted cash flow model as summarized by the Gordon Model provides an ideal basis for an integrated theory of business valuation.

Early Views of the Levels of Value

The so-called levels of value chart first appeared in the valuation literature some time around 1990. However, the general concepts embodied in the chart were known by appraisers (and courts) prior to that time. Even today, most discussions regarding levels of value in the valuation literature are very general, lacking any compelling logic or rationale regarding the factors giving rise to value differences at each level.

The early levels of value chart showed three conceptual levels, as indicated below, and discussed in the third post in this series. The chart is so important to an understanding of valuation concepts that analysts at Mercer Capital have included it, or an evolving version with four levels (introduced in the fifth post in this series) in virtually every valuation report since about 1992.



We, like most appraisers in the 1990s, assumed the existence of the conceptual adjustments referred to as the control premium, the minority interest discount, and the marketability discount. We relied on market evidence from control premium studies to help ascertain the magnitude of control premiums (and minority interest discounts). And we relied on certain benchmark studies, the so-called Pre-IPO Studies and the Restricted Stock Studies, as the basis for estimating the magnitude of marketability discounts. Such reliance contributed then,

and unfortunately, continues to do so today, to a failure to understand the basis for the valuation premiums and discounts being estimated.

By the early 1990s, we grew increasingly uncomfortable with the bold adjustments that we and other appraisers made. In 1994, I introduced the *Quantitative Marketability Discount Model (QMDM)* to develop marketability discounts based on the expected cash flows (and growth) and risks associated with minority interests. This marked the beginnings of an integrated theory of business valuation. *Quantifying Marketability Discounts* was published in 1997 (now, see *Business Valuation: An Integrated Theory, 2nd Edition*).

The Gordon Model, An Integrated Theory of Business Valuation, and Statutory Fair Value

One purpose of this series of posts is to integrate the Gordon Model (and how the markets value companies) and the conceptual framework of the levels of value. In so doing, we will discuss an integrated theory of business valuation, which will help as we continue our discussion of statutory fair value.

We will proceed to:

- Provide a conceptual description of each level of value in the context of the Gordon Model.
- Use the components of the Gordon Model to define the conceptual adjustments between the levels of value, the control premium (and its inverse, the minority interest discount), and the marketability discount.
- Reconcile the resulting integrated valuation model to observed pricing behavior in the market for public securities (the marketable minority level), the market for entire companies (the controlling interest level(s) of value), and the market for illiquid, minority interests in private enterprises (the nonmarketable minority level of value).
- Begin a discussion of this conceptual framework in the context of statutory fair value generally.
- Discuss specific statutory fair value cases and issues in the context of an integrated theory of business valuation.

With this background, we will develop the marketable minority interest level of value, or the middle level in the three-level chart, as the benchmark level of value from which other levels of value are developed and understood.

The Benchmark Marketable Minority Interest Level of Value

The Gordon Model provides a shorthand representation of the value of public securities at the marketable minority interest level of value.

We call normal pricing in the public securities market "marketable minority" because interests being traded there are both marketable and minority in nature. For privately owned enterprises, this conceptual level is referred to with the same name.

In developing an integrated theory, we use the Gordon Model to analyze how the levels of value relate to each other. To do so, we introduce a symbolic notation to designate which elements of the model relate to each level of value.

The following equation introduces conceptual (annotated) math for the benchmark level of value – the marketable minority value.

$$V_{mm} = \frac{CF_{e(mm)}}{R_{mm} - G_{mm}}$$

We just described the marketable minority level of value as the "benchmark" level of value. Control premiums are added to it to develop controlling interests indications of value. Marketability discounts are subtracted to develop nonmarketable minority indications of value. These are the traditional concepts in relationship to the marketable minority level of value. The annotated Gordon Model consists of the following components:

- $\mathbf{V_{mm}}$ is the equity value of a company at the marketable minority level of value, whether public or private. This is the benchmark, observable value for public securities. For private companies, this level is often called the "as-if-freely-traded" value. We say "as-if-freely-traded" because for a private company, it is a *hypothetical* value. By definition, it is not observable for nonmarketable interests of private enterprises since there are no active, public markets for their shares. Appraisers develop indications of value at the marketable minority level as a first step in determining other levels of value. Such indications of value are developed either by direct reference to the public securities markets (using the guideline public company method), or indirectly, using what I call the Adjusted Capital Asset Pricing Model or other build-up methods (see Chapter 6 of *Business Valuation: An Integrated Theory, 2nd Edition*).
- $\mathbf{CF_{e(mm)}}$ is the expected cash flow (to equity) of the enterprise at the marketable minority level for the next period. The marketable minority level of cash flow reflects enterprise earnings, "normalized" for unusual or non-recurring events. These cash flows consider expense structures that are market-based, at least in terms of owner/key shareholder compensation (see the tenth and eleventh posts in the series on normalization of earnings). Public companies attempt to keep investors focused on their "normalized" earnings. Many public companies, for example, disclose *pro forma earnings*, or earnings after adjusting for unusual or nonrecurring (and sometimes not so non-recurring) items. The need to adjust for unusual

or non-recurring items should be intuitively apparent. Unfortunately, too many appraisers fail to grasp this essential element of valuation.

- **R_{mm}** is the discount rate at the marketable minority level of value. While it is not directly observable, it can be inferred from public pricing or estimated using the Capital Asset Pricing Model or other models. For private companies, R_{mm} is most often estimated using one of several build-up approaches.

- **G_{mm}** is the expected growth rate of core earnings for the enterprise under the assumption that all earnings are distributed to shareholders (or g_e from our discussion in the second post on discounted cash flow). However, earnings are often reinvested in businesses. It is the compounding effect of reinvested earnings that enables a company to grow its *reported earnings (and value)* at rates (*g**) in excess of its *underlying core earnings growth rate*. So, G_{mm} is not equal to the expected growth rate of earnings published by stock analysts for public companies. The *analysts' g (g*)* includes the compounding effect of the reinvestment of cash flows on the expected growth of earnings.

The Conceptual Math of the Marketable Minority Level of Value

At this point, we can begin to connect the mathematics of valuation theory with the conceptual levels of value chart. The marketable minority level of value is the conceptual value from which other levels of value are derived. The figure at the bottom of the page presents the conceptual math of the marketable minority level of value.

We refer to the marketable minority level of value as an *enterprise level of value*. We do so because $CF_{e(mm)}$ is defined as the cash flow of the enterprise to equity holders. We hope to expand the integrated theory to embrace valuation at the total capital level in the near future.

All the shareholders of a publicly traded enterprise, controlling or minority, share the benefit of all of its cash flows (as they are capitalized in the public stock markets every day). The importance of this definition will become clear as the remaining mathematical relationships of the conceptual levels of value are developed.

The conceptual math of the marketable minority level indicates that, as we have discussed previously, value is a function of expected cash flows (next period and expected growth) and risk. The figure shows an important relationship regarding the expected growth in value in the middle column. The Gordon Model is a dividend discount model. $CF_{e(mm)}$ is the expected cash flow available for distribution.

- Expected returns to shareholders come in two forms, distribution or dividend yield and capital gains. Dividends provide current income, and reinvested earnings provide the potential for future growth in value and for capital gains.

- If there are no dividends, then $CF_{e(mm)}$ is equal to the net income of an enterprise. Intuitively, that is why the long-term growth rate used in the Gordon Model is typically fairly low, quite often in the low single digits. If all earnings are distributed, growth is limited to inflation and productivity increases. Owners get substantial current returns and limited expected capital gains. If all earnings are paid out to shareholders, then the expected growth in value is the long-term growth of core earnings.

- If some earnings are retained to finance growth, then two things occur. First, owners get a current return in the form of current dividends and a portion of expected returns relates to the more rapid growth (than long term core growth) because of the compounding effect (at the discount rate) of reinvested earnings.

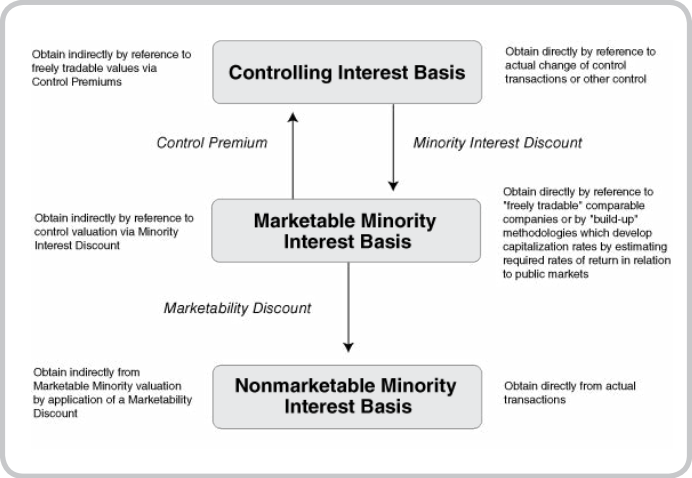
- The point is that expectations for growth in value of an enterprise are related to distribution policy. If all earnings are retained in the enterprise, the expected growth in value is the discount rate. If all earnings are distributed, the expected growth in value is the long-term core (slow) growth in earnings. For distribution policies in between 0% and 100%, the expected growth in value is discount rate (R_{mm}) minus the dividend yield. This is true because shareholders expect to get their expected return either in the form of dividends or capital gains (and are assumed to be indifferent between the two forms of return).

Finally, the right side of the figure below indicates that the Gordon Model provides a benchmark for comparison to other levels of value. The marketable minority level of value is that level to which appraisers have almost automatically applied control premiums to develop controlling interest indications of value. It is also the level from which appraisers have subtracted marketability discounts to derive indications of value at the nonmarketable minority level of value.

	Conceptual Math	Relationships	Value Implications
Marketable Minority Value	$\frac{CF_{e(mm)}}{R_{mm} - G_{mm}}$	$G_v = R_{mm}$ - Div Yld	V_{mm} is benchmark for other levels

The Levels of Value Revisited

Referring again to the three-level, levels of value chart, the control premium and the marketability discount are conceptual adjustments enabling appraisers to relate the marketable minority level of value with the controlling interest level (control premium) and the nonmarketable minority level (marketability discount). The minority interest discount also relates the controlling interest and marketable minority levels.



No valuation premium or discount has meaning unless we understand the base to which it is applied. The marketable minority value is the benchmark (base) level of value for the enterprise in the integrated theory of business valuation. Unless we understand this basic fact, we cannot understand or make proper use of the conceptual valuation adjustments typically used by appraisers.

A review of the valuation literature prior to the latter part of the 1990s yields little insight into the theoretical basis for applying the well-known conceptual premiums and discounts.

- Appraisers applied control premiums because they were observed when public companies changed control.
- Marketability discounts were applied because it was observed that restricted stocks of public companies traded at prices lower than their freely traded counterparts.
- There was virtually no discussion regarding what caused the differences in observed values.

Only in recent years have appraisers begun to understand and to articulate *why* control premiums and restricted stock discounts exist. The integrated theory explains the *why* behind the generally accepted valuation premiums and discounts.

What Does Any of This Have to Do with Statutory Fair Value?

Statutory fair value is an interesting area of valuation. The legislatures in virtually all states have passed laws regarding the kind of value that should be available to minority shareholders in dissenting shareholder or shareholder oppression matters. In most cases, this value is called fair value.

However, as previously noted, with a couple of exceptions (Mississippi being one), fair value is not defined statutorily. As a result, it is up to the courts of the various states to provide judicial interpretations of the concept. We have briefly discussed fair value in Delaware and New York in prior posts, and will continue the discussion in the future.

I hope that this series of posts on statutory fair value will begin to provide a basis for reasonable judicial interpretations of fair value in the context of solid valuation theory.

I also hope that the discussion will encourage appraisers to present their valuations in the context of solid valuation theory.

If courts have good financial, economic and valuation evidence, the chances are improved for statutory fair value decisions that make economic sense.

STATUTORY FAIR VALUE

The Control Levels of Value

August 23, 2011

In the previous post, we introduced what we called The Benchmark Marketable Minority Level of Value. The marketable minority level of value is an enterprise level of value because it is determined by capitalizing (or discounting) the normalized cash flows to equity of a business enterprise.

In this post, we will introduce the "control" levels of value. In the next two posts, we will talk about the financial control and the strategic control levels of value.

Links to a number of dated citations are not readily available. I have included several traditional footnotes as indented quotations.

Normalizing Adjustments and Control

The concept of normalizing earnings is important in the context of statutory fair value. If enterprise cash flows are not normalized, for example, for excessive owner compensation, capitalizing non-normalized earnings provides an indication of value below that of the value of the enterprise if it were to be sold in the market as a going concern. In New York, for example, case law guidance provides in *Beway (Matter of Friedman [Beway Realty Corp.], 87 NY2d 161)*:

> Thus, we apply to stock fair value determinations under section 623 the principle we enunciated for such determinations under section 1118 that, in fixing fair value, **courts should determine the minority shareholder's proportionate interest in the going concern value of the corporation as a whole,** that is, "'what a willing purchaser, in an arm's length transaction, would offer for the corporation as an operating business'" (*Matter of Pace Photographers [Rosen],* 71 NY2d at 748, *supra,* quoting *Matter of Blake v Blake Agency,* 107 AD2d at 146, *supra* [emphasis supplied]).

> When companies are sold, it is customary for owner compensation to be normalized to market levels. Selling owners are happy to do this in order to realize the benefit of the capitalized value of above-market salaries. I studied economics as an undergraduate and in graduate school. We often used an expression to prove (or disprove) a point: "If it were not so, ….." That might be a another way economists have of saying, "on the other hand,…."

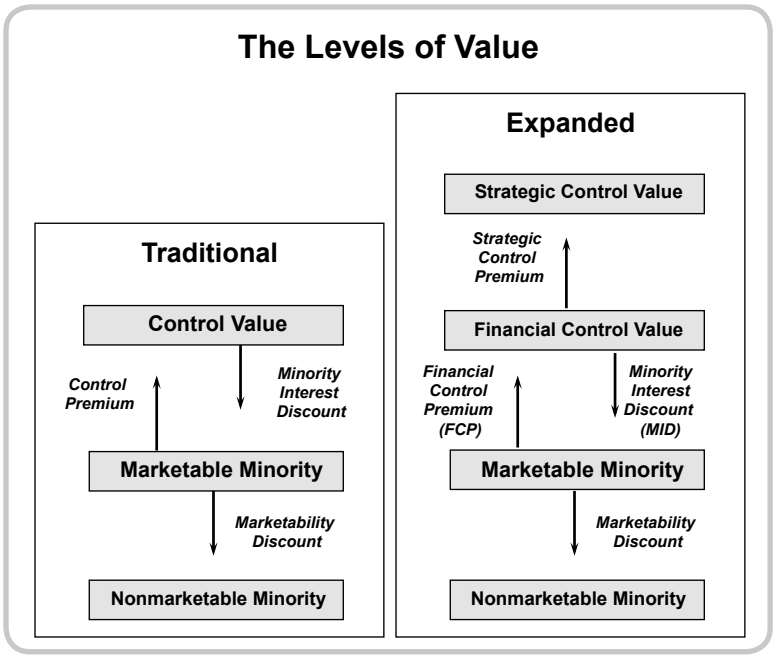
If it were not so that owner compensation is normalized in fair value determinations, then controlling owners who are squeezing out a minority shareholder (or allegedly oppressing) would both continue to receive the current benefit of above-market compensation *and* the benefit of a lower value to be paid to the minority shareholder. If this seems too good to be true, then that is likely what the guidance in *Beway* above is attempting to avoid.

Control Levels of Value

There is a growing consensus that there are at least two conceptual levels of value above the marketable minority level:

- **Financial Control.** The first level describes what a financial buyer is able (and perhaps willing) to pay for control of a business. Financial buyers acquire companies based on their ability to extract reasonable (to them) rates of return, often on a leveraged basis.

- **Strategic Control.** The second control level is referred to as the strategic, or synergistic, level of value. Strategic buyers can (and do) pay more for companies than financial buyers because they expect to realize synergies from acquisitions (e.g., perhaps through eliminating duplicate expenses or achieving cross-selling benefits) that increase future cash flows.



> Steven D. Garber, "Control vs. Acquisition Premiums: Is There a Difference?" (Presentation at the American Society of Appraisers International Appraisal Conference, Maui, HI, June 23, 1998).

This emerging consensus, supported by evidence from change-of-control transaction data, has led to conceptual levels of value charts with four, rather than three, levels. A general comparison of the two charts is shown in the figure above. We will discuss further refinements to the levels of value chart in the next two posts in this series (on the financial control and strategic control levels of value).

The left side of the figure presents the traditional, three-level chart, including the conceptual premium and discounts that enable appraisers to relate the three levels to each other. The right side of the figure presents an expanded, four-level chart. Note that the "financial control premium" on the right and the "control premium" on the left are the equivalent conceptual premiums.

> Z. Christopher Mercer, "A Brief Review of Control Premiums and Minority Interest Discounts," *The Journal of Business Valuation,* (Toronto: Carswell Thomas, 1997), pp. 365-387.

As a result, the minority interest discounts shown on the left and right sides of the figure above are the same conceptual discount. We have called the conceptual premium relating the financial control value to the strategic control value the "strategic control premium."

This flows from the general belief that fair market value is a financial concept based on the hypothetical negotiations of hypothetical willing buyers and sellers, and that the "strategic control premium" reflects the consideration of specific buyers who benefit from particular synergies or strategies. The strategic control level of value might become the appropriate level for fair market value if the *typical buyers* are strategic buyers. This situation existed during much of the last two decades in the consolidating banking industry (prior to about 2008) and in numerous other consolidating industries.

Note that no name is provided for the conceptual discount that would lower the strategic control to the financial control value. Further, note that this conceptual discount also *is not the minority interest discount* relating the financial control value with the marketable minority level of value. These are important observations visually. We will investigate the differences more specifically in the coming posts.

As we move up from the marketable minority level to the levels of financial control and strategic control, we see that it is possible that a controlling shareholder may make adjustments to expected cash flows based on the expected ability to run an enterprise better (financial control) or differently (strategic control). Such adjustments would be *control adjustments* and could have the impact of increasing value if such adjustments would normally be negotiated between hypothetical (or real) buyers and sellers.

In other words, from a conceptual viewpoint, control adjustments are those that, if appropriate, increase enterprise cash flow *above that of the (normalized) marketable minority level*. As the figure above indicates in a conceptual sense, the value of the expected cash flows of the enterprise from the viewpoint of either a financial control buyer or a strategic control buyer may be greater than the value of the normalized expected cash flow of the enterprise.

Careful review of the control (or acquisition) premium data available to appraisers indicates such premiums generally result from transactions motivated by strategic or synergistic considerations. Consequently, the available control premium data more generally reflects the *combination of the financial control premium and the strategic control premium* (see figure above).

> M. Mark Lee, "Premiums and Discounts for the Valuation of Closely Held Companies: The Need for Specific Economic Analysis," *Shannon Pratt's Business Valuation Update*, August 2001.

This observation suggests the following conclusions:*

- Use of available control premium studies as a basis for inferring minority interest discounts in a fair market value context is conceptually incorrect, except where strategic buyers are the norm. The improper use of such data would tend to *overstate* the magnitude of minority interest discounts.
- When applied to financial control values, such discounts would not yield marketable minority interest levels of value, but rather something below that level (with no clear conceptual definition).
- And finally, the application of a "standard" marketability discount to that lower (and conceptually undefined) value would tend to *understate* the value of illiquid interests of private enterprises.

* Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th ed (New York, NY: McGraw-Hill, 2000). calls the strategic control premium "strategic acquisition premium" in their chart at page 347. They state, regarding the chart:

The diagram presented in Exhibit 15-1 reflects the value influence of the ownership characteristics of control versus the noncontrolling stockholder's situation as discussed in Chapter 16. This schematic usually would represent the *fair market value standard of value on a going-concern basis premise of value.* In some cases, there may be yet another layer of value, which may reflect synergies with certain third-party buyers (as examples of: (1) reducing combined overhead by the consolidation of operations or (2) raising prices by reducing competition). There is not yet a widely used term for this additional layer of price premium over fair market, going-concern value. However, this price premium — when combined with the ownership control premium — is sometimes called an *acquisition premium.* The standard of value reflecting these synergies usually would be considered *investment value.* This is because it reflects the *value to a particular buyer,* generally referred to as the *synergistic buyer,* rather than value to the hypothetical willing buyer. This "hypothetical" typical willing buyer acquires the subject company strictly because of its financial merits, and is generally referred to as a *financial buyer.* (emphasis in original)

and

Z. Christopher Mercer, "Understanding and Quantifying Control Premiums: The Value of Control vs. Synergies or Strategic Advantages," *The Journal of Business Valuation,* (Toronto: Carswell Thomas, 1999), pp. 31-54.

And in the Context of Statutory Fair Value

It should be clear that thinking about the levels of value has been evolving for some time. In the next two posts in this statutory fair value series, we will discuss the further evolution in the context of the integrated theory of business valuation.

These concepts are critical to business appraisers in statutory fair value determinations. They are also critical to the judiciaries of the various states as they grapple with judicial determinations of fair value.

STATUTORY FAIR VALUE

The Financial Control Level of Value

August 29, 2011

With the conceptual framing of the control levels of value in the previous post, we can now examine the two controlling interest levels of value.

It is important to have a clear understanding of the levels of value in order to begin to articulate statutory fair value concepts. Absent this understanding, courts are left to deal with important valuation questions on almost an ad hoc basis, relying on perhaps conflicting or inadequate or incorrect (or all three) valuation evidence that might be presented.

Financial Control Value

The following equation illustrates the conceptual math of the first control level of value – the *financial control value.* It introduces notation that we will use to discuss the levels of value in the context of the Integrated Theory. Each symbol is defined below the representation.

$$V_{e(c,f)} = \frac{CF_{e(c,f)}}{[R_f-(G_{mm}+G_f)]}$$

As with the marketable minority level of value, the terms found in the equation are defined as follows:

- $\mathbf{V_{e(c,f)}}$ is the value of the equity of an enterprise as a whole from the viewpoint of financial control buyers who do not expect to achieve improvements relative to the marketable minority value. Traditionally, appraisers have developed the financial control level of value in two ways: 1) directly, by comparison with change of control transactions of similar businesses (the guideline transaction method); and 2) indirectly, by application of control premiums to indications of marketable minority value.

- $\mathbf{CF_{e(c,f)}}$ is the expected cash flow of the enterprise from the viewpoint of the financial buyer. The first step in developing $CF_{e(c,f)}$ is to derive $CF_{e(mm)}$ by normalizing the earnings stream as described in this post. Note that the normalization of earnings is not a "control" process, but one of equating private company earnings to their as-if-public equivalent. The second step involves judging the ability of a control buyer to *improve* the earnings stream beyond the normalization process. This could involve the ability of a specific buyer to improve the existing operations or to run the target company better. However, unless there are competing financial buyers, a single buyer would likely be unwilling to share the benefit of all expected cash flow improvement with the seller. In the real world, there would be a negotiation to determine the extent of such sharing. The issue of normalizing earnings has been discussed at length in three posts, An Introduction to Normalizing Adjustments, Normalizing Adjustments Continued, and Normalizing Adjustments Illustrated. However, normalization is an integral part of public securities pricing. It is not uncommon to find companies with well above-peer group price/earnings multiples based on trailing 12-month earnings, yet with near average multiples of forward (next-year's) earnings. Commonly, investigation reveals an unusual, non-recurring item in the most recent period that the market is "normalizing" and pricing based on the expectation of more normal earnings next year.

Note that the negotiations between buyers and sellers affects the purchase price and not the expected after-acquisition cash flows. This suggests that observed takeover premiums do not reflect the expected total change in cash flow, but only the portion negotiated and shared with sellers.

- **R_f** is the discount rate at the financial control level of value. In the real world, R_f may be identical to R_{mm}, as other writers, including Shannon Pratt, have observed. [Shannon P. Pratt, *Cost of Capital* (New York: John Wiley, 1998), pp. 111-112.] While market forces will tend to equate R_f and R_{mm}, R_f is distinctly specified to allow for potential differences. Financial control buyers may bid up prices in competition with other financial or strategic buyers, causing R_f to fall below R_{mm}. Certain buyers may consciously lower R_f to secure a deal, leading to potential overvaluation. Alternatively, specification of R_f in excess of R_{mm} recognizes that the value of an enterprise to financial control buyers may be less than the freely traded value. In the public markets, this result could occur, for example, when speculative trading pushes a stock's price above financial control values. In the context of various control premium studies, this specification of R_f helps explain the existence of occasional *negative* control premiums in acquisitions, or acquisition prices below the before-announcement trading prices of targets.

- **($G_{mm} + G_f$)** is the expected growth rate of earnings for the financial control buyer. The first factor is the same G_{mm} found at the marketable minority level. The second factor (G_f) is the increment in the growth rate of earnings that a financial control buyer expects to generate. The second factor may not be relevant in determining the value of an enterprise for either of two reasons: 1) the universe of buyers may not expect such an increment in growth; or 2) a specific buyer who can accelerate growth may not share that expected benefit in a negotiation. On the other hand, multiple financial buyers in an auction process may end up competing with each other such that the seller gains all or most of the growth benefit from the second-highest estimate of G_f. Nevertheless, this component of expected growth needs to be specified in order to understand and describe market behavior. Financial control buyers might expect to augment growth by better managing the relationship between the growth of revenue and expenses, more productive use of facilities, better processes, and the like. Note that, unlike strategic synergies, these internal opportunities for cash flow enhancement do not depend on a specific combination with another business.

Financial Control and Marketable Minority Compared

We now have a conceptual model describing the financial control level of value, consistent with the previously specified conceptual model for the marketable minority level of value. The relationship between the two levels of value is shown below.

The conceptual differences in value at the marketable minority and financial control levels of value can be discerned by examining the figure above. This analysis illustrates that control premiums (or other conceptual adjustments) are not automatic, but are based on expected differences in cash flows, risk, and/or growth. Recall our detailed discussion of the discounted cash flow model in the section Discounted Cash Flow (DCF) Method.

Based on the comparative figure, the financial control value would exceed the marketable minority value if, all other things being equal, one or more of the following conditions were true:

- **$CF_{e(c,f)}$ is greater than $CF_{e(mm)}$.** This would be true if the buyer of the enterprise could be expected to improve the operations of the enterprise (and would share that expected benefit with the seller). Note that $CF_{e(c,f)}$ will not exceed $CF_{e(mm)}$ because of above-market salaries paid to owners of a business. Such adjustments were required to derive $CF_{e(mm)}$. *Some appraisers often assume that in valuing minority interests of private companies, no adjustment should be made for above-market owner salaries of perquisites "because the minority shareholder lacks the power to change the cash flows." The preceding discussion of normalizing adjustments*, and the discussion of the minority interest discount in the next post should be the death knell of this common misconception.

- **G_f is greater than zero.** If the financial control buyer expects to augment the future growth of cash flows (and will share that benefit with the seller), then Ve(c,f) can exceed V_{mm}.

- **R_f is less than R_{mm}.** Conceptually, R_f could be less or greater than R_{mm}. Either condition could be true for a specific buyer; however, it is likely that market forces would force the rele-

	Conceptual Math	Relationships	Value Implications
Financial Control Value	$\frac{CF_{e(c,f)}}{R_f - [G_{mm} + G_f]}$	$CF_{e(c,f)} \geq CF_{e(mm)}$ $G_f \geq 0$ $R_f = R_{mm}$ (+/- a little)	$V_{e(c,f)} \geq V_{mm}$
Marketable Minority Value	$\frac{CF_{e(mm)}}{R_{mm} - G_{mm}}$	$G_v = R_{mm}$ - Div Yld	V_{mm} is the benchmark for other values

vant universe of buyers to expect a return no greater than R_{mm} as the appropriate discount rate. The specification of R_f does provide an explanation for financial control premiums that might be paid for enterprises based on competition between private equity funds and hedge funds. Such funds have the capacity to bid up prices by accepting lower returns on individual deals. In fact, financial buyers have been shown to compete with strategic buyers. See "Control Premium Study Shows Decline in Market Multiples," *Shannon Pratt's Business Valuation Update*, October 2001, pp. 6-7 (now Business Valuation Resources (subscription)). Such capacity of private equity funds to bid up deals is likely correlated to the supply of investable funds at their disposal and continuing pressure to employ those funds.

Once again, the point of this analysis is that the financial control premium is not automatic. Sellers have a history of earnings (appropriately adjusted) that provides the basis for future cash flow expectations. Buyers have the benefit of that history and may perceive greater future cash flows. Any differential in value is the function of negotiations between buyers and sellers of enterprises. The conceptual analysis of the Integrated Theory does not predict financial control value, but does provide a vocabulary to describe the economic behavior of rational market participants. The Integrated Theory also provides the conceptual and analytical framework within which appraisers can estimate financial (or strategic) control value in appropriate situations.

Financial Control Value and Statutory Fair Value

The conceptual discussion thus far suggests there could be a congruence of value between the marketable minority and financial control levels of value. This congruence conforms with the common sense observation that in any given year, most public companies are not sold or otherwise taken over. Could it be that for most companies most of the time their public pricing (marketable minority pricing) is reasonably reflective of their financial control values?

If it were not so (there I go again), then more companies would be taken over each year as other public companies, private equity funds and hedge funds, which collectively control many billions of available dollars, would engage in transactions in order to capture any available surplus between a financial control value and the public price. Eric Nath made this observation in an article published in *Business Valuation Review* in 1990 (subscription). The valuation profession has been slow to adapt.

I hope that this series, which, again, is based largely on Chapter 3 of *Business Valuation: An Integrated Theory* Second Edition, helps to bring clarity to what has been a confusing area of valuation for many years.

STATUTORY FAIR VALUE

The Financial Control Premium

August 31, 2011

In the last two posts, we introduced the Control Levels of Value and the Financial Control Level of Value. The discussion of the financial control value suggested that differences between this conceptual level of value and the marketable minority level of value would occur only if there were differences in expected cash flow, risk and/or growth between the two levels.

At this point, the control premium relating the price a financial control buyer might pay to the marketable minority value can be specified in terms of differences (from the marketable minority level) in expected cash flow, risk and/or growth.

$$CP_f = \frac{V_{e(c,f)} - V_{e(mm)}}{V_{e(mm)}}$$

This equation defines the financial control premium as the difference in value between the financial control and the marketable minority levels.

Several observations on the relationship between value at the marketable minority and financial control levels of value follow.

Application of financial control premiums should be limited to situations in which the hypothetical willing buyer reasonably expects to:

- Increase cash flows relative to normalized cash flows of the enterprise; and/or,
- Increase expected growth of cash flows of the enterprise; and/or,
- Decrease the discount rate relative to R_{mm}; and, importantly,
- Be willing to share all or a portion of the expected benefits enumerated above with seller.

In the absence of any of the preceding conditions, the financial control value will be the same as the freely traded, marketable minority value. Why? Because nothing would have changed to create a delta between the two conceptual levels of value.

A further implication of this logic is that values derived by applying guideline public company multiples to normalized earnings of privately owned enterprises will approximate financial control values. This assumes, of course, that the public multiples are properly adjusted for fundamental differences in expectations (primarily for risk and growth) between the guideline public companies and the subject private enterprises. The concept of the fundamental adjustment and its role in the Integrated Theory will be discussed in a future post.

The financial control premium is clearly a range concept. The financial control premium that might be paid for a particular enterprise will vary with potential buyers based on their unique circumstances and the degree of competitive bidding.

> **Insight.** Financial control value is not a concept that relates to a particular financial buyer, or the buyer who could pay the highest price based on his own expectations related to a particular enterprise. That kind of value is known as *investment value,* or value to a particular buyer. This concept of investment value, in the context of financial control, allows for, relative to the marketable minority concept, either a higher or lower value. It also allows for a range of expected values from a range of potential buyers (like observed in the real world).

We have come a long way catching up to Eric Nath's startling suggestion in 1990 that the public market multiples of guideline companies yielded controlling interest values.[1] Suffice it to say

that many appraisers thought this observation was nothing short of heresy. I was in that group![2] The Integrated Theory reconciles Nath's position of control multiples coming from the public markets if the financial control premium is zero.

[1] Eric W. Nath, "Control Premiums and Minority Interest Discounts in Private Companies," *Business Valuation Review,* Vol. 9, No. 2 (1990): pp. 39-46.

[2] Z. Christopher Mercer, "Do Public Company (Minority) Transactions Yield Controlling Interest or Minority Interest Pricing Data?," *Business Valuation Review,* Vol. 9, No. 4 (1990): pp. 123-126. In this article, I charged to the defense of public multiples providing marketable minority value indications. Nath's view is reconciled with the Integrated Theory under the assumption that no value-enhancing factors are available to the financial control buyer, and the financial control premium is therefore zero. I did not recognize this potential for reconciliation in 1990.

We have defined Ve(c,f) from the viewpoint of financial control buyers. Ve(c,f) sets the upper boundary for negotiation of price with sellers (unless a particular buyer is willing to reduce R(f). The greater the positive differences between Ve(c,f) and Ve(mm), the greater the potential for the consummation of transactions. Nath's observation was that, given the relatively low number of acquisitions in any year relative to total number of public companies, the difference, in most instances, must be zero (or not large enough to warrant the interest of financial buyers). This suggests that public market pricing could reflect both marketable minority and financial control pricing. There is a growing consensus among appraisers that there is a difference between financial and strategic control values, and a growing recognition that, to the extent they exist, financial control premiums are likely small.

If financial control premiums, to the extent that they exist, are quite small, then there are important implications for the minority interest discount.

Insight. Yogi Berra is said to have said, "You can observe a lot just by seeing." It wasn't until the mid-1990s that I (and a number of other appraisers, of course) began to "see" that market data for control premiums pertained to something other than financial control. I recall giving a speech in which I analyzed control premium data for a couple of recent years. There were perhaps 400 transactions in each of the years, and about half of the totals for each year were acquisitions of financial institutions by other financial institutions. I recall saying that I couldn't attest that every one of the transactions analyzed were strategic in nature, but that it was clear to me (having just written my first book, *Valuing Financial Institutions,* that virtually every bank acquisition was strategic. And it was apparent from just "seeing" the non-bank acquisitions, that they were strategic in nature, as well. The point I made then was that if my observations were correct, then that control premium data should not be used to develop measures of the Minority Interest Discount, and that doing so would substantially overstate any applicable minority interest discounts.

The Financial Control Premium and Statutory Fair Value

The idea that financial control premiums might be small or non-existent is, despite its logic and grounding in valuation theory, still considered to be somewhat controversial. The corollary, which is that implied minority interest discounts might be small or non-existent, is even more controversial within pockets of the valuation profession.

In statutory fair value determinations, where not proscribed by law or case guidance, some appraisers still apply substantial minority interest discounts to minority interests based on (strategic) control premium data.

In other situations, some appraisers still develop strategic indications of statutory fair value by considering (strategic) control premium data when, in many, if not most jurisdictions, this would not be appropriate.

This discussion of the financial control premium, then, leads directly to an investigation of the so-called "prerogatives of control" and the Minority Interest Discount, to which we will proceed in the next post in this series on statutory fair value.

STATUTORY FAIR VALUE

The So-Called Prerogatives of Control and the Minority Interest Discount

September 8, 2011

We now turn to corollary implications of the analysis of the financial control premium. The *minority interest discount* necessary to adjust a financial control value to a marketable minority value in an operating company may be zero, or quite small. This conclusion follows from the discussion of the conceptual elements of the financial control premium.

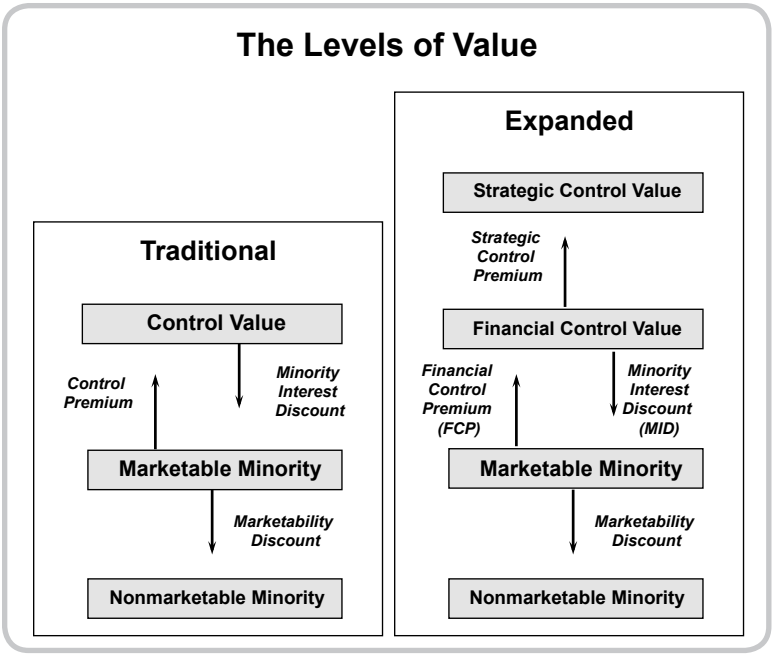
Developing and articulating reasonable financial control premiums and minority interest discounts is difficult outside the conceptual framework of the Integrated Theory. Consider the discussion of the value of control in the most recent edition of Pratt/Reilly/Schweihs. Many appraisers cite the list of prerogatives of control found in each of the Pratt/Reilly/Schweihs books (and other books) as support for the application of a substantial minority interest discount. The prerogatives of control include the ability to unilaterally: [Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business*, 4th ed (New York: McGraw-Hill, 2000), pp. 347-348. The list is growing with succeeding editions.]

1. Appoint or change operational management
2. Appoint or change members of the board of directors
3. Determine management compensation and perquisites
4. Set operational and strategic policy and change the course of the business
5. Acquire, lease, or liquidate business assets, including plant, property, and equipment
6. Select suppliers, vendors, and subcontractors with whom to do business and award contracts
7. Negotiate and consummate mergers and acquisitions
8. Liquidate, dissolve, sell out, or recapitalize the company
9. Sell or acquire treasury share
10. Register the company's equity securities for an initial or secondary public offering
11. Register the company's debt securities for an initial or secondary public offering
12. Declare and pay cash and/or stock dividends
13. Change the articles of incorporation or bylaws
14. Set one's own compensation (and perquisites) and the compensation (and perquisites) of related-party employees
15. Select joint venturers and enter into joint venture and partnership agreements
16. Decide what products and/or services to offer and how to price those products or services
17. Decide what markets and locations to serve, to enter into, and to discontinue serving
18. Decide which customer categories to market to and which not to market to
19. Enter into inbound and outbound license or sharing agreements regarding intellectual properties
20. Block any or all of the above actions

In short, the controlling shareholder is empowered with the rights to manage a business enterprise for the benefit of the controlling shareholder. Appraisers (and courts) have long thought that control buyers pay control premiums for the prerogatives of control listed above. The Pratt/Reilly/Schweihs text concludes the presentation of this list, which first appears in Chapter 15, "Control and Acquisition Premiums," with the following comment:

From the above list, it is apparent that the owner of a controlling interest in a business enterprise enjoys some very valuable rights that the owner of a noncontrolling ownership interest does not enjoy.

The authors present two levels of value charts at the same point in the text. The first chart is the three-level one used for several years in editions of *Valuing a Business* and other publications. The second is the modified and expanded four-level chart presented in this now-familiar figure to the right.



In other words, the control premium in view is the same conceptual premium as the financial control premium indicated in the figure above. (Pratt/Reilly/Schweihs. Citing Jay E. Fishman, Shannon P. Pratt, *Guide to Business Valuations*, 10th ed. (Fort Worth, TX: Practitioners Publishing Company, 2000). Also, at p. 348, citing Z. Christopher Mercer, "Understanding and Quantifying Control Premiums: The Value of Control vs. Synergies of Strategic Advantages," *The Journal of Business Valuation* (Toronto: Carswell Thomson, 1999), p. 51.)

We will see shortly that the statement quoted above may be true as it relates to a controlling owner of a private company and a minority (noncontrolling) shareholder in the same company. It is likely not true (or is not relevant) as it relates to the managements and boards of directors of well-run public companies and the corresponding minority shareholders holding publicly traded shares. Carrying this thought a step further, if the statement about the "rights" of control are not true for well-run public companies (where management and the directorate are expected to do a good job exercising control), then it is also not true for the private company being valued at the marketable minority level of value presented below.

Examination of the conceptual math shown in the figure above reveals no direct consideration of the aforementioned prerogatives of control. What, then, is a control buyer paying for? We observe the following from the equation below, which defines the financial control premium:

$$CP_f = \frac{V_{e(c,f)} - V_{e(mm)}}{V_{e(mm)}}$$

- The financial control premium is created by any differential in cash flows or growth that the control buyer is willing to price into a deal. In other words, the conceptual model suggests that a control buyer would pay a financial control price based only on the expectation of greater future cash flows than expected at the marketable minority level.
- Rather than having some inherent value, the value of the various prerogatives of control is manifest in more favorable expectations with respect to expected cash flows, growth, or risk. Control premiums are paid for the right to run the enterprise differently to achieve enhanced cash flow or accelerated

	Conceptual Math	Relationships	Value Implications
Financial Control Value	$\frac{CF_{e(c,f)}}{R_f - [G_{mm} + G_f]}$	$CF_{e(c,f)} \geq CF_{e(mm)}$ $G_f \geq 0$ $R_f = R_{mm}$ (+/- a little)	$V_{e(c,f)} \geq V_{mm}$
Marketable Minority Value	$\frac{CF_{e(mm)}}{R_{mm} - G_{mm}}$	$G_v = R_{mm}$ - Div Yld	V_{mm} is the benchmark for other values

growth. The price is paid for the expected cash flow and not for the naked right, or prerogative.

- There is no specific portion of the value of an enterprise that should be allocated solely to the prerogatives of control of control.

We conclude, therefore, that control buyers augment the marketable minority level of cash flow through the exercise of the prerogatives.

Insights. Several insights are appropriate regarding the prerogatives of control:

- I have personally been involved in many transactions involving the change of control of companies and financial institutions. In all of the transactions in which I have participated directly in the negotiations, there has never been a discussion of the so-called prerogatives of control as elements of value. The discussions always revolve around expectations for cash flows and their growth and risks to their realization.

- If I buy a car, I receive the title to it. The title gives me the right to "control" the car and its use. If a company's assets are purchased, just like my car, title transfers and the new owner has the right to control their use. I did not pay for "control" of the car, but for its use and enjoyment. The company's assets are not purchased for "control" over them, but for their productive use.

- If the stock of a company is purchased, it is presumed to own or "control" its underlying assets. Acquirers purchase stock for the productive use (i.e., cash flow generation) of the underlying assets. They presume "control" over the company's assets and their employment.

- The assets of acquired companies are valued for purchase price allocation routinely. I am not aware of an intangible asset called "prerogatives of control" for financial reporting purposes.

We have observed thus far that unless the control buyer expects to achieve augmented levels and growth of cash flows, the financial control premium could be zero, or at least, quite small. Recalling the logic of the economist, if it were not so…In other words, if a substantial premium were paid with no expectation of augmented cash flows, then the control buyer would have to accept a substantially lower return. No rational purchaser would pay extra just for the right to control when control is assumed in the transaction.

The Minority Interest Discount

The conceptual difference between the financial control value and the marketable minority value is the financial control premium, as is seen in the equation above. If that premium is zero (or quite small), it is also true that the minority interest (or lack of control) discount is quite small.[4] Several observations about the relationships between the marketable minority and financial control levels of value are summarized below:

- Minority shareholders of public companies lack control, which is vested with managements and boards of directors. Yet we have observed (practically as with Nath, and conceptually with the Integrated Theory) that the marketable minority value and the financial control value may approximate each other for most public companies. Again, otherwise there would be strong financial incentive for the takeover of many public companies. Absent such a level of activity, it is reasonable to assume that the marketable minority and financial control values for most public companies approximate each other.

- The implication of this line of reasoning is that there is no (or very little) discount for lack of control considered in the pricing of public securities. This makes sense because investors in the public markets are not investing to gain control – they invest in companies and expect managements to run them in the best interests of the shareholders. Otherwise, the shareholders would exercise the control they do have – selling their shares and putting downward pressure on market prices, creating opportunities for takeovers by financial buyers.

- Further, observe that at the marketable minority level, all the cash flows of public enterprises are expected to be distributed to the shareholders in dividends or reinvested in the enterprises at their discount rates. Share prices are not reduced because minority shareholders do not control or have direct access to enterprise cash flows, since minority shareholders have access to the benefit of the market's capitalization of all expected future cash flows in the current market price. At any time, a minority shareholder in a public enterprise can place a sale order and achieve current market value in three days.

- This reasoning suggests that the public securities markets eliminate most, if not all, of any discount for lack of control.

The logical inference following these observations is that unless there are cash flow-driven differences between the enterprise's financial control value and its marketable minority value, there will be no (or very little) minority interest discount. The definition of the discount for lack of control (the minority interest discount), as found in the Glossary of the ASA Business Valuation Standards, is:

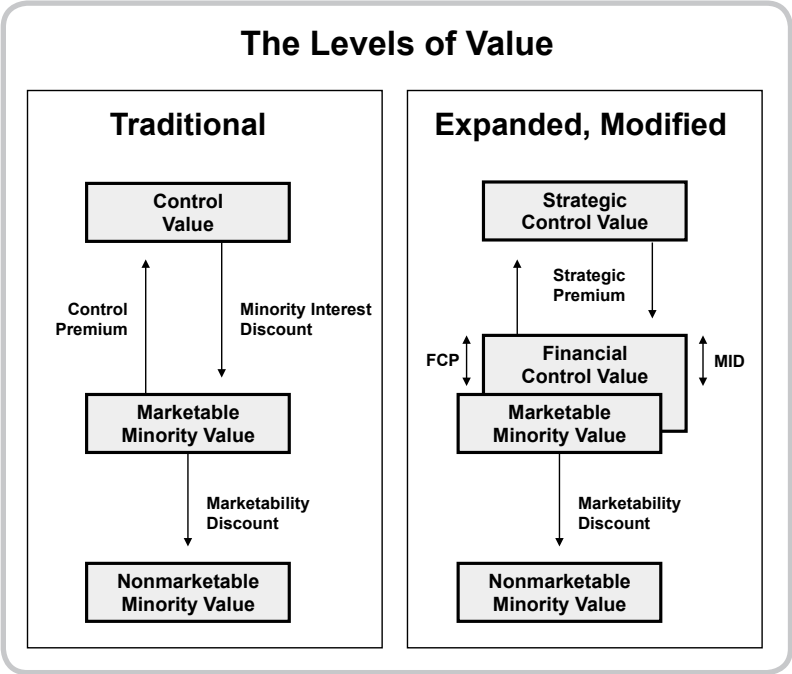
> An amount or percentage deducted from the pro rata share of value of 100 percent of an equity interest in a business to reflect the absence of some or all of the powers of control.

It is important to note that this definition is consistent with the notion that the discount for lack of control might be nil or quite small if the financial control premium is similarly nil or small.

Insight. The capital structure of an enterprise may include voting and nonvoting stock. If the vote is perceived to decrease risk somewhat relative to the nonvoting shares, voting shares may trade at a small premium to nonvoting shares. Stated alternatively, nonvoting shares may trade at a small discount to voting shares. The discount does not reflect merely the lack of vote, but rather, the increased risk perceived to be associated with the lack of the vote.

Market discipline causes most public companies to be run in reasonable fashion, with cash flows being optimized and either reinvested or distributed to achieve appropriate returns to shareholders. The minority interest discount will exist only if the typical control financial buyer can expect to augment cash flows from properly normalized cash flows at the marketable minority level.[6]

> **Insight.** These observations are made in relationship to operating companies. Their relevance for asset holding entities needs to be addressed further. The logic of the Integrated Theory suggests that there is no reason for minority interest discounts related to asset holding entities to be of great magnitude. In practice, I have used minority interest discounts in the range of 0% to 10% for several years when valuing asset holding entities. The issue of minority interest discounts seldom arises when valuing operating companies, since most valuation methods, other than comparison with guideline transactions of whole companies, yield marketable minority level indications of value.



The financial control premium was defined in the previous post. The related minority interest discount from the financial control value (MID_F) is defined in the following equation:

$$MID_F = \left(1 - \frac{V_{mm}}{V_{e(c,f)}} \right)$$

The conceptual analysis thus far suggests that our levels of value chart should be modified to better reflect the conceptual relationship between the financial control and marketable minority levels of value.

The expanded, modified chart in the figure at the top of the page depicts the much smaller (or non-existent) difference between the financial control and marketable minority levels of value suggested by our analysis. This is the levels of value chart that I use in valuation reports, speeches, articles, and as found on Mercer Capital's website as a resource. This chart summarizes in picture form the conceptual math of the Integrated Theory. It also shows the nonmarketable minority level of value, which we will discuss in future posts.

The Minority Interest Discount and Statutory Fair Value

The odyssey to a better understanding of the levels of value began with Eric Nath's 1990 article. Appraisers began questioning the use of (strategic) control premium data as the basis for estimating minority interest discounts in the mid-1990s. I began speaking about an integrated theory of business valuation in the early 2000s, and published *The Integrated Theory of Business Valuation* (out of print) in 2004. *Business Valuation: An Integrated Theory Second Edition* (with Travis Harms) was published in 2007.

My experiences in testifying regarding statutory fair value have convinced me that an understanding of the Integrated Theory will assist appraisers and courts in future statutory fair value determinations. With the vocabulary we are building, we will turn to discussions of specific statutory fair value cases and examine their valuation economics in light of the Integrated Theory.

The strategic control value will be developed to round out the enterprise levels before proceeding to the shareholder level (nonmarketable minority value). However, we do pause to observe that what can be large differences between the enterprise and shareholder levels of value is not attributable to the familiar prerogatives of control, but rather the lack of marketability.

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[1] Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business*, 4th ed (New York: McGraw-Hill, 2000), pp. 347-348. The list is growing with succeeding editions.

[2] Ibid, p. 349.

[3] Ibid, p. 347. Citing Jay E. Fishman, Shannon P. Pratt, *Guide to Business Valuations*, 10th ed. (Fort Worth, TX: Practitioners Publishing Company, 2000). Also, at p. 348, citing Z. Christopher Mercer, "Understanding and Quantifying Control Premiums: The Value of Control vs. Synergies of Strategic Advantages," *The Journal of Business Valuation* (Toronto: Carswell Thomson, 1999), p. 51.

[4] "Definitions," *Business Valuation Standards* (Washington, D.C.: American Society of Appraisers, June 2005), pp. 21-31. This lack of control discount is theoretically consistent with eliminating a financial control premium.

[5] The capital structure of an enterprise may include voting and nonvoting stock. If the vote is perceived to decrease risk somewhat relative to the nonvoting shares, voting shares may trade at a small premium to nonvoting shares. Stated alternatively, nonvoting shares may trade at a small discount to voting shares.

[6] These observations are made in relationship to operating companies. Their relevance for asset holding entities needs to be addressed further. The logic of the Integrated Theory suggests that there is no reason for minority interest discounts related to asset holding entities to be of great magnitude. In practice, we have used minority interest discounts in the range of 0% to 15% for several years when valuing asset holding entities. The issue of minority interest discounts seldom arises when valuing operating companies, since most valuation methods, other than comparison with guideline transactions of whole companies, yield marketable minority level indications of value.

NEW YORK STATUTORY FAIR VALUE

The Marketability Discount

July 21, 2011

Peter Mahler on the *New York Business Divorce* blog writes a new post: "The Marketability Discount in Fair Value Proceedings (in New York): An Emperor Without Clothes?"

To remind you of the story of *The Emperor's New Clothes:*

> An Emperor who cares for nothing but his appearance and attire hires two tailors who promise him the finest suit of clothes from a fabric invisible to anyone who is unfit for his position or "just hopelessly stupid." The Emperor cannot see the cloth himself, but pretends that he can for fear of appearing unfit for his position; his ministers do the same. When the swindlers report that the suit is finished, they mime dressing him and the Emperor then marches in procession before his subjects, who play along with the pretense. Suddenly, a child in the crowd, too young to understand the desirability of keeping up the pretense, blurts out that the Emperor is wearing nothing at all and the cry is taken up by others. The Emperor cringes, suspecting the assertion is true, but holds himself up proudly and continues the procession. (Source: Wikipedia)

Peter's post raises several questions, including: Who is the Emperor? Who are his ministers? Who are the subjects? Who is the child in the crowd? And who are the swindling (or let me use the term, misleading) tailors?

There is much more to the post than the title. I suggest that you take a look at Peter's current post, another recent post he wrote on the topic, and the string of posts on statutory fair value on this blog for background.

NEW YORK STATUTORY FAIR VALUE

To "Marketability Discount" or Not

May 24, 2012

Two speakers at the recent *Business Valuation Conference* of the New York State Society of CPAs (May 21, 2012) addressed the topic of shareholder litigation in New York related to determinations of statutory fair value.

At the outset of this post, let me say, as I have said many times before, I am not a lawyer. I am agnostic with respect to what the definition of statutory fair value in any jurisdiction *should be*. However, if statutory and/or judicial guidance is unclear, there is much room for disagreement and misunderstanding on the part of all parties.

Marketability Discount Violates Preponderance of *Beway* Guidance

I was the first speaker at the conference and gave a presentation entitled "Shareholder Litigation in New York." I have addressed this topic in previous posts, although the presentation had a particular twist. In the presentation, I concluded that there is no *economic* rationale for the employment of a marketability discount in New York statutory fair value proceedings based on a review of *Friedman v. Beway Realty Corp.* (87 N.Y. 2d 161 (1995)), the most recent case on the topic from the highest New York court, the Court of Appeals.

Some of my logic will show through in the remainder of this post and story.

Marketability Discount Here to Stay?

Fred D. Weinstein, a New York lawyer with Kurzman Eisenberg Corbin & Lever, LLP who has considerable experience in statutory fair value matters, spoke immediately following me. Mr. Weinstein reached a different conclusion regarding marketability discounts in New York statutory fair value matters based on a discussion of a range of cases, including *Beway*. His conclusion:

> Marketability discounts have been and are likely to be repeatedly upheld.

While Mr. Weinstein indicated that his review of New York case law did not reveal any, or at least hardly any, rationale for the application of marketability discounts, he seemed to believe that the matter is so ingrained in case law that it will be difficult for the marketability discount to disappear.

Mr. Weinstein cited principles of New York law with respect to the valuation of businesses for statutory fair value purposes in New York:

1. Value the corporation as an operating business, not one in liquidation. *Blake Agency, Inc.,* 107 A.D.2d 139 (2nd Dept. 1985)

2. Valuation is based on "the shareholder's proportionate interest in a going concern. *Friedman v. Beway Realty Corp.,* 87 N.Y.2d 161 (1995)

3. Equal treatment of all shares of the same class of stock. *Matter of Cawley v. SCM Corp.,* 72 N.Y.2d 465 (1988)

These principles were actually enumerated in *Beway* in a discussion primarily addressing the minority interest discount. I quoted the *Beway* guidance in a previous post. Having stated these valuation principles of New York statutory fair value law, *all of which relate to the valuation of enterprises,* Mr. Weinstein then pointed out that:

> Whatever the method of valuation of an interest in a closely held enterprise, *it should include consideration of any risk associated with illiquidity of the shares.* (Citing *Matter of Seagroatt Floral Company, Inc.* 78 N.Y.2d 439 (1991), which is referenced in the later *Beway* case.)

Note that the italicized the in the quote above references the *illiquidity of shares* and not of the enterprise. Mr. Weinstein cited

cases in which the marketability discount has been considered and/or upheld. He also pointed out that where the assets of corporations (or other entities) consist primarily of real estate, the New York courts have tended to limit the magnitude of the marketability discount. Nevertheless, the marketability discount is likely here to stay per Mr. Weinstein.

Let's put Mr. Weinstein's logic, which is driven by his analysis of cases, to a simple test by setting up a hypothetical statutory fair value situation. By the way, I am not at all picking on Mr. Weinstein. He provided an excellent summary of the current state of statutory fair value in New York in his presentation. His excellent summary does, however, provide a starting point for the following story.

A Hypothetical "Fair Value" Story

Seaway Corporation ("Seaway" or "the Company") is an S corporation domiciled in New York. The Company operates a small chain of restaurants in New York City and is owned by a controlling owner (75%) and a minority owner (25%). The two owners were life-long friends and had invested in Seaway together more than a decade ago. Over time, they bought out the other owners and the ownership was as described at the time of this story.

Unfortunately,the two owners have had a falling out of major proportions over the future direction of the business. As a result, their friendship and the business were threatened. They did, however, have the common sense to call upon their long friendship to try to work things out so they could go their separate ways.

The following ensued:

- The controlling owner could have caused the corporation to engage in a "reverse stock split," the effect of which is to "squeeze out" the ownership interest of the minority owner.
- The minority owner could then have perfected his right to dissent and to receive the "fair value" of his shares.
- Instead, the parties decided to try to work things out themselves along the lines of how such a legal solution might play out.
- The parties agreed, based on advice of qualified business appraisers (one of whom was me, so we know the value is reasonable!), that Seaway has a fair (market) value of $20 million at the financial control level of value. No minority discount was applied in deriving this value. Based on this conclusion, the minority owner's 25% interest in Seaway has a fair value of $5 million and the controlling owner's 75% share is worth $15 million.
- The minority owner is satisfied with this result and is willing to settle. Nevertheless, the majority owner has read *Beway* and raises the question about the applicability of a marketability discount.

There are no lawyers involved at this point. We have two businessmen who agree on the value of a business, and then one who raises a question based on case law. Neither of the owners are lawyers, but they both can read and have read *Beway*, which they have been told is the latest guidance from New York's highest court.

The minority owner explains that the Company has been valued consistent with the guidance summarized above by Mr. Weinstein. The appraisers valued the Company as a operating business (i.e., a going concern) and not in liquidation, which is consistent with the first principle mentioned above. The result provides the shareholder's proportionate interest in (the value of) a going concern, consistent with the second principle mentioned above. Finally, the allocation of value between the minority owner ($5 million) and the controlling owner ($15 million) provides equal treatment of all shares of the same class of stock, consistent with the third principle mentioned above.

Therefore, the minority owner says the negotiation is over. All he needs is his $5 million. The controlling owner again reiterates that there needs to be a marketability discount.

The minority owner then reads *Beway* more carefully and pulls out further guidance. He points out that the valuation and allocation of value is consistent with virtually all of the guidance of the case and concludes, specifically that the imposition of a marketability discount into this fair value determination would:

- Reduce the value of the minority interest below its *investment value.*
- Deny the minority interest its "proportionate interest in a going concern"
- Provide unequal treatment of the minority interest relative to the controlling interest
- Provide for minority shares being valued at less than the controlling shares
- Deny protection to the minority from being forced to sell at "unfair values" imposed by those dominating the corporation
- Shift "proportionate economic value of the corporation as a going concern from minority to majority shareholders"
- "..Imposes a penalty for lack of control and unfairly enriches the majority stockholders, who may reap a windfall from the appraisal process by cashing out a dissenting shareholder."

The minority owner was convinced that his logic, that was driven by his careful reading of *Beway*, would carry the day. But the controlling owner insisted that *Beway* called for the imposition of a marketability discount.

The minority owner reflected on this and developed the chart at the top of the following page.

The minority owner showed this chart to the majority owner and explained that the imposition of any marketability discount greater

Fair Value	Marketability Discount ($)	Minority Value	Majority Value	Transfer from Minority to Majority
		25.0%	75.0%	
$20,000,000	*Pro Rata*	$5,000,000	$15,000,000	$0
Marketability Discounts*	*Share of Enterprise as a Going Concern*			
0.0%	**$0**	**$5,000,000**	**$15,000,000**	$0
5.0%	$19,000,000	$4,750,000	$15,250,000	**$250,000**
10.0%	$18,000,000	$4,500,000	$15,500,000	**$500,000**
15.0%	$17,000,000	$4,250,000	$15,750,000	**$750,000**
20.0%	$16,000,000	$4,000,000	$16,000,000	**$1,000,000**
25.0%	$15,000,000	$3,750,000	$16,250,000	**$1,250,000**
30.0%	$14,000,000	$3,500,000	$16,500,000	**$1,500,000**

*Applied to Minority Interest Only

than zero would shift value from him to the majority. This is clearly illustrated in the right-most column. The majority owner could not really argue with the simple logic of the table, but he reiterated that *Beway* appeared to require the application of a marketability discount.

The minority owner thought about this and looked at the table again. He concluded that he would, in accordance with the apparent guidance of *Beway*, accept a marketability discount. He told the majority owner that he would accept a marketability discount of 0%. The majority owner said, of course, that 0% was not a marketability discount at all, to which the minority owner said that the math worked just as well at 0% as it did at any other percentage. He observed that the decision to apply a 0% marketability discount was absolutely consistent with the logic that he read from *Beway*.

Since there were no lawyers involved, the majority owner had a difficult time arguing with the minority owner's logic. He paid the proportionate share of the enterprise value of $20 million, or $5 million to the minority owner. The minority owner paid his taxes and reinvested the funds in another successful venture. Absent the disagreement between the two owners, Seaway grew and became even more successful.

Everyone is happy now. The former minority owner and the controlling owner have reestablished their friendship. Both are quite successful. The world is a beautiful place. And there was a marketability discount — of 0%.

[For more information on the topic, see "The Marketability Discount in Fair Value Proceedings: An Emperor Without Clothes?" by Peter Mahler that provides additional color to the topic of this post.]

NEW YORK STATUTORY FAIR VALUE

Matter of Giaimo #1

May 18, 2011

Peter Mahler reviews a new statutory fair value case issued on April 25, 2011 in New York in his New York Business Divorce Blog.

> An epic corporate governance and stock valuation battle between rival siblings, fighting over a Manhattan real estate portfolio worth upwards of $100 million, generated an important ruling last week by New York County Supreme Court Justice Marcy S. Friedman. Justice Friedman's decision in *Matter of Giaimo (EGA Associates, Inc.)*, 2011 NY Slip Op 50714(U) (Sup Ct NY County Apr. 25, 2011), and the underlying, 184-page Report & Recommendation by Special Referee Louis Crespo dated June 30, 2010, are must reading for business appraisers, attorneys and owners of closely held real estate holding corporations who are involved in, or who are contemplating bringing or defending against, a "fair value" proceeding under New York's minority shareholder oppression or dissenting shareholder statutes.

The case involved two C corporations that collectively owned 19 residential apartment buildings, most or which are located in Manhattan's Upper East Side. The companies are EGA Associates, Inc. ("EGA") and First Avenue Village Corp ("FAV").

The stock in the corporations was owned equally by three siblings, Edward, Robert and Janet. Edward's will provided that his stock be divided equally between his surviving siblings at his death; however, Janet claimed that shortly prior to his death in 2007, Edward sold one share of each corporation to her, giving her control of both corporations at just above 50% of the shares.

Robert filed suit to invalidate the sale of the shares, and simultaneously, Robert sought judicial dissolution of the corporations (EGA and FAV). Janet elected to purchase Robert's shares under Section 1118 of the Business Corporation Law in New York, and the matter was referred to a Special Referee to determine the fair value of the shares of the two corporations.

An 18 day trial occurred in January, February and early March of 2009. The Special Referee issued a report of more than 180 pages on June 30, 2010. Justice Friedman's opinion was issued April 25, 2011.

Because of the length of the response on the first issue, this first post on *Giaimo* will be followed by a second in the near future.

Counsel for Robert Giaimo was Philip H. Kalban of Putney, Twombly, Hall & Hirson LLP, New York City. Having attended a substantial portion of the trial, it is clear to me that Robert was well-represented in this matter. I asked Phil to read this and the subsequent post to help ensure the factual accuracy of my comments. However, I am responsible for content in each post.

Summary of the Issues

The Special Referee first determined the market values of the various apartment buildings, siding mostly with Robert's real estate appraiser, but making adjustments in the appreciation rates that lowered value overall.

There were two important valuation issues and some related issues pertaining to Edward's estate (and that of the siblings' mother, as well). While important to the parties, they are not significant for this post.

The first valuation issue related to the issue of the applicability of a marketability discount (also called the discount for lack of marketability or DLOM). The Special Referee concluded that no marketability discount should be applied, and Justice Friedman agreed, although not for the same reasons.

The second issue was whether, in a fair value determination in New York, it was appropriate to consider the entire built-in gain (embedded capital gains, or BIG) in each of the C corporations. The issue was

significant because the book values of the two corporations were minimal in relationship to the appreciated values of the apartment buildings and a combined federal, state and New York City capital gains tax of nearly 46%.

Janet's counsel (and business appraisal experts) argued that the entire BIG should be applied as a liability in determinations of net asset value. Robert's counsel argued that none of the BIG should be considered as a liability, but his business appraisal expert testified as to appropriate methods for partial consideration if the court determined that a BIG deduction was appropriate.

The court agreed with the special referee's application of a so-called "Murphy Discount," which was decided while the Special Referee was preparing his report (*Matter of Murphy (United States Dredging Corp.*), 74 AD3d 815 (2d Dept 2010). The concluded BIG liability was about 50% of the combined embedded gains in the two corporations.

I know what Robert's expert concluded, because I was that expert.

No Marketability Discount

No minority interest discount was applied in *Giaimo*, and no marketability discount was applied, either. The Mahler blog post summarizes the marketability discount issue:

> As to DLOM, Justice Friedman states her disagreement with Mercer's position, upon which Referee Crespo relied, that the valuation of a business as a going concern at a financial control level of value is inconsistent with a marketability discount. Justice Friedman finds Mercer's position contrary to applicable precedent, particularly the Court of Appeals' 1995 *Beway* decision (*Matter of Friedman [Beway Realty Corp.]*, 87 NY2d 161) likewise involving a real estate holding company in which the court expressly upheld application of DLOM in fair value proceedings. Justice Friedman rejects Referee Crespo's effort in his Report to distinguish *Beway* on the ground that, unlike in *Giaimo*, the properties held by the subject realty company in that case had mortgage financing.

Justice Friedman nonetheless finds that Referee Crespo's decision not to apply DLOM "is appropriate on this record." Noting that fair value is a question of fact for which there is no single formula for mechanical application, she essentially finds that the subject corporations' shares are readily marketable, stating as follows:

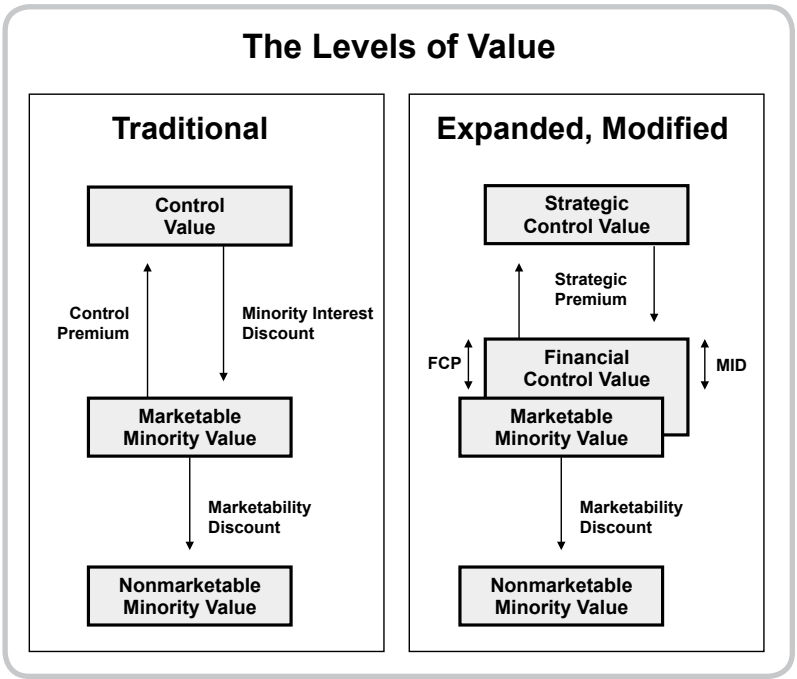
> **As discussed more fully below, in determining the built-in gains tax issue, the Referee specifically made a finding of fact, which is amply supported by the record, that the availability of similar properties on the open market is limited and that a buyer would accordingly buy the properties that EGA and FAV own through the corporations. This finding of the marketability of the corporations' shares is as relevant to the determination as to whether to apply a discount for lack of marketability as it is to whether to reduce the value of the corporations by embedded taxes. The court accordingly holds that the Referee's award on the DLOM should be confirmed.**

This was an excellent result for Robert as the shareholder being forced to sell his shares. The decision affirms that no marketability discount should be applied, but for reasons other than stated initially by Mercer. Mercer stated that the valuation of a business as a going concern at the financial control level of value is inconsistent with the application of a marketability discount. At trial, I discussed this issue at some length and supported that testimony with the now familiar levels of value chart and references to articles and texts. The levels of value chart is placed below for reference.

Visually, the application of a marketability discount lowers the conceptual level of value from marketable minority (left) or financial control/marketable minority (right) to the nonmarketable minority level of value. This is clearly a **minority interest level of value** and does not represent a proportionate share of the value of an entire business as a going concern.

We know that the court did not apply a marketability discount as in *Beway*. The rationale was also provided by Mercer based on two factors:

- I testified that the market for apartment dwellings in Manhattan was very hot. This testimony was based on detailed conversations with well-known real estate appraisers and brokers in



Manhattan (which information can ordinarily be relied upon by an expert). One of Janet's experts introduced a publication (that I had not found), which, we argued, confirmed this market condition with specific sales statistics.

- I also testified that both real estate appraisers had considered "exposure to market" in their market value determinations of the properties. Both appraisers assumed that the individual properties had been exposed to the market for periods of six to twelve months prior to the valuation dates, and that their opinions of market value reflected this exposure to market. Given that exposure to market was considered in the underlying asset appraisals, it made no economic sense to assume that the sale of the "corporate wrappers" inclusive of the properties would require additional exposure to market.

In other words, I testified first, that there was no reason to apply a marketability discount in a going concern appraisal at the financial control level. However, the additional arguments regarding the state of the Manhattan real estate market and exposure to market only further supported the first position, which Justice Friedman did not accept. She did accept the real estate market and exposure to market arguments. Perhaps she took this position because it was not necessary for her to tackle the precedent issue in *Beway* directly.

The result in *Giaimo* was clearly a determination of fair value at the financial control level of value, with no minority interest and no marketability discounts applied. This was a good result from an economic viewpoint if fair value is to be considered to be the value of a corporation at the financial control level of value.

However, the marketability discount issue from *Beway* still lives on to rise up another day.

No Minority Discount in New York

Mercer did not simply disagree with the *Beway* decision (*Matter of Friedman [Beway Realty Corp.]*, 87 NY2d 161). *Beway* states, in part (emphasis added):

> A **minority discount** would necessarily deprive minority shareholders of their proportionate interest in a going concern, as guaranteed by our decisions previously discussed.

and,

> Likewise, imposing a **minority discount** on the compensation payable to dissenting stockholders for their shares in a proceeding under *Business Corporation Law Section 623 or 1118 would result in minority shares being valued below that of majority shares, thus violating our mandate of equal treatment of all shares of the same class in minority stockholder buyouts.*

This guidance, as I read it from a valuation perspective, suggests that ***control shares of the same class as those minority shares being purchased pursuant to Section 1118 or 623 should be treated the same as the minority shares.*** This provides affirmation that the value called for in *Beway* is a controlling interest indication of fair value. The guidance of *Beway* couldn't be clearer at this point. But to drive home the point, read the following series of paragraphs [bold emphasis added, italics in text of decision]:

> Thus, we apply to stock fair value determinations under section 623 the principle we enunciated for such determinations under section 1118 that, in fixing fair value, **courts should determine the minority shareholder's proportionate interest in the going concern value of the corporation as a whole,** that is, "'what a willing purchaser, in an arm's length transaction, would offer for the corporation as an operating business'" (*Matter of Pace Photographers [Rosen]*, 71 NY2d at 748, *supra*, quoting *Matter of Blake v Blake Agency*, 107 AD2d at 146, *supra* [emphasis supplied]).
>
> Consistent with that approach, we have approved a methodology for fixing the fair value of minority shares in a close corporation under which the investment value of the entire enterprise was ascertained through a capitalization of earnings (taking into account the unmarketability of the corporate stock) and then **fair value was calculated on the basis of the petitioners' proportionate share of all outstanding corporate stock** (*Matter of Seagroatt Floral Co.,* 78 NY2d at 442, 446, *supra*).
>
> Imposing a discount for the minority status of the dissenting shares here, as argued by the corporations, would in our view conflict with two central equitable principles of corporate governance we have developed for fair value adjudications of minority shareholder interests under Business Corporation Law §§ 623 and 1118. **A minority discount would necessarily deprive minority shareholders of their proportionate interest in a going concern, as guaranteed by our decisions previously discussed. Likewise, imposing a minority discount on the compensation payable to dissenting stockholders for their shares in a proceeding under Business Corporation Law §§ 623 or 1118 would result in minority shares being valued below that of majority shares, thus violating our mandate of equal treatment of all shares of the same class in minority stockholder buyouts.**
>
> A minority discount on the value of dissenters' shares would also **significantly undermine one of the major policies** behind the appraisal legislation embodied now in Business Corporation Law § 623, the remedial goal of the statute **to "protect minority shareholders `from being forced to sell at unfair values imposed by those dominating the corporation while allowing the majority to proceed with its desired [corporate action]'"** (*Matter of Cawley v SCM Corp.,* 72 NY2d at 471, *supra*, quoting *Alpert v 28 William St. Corp.,* 61 N.Y.2d 557, 567-568). This protective

purpose of the statute **prevents the shifting of proportionate economic value of the corporation as a going concern from minority to majority stockholders.** As stated by the Delaware Supreme Court, "to fail to accord to a minority shareholder the full proportionate value of his [or her] shares imposes a penalty for lack of control, and unfairly enriches the majority stockholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder" (*Cavalier Oil Corp. v Harnett,* 564 A2d 137, 1145 [Del]).

Furthermore, a **mandatory reduction in the fair value of minority shares to reflect their owners' lack of power in the administration of the corporation will inevitably encourage oppressive majority conduct,** thereby further driving down the compensation necessary to pay for the value of minority shares. "Thus, the greater the misconduct by the majority, the less they need to pay for the minority's shares" (Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Evaluation of Minority Shares,* 65 Notre Dame L Rev 425, 487).

We also note that a minority discount has been rejected in a substantial majority of other jurisdictions. "Thus, statistically, minority discounts are almost uniformly viewed with disfavor by State courts" (*id.*, at 481). The imposition of a minority discount in derogation of minority stockholder appraisal remedies has been rejected as well by the American Law Institute in its Principles of Corporate Governance (*see*, 2 ALI, Principles of Corporate Governance § 7.22, at 314-315; comment *e* to § 7.22, at 324 [1994]).

It should be clear that New York statutory guidance is clear in not applying a minority interest discount. However, there is other guidance in *Beway* that adds confusion to the mix and, effectively, applies an "implicit minority discount." In discussing the application of a marketability discount, the Court stated:

> McGraw's technique was, first, to ascertain what petitioners' shares hypothetically would sell for, relative to the net asset values of the corporations, if the corporate stocks were marketable and publicly traded; and second, to apply a discount to that hypothetical price per share in order to reflect the stock's actual lack of marketability.

Note that the valuation date in *Beway* was in 1986. See also the sixth post in the statutory fair value series, Applicability of Marketability Discounts in New York. The appellate decision in *Beway* was rendered in December 1995. Valuation theory and concepts have evolved considerably since 1986 or 1995. But we only need to look at the evidence to realize what happened in *Beway*. Kenneth McGraw was an expert for the corporation in *Beway*. The technique he applied was clearly a **minority interest technique**. Application of a marketability discount based on reference to restricted stock studies derives a *shareholder level value* and presumes the inclusion of any minority interest discount. This was apparently not evident to the Court in *Beway*. The valuation industry was developing rapidly during the 1980s and 1990s. The level of value charts that are so ubiquitous today were first published in 1990, and did not receive wide distribution immediately. Perhaps the court was not presented with this visual, conceptual device.

It should be evident, however, that the application of a marketability discount very clearly moves the valuation from marketable minority/financial control (enterprise levels representing values of entire corporations) to the nonmarketable minority level of value, which clearly is a minority interest value. Application of a marketability discount in a fair value determination, where fair value is interpreted as a proportionate share of the value of the business at the financial control level and as a going concern, clearly has the effect of imposing an unwarranted minority interest discount by another name. This is, again, contrary to guidance of *Beway*.

> Mandating the imposition of a 'minority discount' in fixing the fair value of the stockholdings of dissenting minority shareholders in a close corporation is inconsistent with the equitable principles developed in New York decisional law on dissenting stock holder statutory rights.

Conclusion

Justice Friedman agreed with the conclusion of no marketability discount in *Giaimo*, but she reached that conclusion without tackling the problem of the unclear and misguided (by faulty valuation evidence) conclusion regarding the applicability of marketability discounts in statutory fair value determinations. The application of a marketability discount in a statutory fair value determination in New York would have the economic effect of imposing, albeit implicitly, an undesired minority interest discount. I'll be careful with terminology here. Recall that in the fifth post in the statutory fair value series, we talked about an "implicit minority discount" in Delaware, which is a different concept entirely.

Since I know that these posts on fair value are being read with interest by an increasing readership, let me go back to the first post in the series, where I said:

> At the outset of this series of posts on statutory fair value, let me be clear: I am agnostic with respect to what fair value should be in any particular state. That is a matter of statutory decision-making and judicial interpretation. As a business appraiser, what I hope is that the collective (statutory and judicial) definitions of fair value are clear and able to be expressed in the context of valuation theory and practice.
>
> In my experience, disagreements over the applicability (or not) of certain valuation premiums or discounts provide the source of significant differences of opinion between counsel for dissenting shareholders and, unfortunately, between business appraisers. Because fair value is ulti-

> mately a legal concept, appraisers should consult with counsel regarding their legal interpretation of fair value in each jurisdiction.

I was not "for" or "against" a marketability discount in *Giaimo*. I was "for" the determination of fair value as the functional equivalent of fair market value at the financial control level of value (and on a going concern basis). My engagement instructions from counsel called for this determination. I am "for" clear judicial guidance for fair value determinations that is consistent with prevalent valuation and financial theory. I hope that debate over this continuing series on statutory fair value will help this process along in New York and other states, as well.

In the next post, we will address the issue of embedded capital gains in C corporation real estate holding companies that existed in FAV and EGA in *Giaimo*.

NEW YORK STATUTORY FAIR VALUE

Matter of Giaimo #2

May 20, 2011

In the last post, we linked to Peter Mahler's review of the recent New York case *Giaimo (Matter of Giaimo (EGA Associates, Inc.)*, 2011 NY Slip Op 50714(U) (Sup Ct NY County Apr. 25, 2011).

This is a statutory fair value determination pertaining to two C corporation real estate holding companies. The matter involved litigation between siblings, Robert and Janet Giaimo.

Justice Marcy Friedman's decision was based on her analysis of the Report & Recommendation by Special Referee Louis Crespo dated June 30, 2010.

The following summary is repeated from the previous post for convenient background.

Summary of the Issues

The Special Referee first determined the market values of the various apartment buildings, siding mostly with Robert's real estate appraiser, but making adjustments in the appreciation rates that lowered value overall.

There were two important valuation issues and some related issues pertaining to Edward's estate (and that of the siblings' mother, as well). While important to the parties, they are not significant for this post.

The first valuation issue related to the issue of the applicability of a marketability discount (also called the discount for lack of marketability or DLOM). The Special Referee concluded that no marketability discount should be applied, and Justice Friedman agreed, although not for the same reasons. (I discussed this portion of the opinion in the first post on *Giaimo*.)

The second issue was whether, in a fair value determination in New York, it was appropriate to consider the entire built-in gain (embedded capital gains, or BIG) in each of the C corporations. The issue was significant because the book values of the two corporations were minimal in relationship to the appreciated values of the apartment buildings and a combined federal, state and New York City capital gains tax of nearly 46%.

Janet's counsel (and business appraisal experts) argued that the entire BIG should be applied as a liability in determinations of net asset value. Robert's counsel argued that none of the BIG should be considered as a liability, but his business appraisal expert testified as to the appropriate methods for consideration if the court determined that a BIG deduction was appropriate.

The court agreed with the special referee's application of a so-called "Murphy Discount," which was decided while the Special Referee was preparing his report (*Matter of Murphy (United States Dredging Corp.)*, 74 AD3d 815 (2d Dept 2010). The concluded BIG liability was about 50% of the combined embedded gains in the two corporations.

I know what Robert's expert concluded, because I was that expert.

Partial Consideration of Built In Gain Liability

The Mahler blog post summarized the result in Justice Friedman's opinion:

> Justice Friedman next turns to Janet's argument that Referee Crespo erred by not calculating the BIG discount at 100% assuming liquidation upon the valuation date. Janet argued that the Manhattan trial court was bound to follow the Manhattan (First Department) appellate court's ruling in *Wechsler v. Wechsler*, 58 AD3d 62 (1st Dept 2008), a matrimonial "equitable distribution" case in which the court applied a 100% BIG discount, rather than the

> Brooklyn (Second Department) appellate court's *Murphy* decision upon which Referee Crespo relied. Justice Friedman notes that the *Murphy* decision expressly distinguishes *Wechsler* on grounds equally applicable in *Giaimo*, namely, there was no issue presented or expert testimony in *Wechsler* about reducing the BIG taxes to present value. "Given the lack of precedent in this [First] Department on the issue of whether the BIG should be reduced to present value," Justice Friedman writes, "the support for that approach in the Second Department, and the factual support in the record for the 10 year projection, the Court does not find that the Special Referee committed legal error in following the present value approach."

Justice Friedman rejected Robert's contention that there should be no BIG deduction, stating that Robert relied largely on cases from other states that refuse to consider the BIG unless the corporation was actually undergoing liquidation at the valuation date.

> These cases treat an assumed liquidation as inconsistent with valuation of the corporation as an ongoing concern. While the reasoning has much to recommend it, New York follows the contrary view that it is irrelevant whether the corporation will actually liquidate its assets and that the court, in valuing a close corporation, should assume that a liquidation will occur.

Some additional background is appropriate. First, both experts for Janet concluded that 100% of the embedded BIG liability should be considered (i.e., deducted) in their determinations of net asset value. I concluded that 40% of the BIG liability should be considered as a liability. This conclusion was supported by a series of calculations and market evidence regarding the 2007 market for apartment buildings in Manhattan.

I wrote an article in 1998, following the issuance of the *Davis* case in U.S. Tax Court. The article, "Embedded Capital Gains in C Corporation Holding Companies," was published in *Valuation Strategies*, November/December, 1998.

An important conclusion of the article was that, in fair ***market*** value determinations involving C corporation asset holding companies (like EGA and FAV), the usual negotiations between hypothetical buyers and sellers would result in a conclusion of consideration of 100% of the BIG liability. This is true when buyers have the choice of buying assets inside a corporate wrapper and purchasing identical assets in "naked form," or without any issues of BIG. The article shows that the only way that buyers can get equivalent investment returns between the two choices, buying an asset in a corporate wrapper that has embedded BIG and purchasing the "naked asset," is by charging the full amount of the embedded capital gain. And the article makes no assumption about the potential ability of a buyer to convert the C corporation to an S corporation and hold for ten years until the embedded BIG "goes away." Simply put, buyers who have the alternative choice of acquiring identical "naked assets" won't agree to that concept. [emphasis added]

Janet's counsel cross-examined me fairly hard on this issue, attempting to show that I was inconsistent between the article and the treatment in *Giaimo*. However, a critical assumption is made in reaching the article's conclusion of charging 100% of the embedded BIG in C corporation asset holding companies:

> When analyzing the impact of embedded capital gains in C corporation holding companies, one must examine that impact in the context of the opportunities available to the selling shareholder(s) of those entities. One must also consider the realistic option that potential buyers of the stock of those entities must be assumed to have – **that of acquiring similar assets directly**, without incurring the problems and issues involved with embedded capital gains in a C corporation.

At the valuation date, the market for comparable Manhattan apartment buildings was very tight. There had been only a handful of transactions in the market, which consisted of many thousands of buildings, in the last year. Brokers we spoke with indicated that because of the nature of the market, and because EGA and FAV owned multiple properties each, there would likely be competitive bidding that would enable the stock of the corporations to be sold with a sharing of the BIG liability. In other words, comparable "naked assets," i.e., apartment buildings in Manhattan outside corporate wrappers like EGA and FAV, were not available. The Special Referee was convinced by this evidence that there was sufficient liquidity as a result that no marketability discount should be applied **(see the previous post on *Giaimo*)**

Having reached this conclusion, the question became one of how much "sharing" of the BIG liability would be appropriate in a determination of statutory fair value. Recall that we were instructed by counsel that fair value should be determined as the functional equivalent of fair market value on a financial control basis.

- In *Murphy*, a case involving a real estate holding company with an embedded BIG of $11.6 million, the court allowed a discount of $3.4 million, or about 29.3% of the BIG. This was based on a present value calculation assuming liquidation of the underlying properties in 19 years assuming no growth in value. The implied discount rate was 6.7%. (*Matter of Murphy (United States Dredging Corp.)*, 74 AD3d 815, 2010 NY Slip Op 04794 (2d Dept June 1, 2010))

Based on the court's analysis in *Murphy*, I presented an analysis based on the facts of the *Giaimo* case with the following assumptions.

- The properties would grow in value at an expected rate of 2.5%.
- The properties would be liquidated at the end of a ten year holding period. This was based on assumptions in the underlying real estate appraisals.
- The discount rate used was 10% based on a small premium to the discount rates used in the real estate appraisals.

- The combined capital gains tax rate (federal, state and city) was 45.63%.

Given these assumptions, the present value of the expected future embedded capital gains tax represented 49.4% of the embedded BIG at the valuation date. Just to be clear, that means that for each dollar of embedded capital gain, the analysis suggests reducing net asset value by 49.4 cents. My conclusion, based on this analysis and others presented in court, was that the liability should be 40 cents of each dollar of BIG.

The Special Referee concluded that the appropriate BIG should be about 50% based on an analysis similar to that outlined above. Expected growth was 3% per year (not compounded), for ten years, and with a 10% discount rate.

This finding was affirmed by Justice Friedman's opinion.

Concluding Comments

Giaimo is an interesting case that addresses two important issues in statutory fair value determinations in New York.

- The marketability discount issue was decided by Judge Friedman in a manner in which she did not have to tackle the precedent established in *Beway*. She determined that the Special Referee had sufficient economic evidence based on the marketability of the properties and the market for the properties in EGA and FAV to substantiate his opinion of no marketability discount.

- The Special Referee's determination of the BIG liability was clearly in line with both the precedent treatment in *Murphy* and the economic reality of the marketplace for apartment dwellings in Manhattan at the valuation date.

It remains to be seen if there will be an appeal in the matter.

IOWA STATUTORY FAIR VALUE

Fair Value Different for Banks and Bank Holding Companies

January 23, 2012

What is the meaning of *fair value* in statutory determinations in Iowa? Well, apparently, it depends, as we learn in *Rolfe State Bank v. Gunderson et al* (No. 09-0651, Filed February 11, 2011)

Rolfe State Bank, an Iowa chartered state bank in Rolfe, Iowa was substantially owned by Dixon Bancshares, Inc. During 2008, the board of directors of Rolfe State Bank effected a reverse stock split, the effect of which was to squeeze out the Bank's remaining minority shareholders, and to provide for them to receive the *fair market value* of their shares. Fair market value was determined to be $2,000 per share based largely on an appraisal performed by BCC Advisors, Des Moines, Iowa with two small upward adjustments by the Bank's board of directors.

This was not an unusual transaction. Most bank holding companies own 100% of the stock in their subsidiary banks. Dixon Bancshares evidently desired to obtain that same result, and did.

By way of perspective, there are 333 banks in Iowa as of today. Of these, all but 22 are owned by bank holding companies. I don't know how many of the Iowa bank holding companies own 100% of the stock of their bank subsidiaries, but experience would suggest that the great majority of them do. Of the 22 banks not owned by bank holding companies, 20 of them are state banks, with the other two being national banks regulated by the Office of the Comptroller of the Currency.

This Iowa case, then, involved the minority appraisal rights of shareholders of an Iowa state bank in a reverse stock split. After Rolfe State Bank, there are likely very few others, since most banks are wholly-owned by their parent bank holding companies.

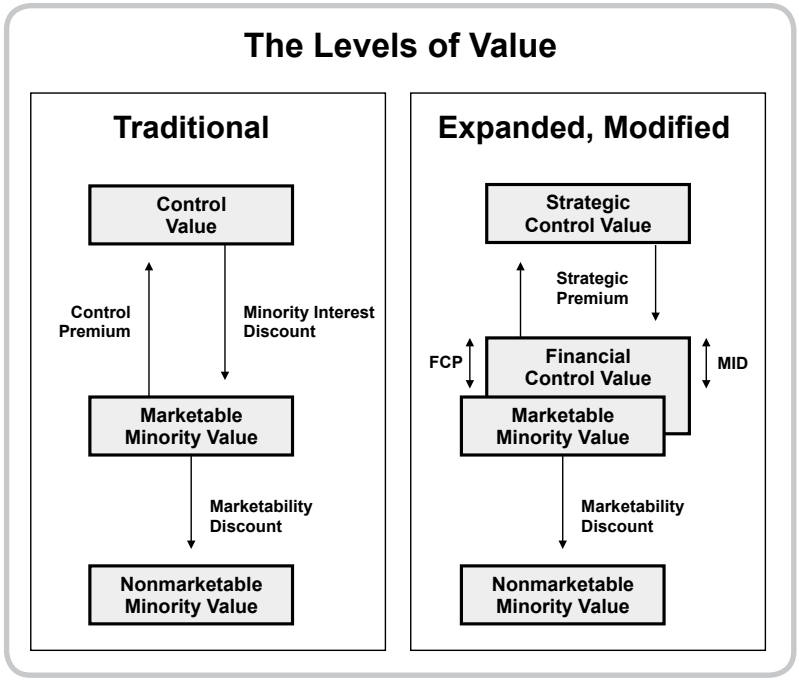
The lower (district) court concluded that the Bank had misinterpreted Iowa law to require the consideration of valuation factors recognized for federal tax purposes, including minority status and marketability discounts. In its appeal, the Bank argued that the district court "ignored both the plain meaning of the statute and its legislative history." The Iowa Supreme Court affirmed the lower court's decision that section 524.1406(3)(a) does not apply to state banks engaging in reverse stock splits.

We see the implications of the decision in the levels of value chart below. The Bank argued that value should be at the nonmarketable minority level. That is the bottom conceptual level on the chart, and relates to the value of individual interests in banks (or companies). The district court disagreed and said that the minority interest and marketability discounts should not apply, which called for value at the control value level, or at or towards the top conceptual level on the chart on the next page. For purposes of this discussion today, I won't go into differences at the controlling interest levels.

In reaching its conclusion, the Supreme Court found that minority interest and marketability discounts do not apply to state banks in Iowa engaged in reverse stock splits. The interesting thing about this case is that, had Rolfe State Bank been owned by a one-bank holding company, *the discounts would have applied.*

The Supreme Court cited a 1996 case to provide historical perspective. In *Security State Bank v. Ziegeldorf,* 554 N.W.2d 884 (1996), the Supreme Court held that minority interest and marketability discounts could not be applied in determining the fair value of dissenters shares in reverse stock split transactions. The entities involved in that case were Security State Bank, Hartley and Security State Bank, Lake Park.

Following that decision, the legislature amended the Iowa Banking Act (Iowa Code section 524.1406), a provision dealing with bank mergers. There was another amendment to legislation in 2000 that addressed the issue of marketability and minority discounts for *bank holding companies.* The Supreme Court further examined the legislative history and legislative intent and found that the statutory language allowing consideration of valuation discounts pertained only to bank holding companies, and not to banks. The decision reached the following conclusion:



> When the legislature provides for expanded application of marketability an minority discounts for bank holding companies in the bright sunshine of Iowa Code section 490.1301, we do not think it very easy to imply that the legislature intended the same result to occur with respect to banks in the shadow of the merger provisions of Iowa Code chapter 524.

and then:

> …applying the established rules of statutory construction, we conclude that the amendment to section 524.1406(3)(a) was intended to effectuate the extension of the discounts to bank holding companies. If the legislature wishes to amend Iowa Code chapter 490 to apply the discounts to banks in a wide variety of appraisal rights contexts, including a reverse stock split, it is free to do so.

In all likelihood, the legislature was lobbied by the banking industry for more favorable treatment *of bank holding companies* in reverse stock splits (relative to the doctrine of *Ziegeldorf*, which did not allow valuation discounts in statutory fair value determinations. This more favorable treatment came by allowing treatment of discounts for bank holding companies. Chances are, everyone thought that the legislation would apply to both banks and bank holding companies.

Recall that I speak from business and valuation perspectives only and offer no legal opinions. It would appear that fair value in statutory determinations in Iowa considers the following:

- *For corporations generally and for Iowa state chartered banks.* Statutory fair value is the economic equivalent of fair market value at a controlling interest level. This inference is consistent with the interpretation in *Rolfe State Bank* of the meaning of *Zieleldorf*. This is the interpretation found in many states.
- *For Iowa bank holding companies.* Statutory fair value is the economic equivalent of fair market value at the nonmarketable minority level of value.

For corporations generally and for the 20-plus Iowa state chartered banks, statutory fair value means one thing and for Iowa bank holding companies, it means quite another. Interesting.

NEVADA STATUTORY FAIR VALUE

Financial Control

July 5, 2011

The Supreme Court of the State of Nevada recently issued an opinion regarding the determination of statutory fair value in an interest matter. See *American Ethanol, Inc. v. Cordillera Fund, LP,* 2011 WL 1706823 (Nev.)(May 5, 2011).

The Cordillera Fund purchased 583,334 shares of convertible preferred stock of American Ethanol for a price of $3.00 per share, or an investment of $1.75 million. This investment occurred in 2006 at an unspecified date. In July 2007, American Ethanol and appellant AE Biofuels, Inc., formalized a merger agreement, and American Ethanol notified its stockholders of their NRS Chapter 92A right to dissent. In response, Cordillera gave American Ethanol notice of its intent to dissent and demand payment for its total shares. The other American Ethanol stockholders approved the merger, and on December 7, 2007, the articles of merger were filed with the Nevada Secretary of State.

We learn the following from the case:

1. Cordillera Fund perfected its right to dissent and to have the fair value of its shares determined by the trial court.

2. Cordillera did not hire an appraiser, but pointed to offering documents which indicated that the value of its convertible preferred shares was $3.00 per share at the merger date.

3. American Ethanol advanced the thought that the fair value was $0.15 per share, based on the book value of the stock.

4. Neither side submitted an appraisal of the American Ethanol convertible preferred shares.

5. The trial court found that the fair value of the shares was $3.00 per share, plus statutory interest.

6. American Ethanol appealed claiming that the trial court had abused discretion because Cordillera failed to meet its burden of proof regarding the fair value of the shares.

No Abuse of Discretion

Following a line of Delaware cases, the Nevada Supreme Court held that both parties have the burden of proof regarding establishing fair value at trial. The trial court judge then has the responsibility of reaching his or her final determination of fair value after considering all the evidence. The question of the burden of proof was one of first impression in a statutory fair value case in Nevada. The Court concluded:

> The Delaware approach accords with notions of judicial economy and fairness, because it places on the parties the affirmative duty to prove their respective valuations but recognizes that, in the end, the court remains the final arbiter of fair value. As in Delaware, Nevada law makes the court the final arbiter of fair value. See NRS 92A.490(1) (the "corporation shall . . . petition the court to determine the fair value"); NRS 92A.490(5)(a) ("dissenter . . . is entitled to a judgment [f]or the amount, if any, by which the court finds the fair value of the dissenter's shares"). Accordingly, we adopt Delaware's approach in determining fair value of a dissenting stockholder's shares of stock. As such, in a stockholder's right-to-dissent appraisal action, both the dissenting stockholder and the corporation have the burden of proving their respective valuation conclusions by a preponderance of the evidence in the district court. Final responsibility for determining fair value, however, lies with the court, which must make its own independent value determination.

The Court held that there had been no abuse of discretion on the part of the trial court, which had considered all of the evidence presented before it by both parties to the litigation.

Statutory Fair Value

Having found no abuse of discretion, the Supreme Court's conclusion of agreeing with the trial court's determination of value at $3.00 per share was foreordained. What else can we learn from the case?

Fair value was to be determined under what is now the prior statute, or the statute that existed in December 20007 at the merger date. The relevant version of NRS 92A.320 stated only that fair value is "the value of the shares immediately before the effectuation of the corporate action to which [the stockholder] objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable" NRS 92A.320 (2008);[5] see 3 Model Bus. Corp. Act Ann. § 13.01 (4th ed. 2008). There was no further guidance for Nevada courts, so fair value must be defined, and then determined by, the courts.

The Nevada statute was changed in 2009 to provide somewhat more guidance from the legislature (NRS 92A.320):

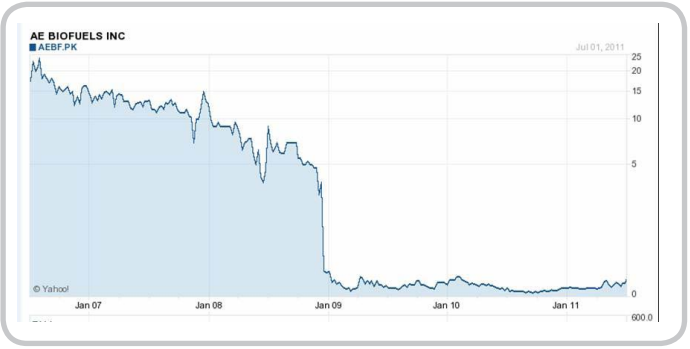
> "Fair value," with respect to a dissenter's shares, means the value of the shares determined:
>
> 1. Immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable;
>
> 2. Using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and
>
> 3. Without discounting for lack of marketability or minority status.

This new definition is in the direction of defining statutory fair value in Nevada as an enterprise level concept. It could be interpreted as representing the financial control level of value. The new statutory guidance will be helpful to business appraisers and, hopefully, the courts, in future statutory fair value determinations in Nevada.

What Really Happened?

It is not always possible to figure out the motivations of the parties based on reading appellate level cases. We know that when there is a valuation dispute, the buyer wants to pay as little as possible and the seller wants to receive as much as possible. That is human nature and uninformative.

It would seem that Cordillera was motivated to get back its 2006 investment of $3.00 per share ($1.75 million). That motivation is fairly clear. Why then would American Ethanol argue that the shares were only worth $0.15 per share less than two years after the investment (December 2007)? The answer to this question may be fairly clear, as well. By the time that the matter got to trial, things were probably not going as well with American Ethanol (or AE Biofuels, its successor). Take a look at the stock chart.



American Ethanol likely did not want to pay $3.00 per share to purchase the convertible preferred shares because their stock's performance was declining and in the tank by the time the matter got to court. [I don't know the relationship between the pricing of the convertible preferred and the common shares.] However, as was made clear in the case, the valuation date was in December 2007, and fair value was determined as of that date.

Interestingly, neither side introduced a valuation expert or independent assessments of the fair value of the convertible preferred shares. One can only wonder at the positions taken, or why either side, much less both sides, would not have an independent appraisal of the fair value of the shares as of the valuation date.

The Supreme Court decision, in a footnote, stated:

> Although an appraisal would have been advantageous, neither party had an obligation to provide an appraisal pursuant to NRS 92A.490(1). In addition, while it might have been effective for the district court to appoint an appraiser pursuant to NRS 92A.490(4), it was under no obligation to do so. **During oral argument, appellants' counsel stated that appraising Cordillera's shares of stock would be an extraordinarily difficult endeavor because: (1) Cordillera owned preferred stock, not common stock; (2) American Ethanol stock was not trading on a stock exchange; and (3) Cordillera owned very few shares of stock in relation to the total amount of the outstanding stock. Appellant's counsel maintains that an appraiser was obtained by appellants, but that the appraiser could not provide an appraisal.** (emphasis added)

I find it interesting that the appellants (that's American Ethanol) argued that a business appraiser was not able to determine a value for the convertible preferred shares for the reasons indicated in the quote above.

One might wonder if they retained an expert at the very latest minute and he or she was unable to complete the assignment because of time constraints. I'm not sure that the Supreme Court justices believed that argument, stating that an appraisal(s) would have been "advantageous."

KENTUCKY STATUTORY FAIR VALUE

Not a Shareholder-Level Concept

January 10, 2012

The Kentucky Supreme Court recently addressed the state's law providing shareholders the right to dissent from certain significant corporation actions and to obtain the *fair value* of their shares. The case, *Shawnee Telecom Resources, Inc. v. Kathy Brown*, provides a number of interesting insights into the evolution of statutory fair value in the various states, and, in this matter, in Kentucky.

Kentucky has had an interesting history regarding statutory fair value.

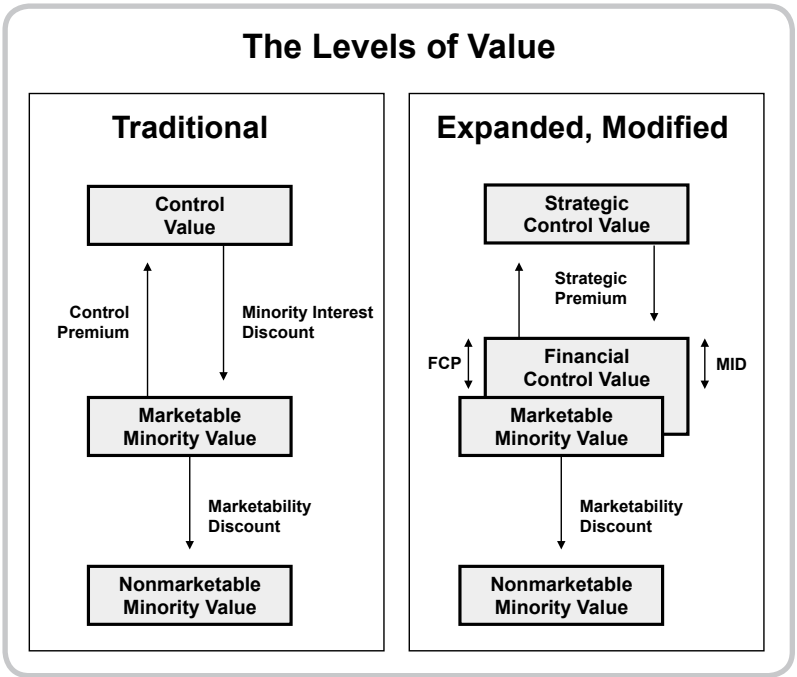
For many years, the leading case on the issue was a Court of Appeals decision in *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky App. 1982). This case allowed the application of a 25% marketability discount, and was the reigning precedent for nearly thirty years.

The Ford case was overruled by another Court of Appeals decision in *Brooks v. Brooks Furniture Mfgrs., Inc.* 325 S.W.3d 904 (Ky. App. 2010). The Court of Appeals explicitly overruled Ford with respect to the application of the marketability discount. However, the Court of Appeals also rejected the use of the net asset value method. Enter the Kentucky Supreme Court:

> The case before us presents squarely the broad issue of "fair value" and the more specific issues of the continuing viability of a marketability discount in a dissenters' rights appraisal action and the appropriateness of valuing closely held corporate stock under the net asset method. Having thoroughly considered the statute [Subtitle 13 of the Kentucky Business Corporation act, Kentucky Revised Statutes (KRS) Chapter 271B] and its underlying purpose, we conclude that "fair value" is the shareholder's proportionate interest in the value of the company as a whole and as a going concern. Any valuation method generally recognized in the business appraisal field, including the net asset and the capitalization of earnings methods employed in this case can be appropriate in valuing a given business….

What is fascinating about this case is that the Kentucky Supreme Court seems to have not only understood the concepts underlying what we in the business appraisal profession call the levels of value, but also reflected that understanding in clearly written prose. The levels of value charts are shown below.

The traditional, three-level chart is shown on the left. The chart that is generally recognized by most writers in the field now is the four-level chart on the right. The levels above that of the market-



able minority level are referred to as *enterprise* or *entity* levels of value. Values at the enterprise levels are developed based on the expected cash flows, risks and expected growth *of the enterprises*, or as noted above, "the value of the company as a whole and as a going concern."

The level below that of marketable minority is the nonmarketable minority level of value. This is the *shareholder level of value.* Value at this level is based on the expected cash flows, risks and expected growth pertaining to a particular shareholder's interest in the business. Intuitively, most people recognize that the value of an illiquid minority interest in a business is likely worth less than that interest's proportionate share of enterprise value.

The Supreme Court understands the distinction, as is clear in the following:

> As for applying a marketability discount when valuing the dissenter's shares, we join the majority of jurisdictions which, as a matter of law, reject this *shareholder-level discount* because it is premised on fair *market* value principles which overlook the primary purpose of the dissenters' appraisal right — the right to receive the value of their stock in the company as a going concern, not its value in a hypothetical sale to a corporate outsider. However, generally recognized *entity-level discounts*, where justified by the evidence are appropriate because these are factors that affect the intrinsic value of the corporate entity as a whole. [emphasis added]

This language regarding entity level valuation is consistent with the recent case I wrote about from the South Dakota Supreme Court. The post was titled "Statutory Fair Value (South Dakota): Customer Risk Consideration is not a Valuation Discount." The point of that case was that it is inappropriate to lump entity-level adjustments into so-called valuation discounts like the minority interest discount or the marketability discount.

The Kentucky Supreme Court reviewed a good bit of history pertaining to statutory fair value. In so doing, a number of important points were made to clarify the meaning of fair value in Kentucky.

> Because an award of anything less than a fully proportionate share would have the effect of transferring a portion of the minority interest to the majority, and because it is the company being valued and not the minority shares themselves as a commodity, shareholder level discounts for lack of control or lack of marketability have also been widely disallowed.
>
> Fair value should be determined using the customary valuation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rise to appraisal (quoting Principles of Corporate Governance: Analysis and Recommendations § 7.22(a) (ALI 1994))
>
> …[W]e find a broad consensus among courts, commentators, and the drafters of the Model Act that "fair value" in this context is best understood, not as a hypothetical price at which the dissenting shareholder might sell his or her particular shares, but rather as the dissenter's proportionate interest in the company as a going concern.
>
> Because a hypothetical market price for the dissenter's particular shares as a commodity is thus not the value being sought, market adjustments to arrive at such a price, such as discounts for lack of control or lack of marketability, are inappropriate.

An Amicus Brief was filed by the Kentucky Chamber of Commerce that suggested that dissenting shareholders might obtain a windfall in an appraisal proceeding if the typical valuation discounts were not applied. The logic was that there would be a likelihood that the minority shareholder purchased his or her shares at a discounted level and that if they were bought out at undiscounted levels, there could be a windfall to them. This logic was dismissed by the court. Dissenters are not voluntary participants in transactions, and therefore need to be protected.

The court also found that the net asset value method, appropriately considered in the value of an enterprise, was an appropriate valuation method.

The Kentucky Supreme Court was specific that entity-level discounts, where supported by the evidence, are acceptable. Shawnee argued that, if a marketability discount was not allowable at the shareholder level, one should be available at the entity level. The court was wary of this argument, stating:

> We agree [that a marketability discount at the entity level could be applicable] but with the strong caveat, that any entity level discount must be based on particular facts and authority germane to the specific company being valued, i.e., there can be no automatic 15-25% discount of the whole entity's value simply because it is closely held and not publicly traded.

The court listed a number of "recognized entity-level discounts" that could be appropriate in specific circumstances, including a key manager discount, a limited customer [see the South Dakota Supreme Court's analysis of this one] or supplier base discount, a built-in capital gains discount, a "portfolio" discount, a small size discount or a privately held company discount. The court referred to Shannon Pratt's book, *Business Valuation Discounts and Premiums* when discussing this list of discounts.

Immediately following this list of entity-level discounts, the court emphasized the distinction between entity-level and shareholder-level discounts, which I quote because of the importance of the discussion:

> As noted above, the distinction between entity-level and shareholder-level discounts is recognized in the business valuation literature, Shannon P. Pratt, *Business Valuation*

> *Discounts and Premiums*, p. 3 (2001) [linked above], and was referred to in *Cavalier*, where the Court observed that shareholder-level discounts, such as those for lack of control and lack of marketability, tend to defeat the protective purpose of the appraisal remedy by transferring a portion of the dissenter's interest in the company to the majority. Entity-level discounts, on the other hand, take into account those factors, such as a company's reliance on a key manager, that affect the value of the company as a whole…" *Cavalier* authorized corporate level discounting as a means of establishing the intrinsic value of the enterprise." *Where such entity-level adjustments are proper, they should be incorporated into the valuation technique employed, and the appraiser should be able to cite the relevant facts and authority for making the adjustment.* (emphasis added)

The Court then discussed the Delaware Chancery Court's rejection of "the sort of marketability discount that the court applied." *Borruso v. Communications Telesytems International*, 753 A.2d 451 (Del. Ch. 1999). While holding that an appraiser might properly support a discount based on privately held companies selling at lower multiples than publicly traded companies, the court found that there was insufficient evidence to support the discount applied. The court cited, among other things, my article "Should Marketability Discounts Be Applied to Controlling Interests in Companies?" in the June 1994 edition of Business Valuation Review [subscription required. Email me if you'd like a copy].

As if to hammer the point home, the Court stated:

> On remand, Shawnee is free to present evidence tending to show that its going concern value is lessened by such factors as its small size and its private nature, but otherwise it is not entitled to a discount based simply on the generally perceived lack of marketability of closely held corporate shares.

The conclusion of *Shawnee* is instructive:

> In sum, we agree with the Court of Appeals that Ford [applying a marketability discount] has outlived its usefulness and does not provide a suitable interpretation of the appraisal remedy currently available under KRS Subchapter 271B.13. under that subchapter, a properly dissenting shareholder is entitles to the "fair value" of his or her shares, which is the shareholder's proportionate interest in the value of the company as a whole as a going concern. Going concern value is to be determined in accord with the concepts and techniques generally recognized and employed in the business and financial community. Although the parties may, and indeed are encouraged to, offer estimates of value derived by more than one technique, the trial court is not obliged to assign a weight to or to average the various estimates, but may combine or choose among them as it believes appropriate given the evidence. If the articular technique allows for them, adequately supported entity-level adjustments may be appropriate to reflect aspects of the company bearing positively or negatively on its value. Once the entire company has been valued as a going concern, however, by applying an appraisal technique that passes judicial muster, the dissenting shareholder's interest may not be discounted to reflect either a lack of control or a lack of marketability….

A careful reading of this case indicates that the Kentucky Supreme Court warns courts (and appraisers) that shareholder-level discounts disguised as entity-level adjustments are not appropriate.

In terms of the levels of value chart above, fair value in Kentucky could be interpreted to be the functional equivalent of fair market value at the entity-, or enterprise level. What is not clear, however, is whether the Kentucky Supreme Court would embrace valuation in dissenters' rights matters at the strategic control level. The case addressed protections afforded by the Kentucky statute to dissenting, generally minority, shareholders. There was no discussion of taking into account any potential synergies that might occur in a strategic or synergistic sale of the business.

The Court is clear that there can be no downward bias from entity-level valuation to the shareholder level of valuation in *Shawnee*. However, the issue of any upward bias in statutory fair value determinations was not addressed in the case. See the discussion of the implicit minority discount (i.e., premium) in the Delaware Chancery Court in my post, Statutory Fair Value: The Implicit Minority Interest Discount.

SOUTH DAKOTA STATUTORY FAIR VALUE

Customer Consideration is Not a Valuation Discount

January 5, 2012

Jay E. Link is the son of John (Jack) Link and the brother of Troy Link. Jack and Troy ousted Jay from the family business, Link Holding, Inc., L.S.I., Inc., Linked Snacks, etc. ("LSI" or "the Company") they collectively owned in 2005.

A Buy-Sell Agreement

There was a buy-sell agreement, which, among other things, granted the Company the right to redeem, in whole or in part, any of the shareholder's shares if their employment with the Company was terminated, with or without cause.

The purchase price was to be the *fair market value* of the shares (all were minority shares, apparently), taking into account their lack of control and lack of marketability. Such fair market value was to be determined by a business appraiser mutually agreed upon by the parties.

This was a case of a buy-sell agreement gone bad.

Massive and multi-year, multi-state litigation ensued.

The buy-sell agreement valuation process, calling for the parties to agree on a single appraiser, was not invoked. After considerable fighting, both sides filed suit in late 2005. Accusations abounded and both sides asked for punitive damages. As result of the litigation, agreement was reached for a three appraiser process calling for conclusions regarding fair market value and the *fair value* of Jay's shares in the Companies.

The litigation culminated in opinions rendered by the Supreme Courts of both South Dakota (*Link v. L.S.I., Inc.*, 793 N.W.2d 44 (S.D. Dec. 29, 2010)) and Wisconsin (*Northern Air Services, Inc. v. Link Case* No. 2008AP2897 (WI S.Ct., Jul. 14, 2011)). Interested readers can look at both cases and any number of articles about this litigation, including here and here.

South Dakota Statutory Fair Value

The preceding background is appropriate to set the stage to discuss an important issue in the South Dakota Supreme Court case. The valuation processes had already occurred. The South Dakota Supreme Court ("SDSC") was determining, in part, whether the circuit court (Third Judicial Circuit, Jerauld County, South Dakota) had erred in determining the *fair value* of Jay's shares.

The SDSC recounted a bit of history, which we summarize for additional background, with an occasional comment:

- The parties were unable to negotiate a buy-out of Jay's shares. They had to agree on a single appraiser per the buy-sell agreement, and that most assuredly was not going to happen.
- Jay filed an action in South Dakota on November 17, 2005 to dissolve LSI, and LSI filed an election to purchase Jay's shares on the same day.

There was an agreed upon valuation process in the Wisconsin action calling for three business appraisers. Jay and LSI each selected an appraiser and there was a third, neutral business appraiser.

- The appraisers were to determine both the fair market value (including valuation discounts) and the fair value (excluding valuation discounts) of the shares.
- The appraised price was to be reached by agreement of any two of the three appraisers.
- Draft reports were exchanged among the business appraisers.
- The neutral appraiser's initial conclusion of the fair value of Jay's shares was $21.0 million. The appraisers talked to each other following the exchange of drafts.

- LSI's appraiser convinced the neutral appraiser that, because the Company had only one customer, its value should be reduced to appropriately account for this customer concentration risk.

- The final determination of fair value was $16.55 million based on majority vote of the appraisers (presumably, the Company's appraiser and the neutral appraiser). The (discounted) fair market value determination was $11.2 million.

With the conclusion reached in the Wisconsin action, LSI noticed a hearing to lift the stay on the South Dakota action calling for LSI to purchase Jay's shares. There was an extensive hearing with testimony from the three appraisers from the Wisconsin matter in Jerauld County Circuit Court. The court issued a memorandum decision (not cited in the SDSC opinion) and reached the conclusion that the fair value of Jay's shares in LSI was $16.55 million. The value of all of his shares in all companies was $43.2 million.

There were other issues, but the conclusion of fair value is the one of interest today. In particular, the focus is on the "discount" in the neutral appraiser's valuation conclusion from the original $21.0 million to the final, agreed upon value of $16.55 million.

Fair Value and Valuation Discounts

Reading through the lines, it appears that Jay argued in the appeal that fair value was to be an undiscounted value. He appears to have argued that the use of the "concentration risk discount" (my term) implicit in the reduction of the neutral appraiser's conclusion from $21.0 million to $16.55 million was a "marketability" valuation discount that should not be allowed.

The SDSC noted that the agreed upon valuation procedure had been followed and that the final conclusion of the appraisers represented "the undiscounted fair value of Jay's shares."

> The neutral appraiser testified that when he issued his initial report, in which he initially valued Jay's shares at $21,000,000, he did not take into account LSI's 'extremely concentrated customer base relative to the peer group of companies that we utilized from a market perspective.' LSI's only customer is Link Snacks. After discussion, the neutral appraiser testified he was persuaded that he had not considered all the different risks associated with only having one customer and that this was a 'proper' criticism of his initial opinion. Jay argues that this 'give and take' process included a decrease in valuation because 'a hypothetical willing buyer would pay less for LSI because of the significant risk associated with such a high customer concentration.'

The SDSC was satisfied that the circuit court had considered perceived issues with the conclusion of Jay's appraiser and had exercised judicial discretion in rejecting his higher conclusion. The SDSC opinion then, quite perceptively, concluded:

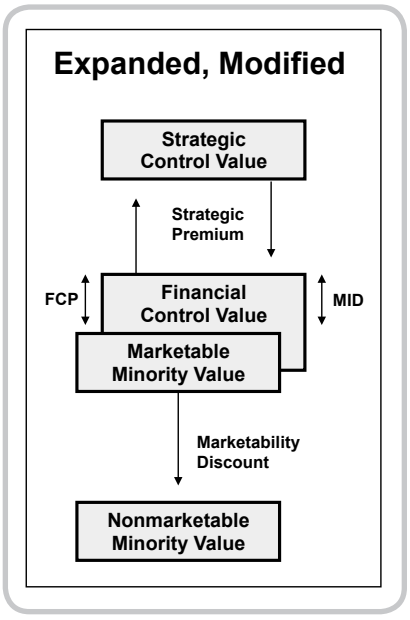
> Furthermore, the decrease from the neutral appraiser's initial report was not a discount. The decrease was due to further discussion and consideration of LSI's high customer concentration, which is one of the factors the appraisers considered in reaching the final opinion of the fair value of Jay's shares. In looking at the entire appraisal process, to which Jay agreed, and the many factors of the business that had to be considered, this decrease was not a discount.

The court concluded that the lower court had, indeed, applied an appropriate valuation method in arriving at its conclusion, sustaining the final valuation of $16.55 million for Jay's shares.

Valuation Adjustments in Enterprise Valuations

Jay was attempting to lump the "discount" for customer risk together with the more commonly used "valuation discounts" found in the South Dakota definition of fair value per SDCL 47-1A-1301(4):

> "Fair value," the value of the corporation's shares determined:
>
> a) Immediately before the effectuation of the corporate action to which the shareholder objects;
>
> b) Using customary and current valuation concepts generally employed for similar businesses in the context of the transaction requiring appraisal; and
>
> c) Without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to subdivision 47-1A-1302(5).



Letter c) discusses the familiar marketability discount (of discount for lack of marketability) and the minority interest discount (or discount for lack of control), suggesting that their use in fair value determinations is generally inappropriate.

The purpose of discussing these two valuation discounts is to define the intended fair value at the appropriate level of value on the levels of value chart. We have talked about this chart in the Statutory Fair Value series. We have interpreted this level of value to be the functional equivalent of the fair market value of a subject company at the financial control level of value in The Financial Control Level of Value and other posts.

The minority interest discount is reflected as MID in the chart above. Minority interest and marketability discounts, if appropriate for a particular appraisal, are applied once the business appraiser has reached a conclusion at the enterprise level. Their application is not appropriate according to the definition cited above and the SDSC opinion in *Jay E. Link v. L.S.I., Inc, et al*.

The Fundamental Adjustment

In *Business Valuation: An Integrated Theory Second Edition*, we discuss the fact that in reaching conclusions of value at the enterprise levels, it may be appropriate to adjust selected multiples from comparable guideline public companies. These adjustments, which we call *fundamental adjustments*, are necessary to reflect risks present (or not) in private companies that are not (are) present in the reference public group. These same risks must be accounted for in the development of discount rates applicable to private companies.

Fundamental adjustments can be positive (premiums) or negative (discounts), and relate to differences in expected risks and expected growth of cash flows relative to guideline public companies. Regarding risks:

- When comparing a subject private company with public guideline companies, the objective is to ascertain the appropriate discount rate, or capitalization rate, for the subject private company. In doing so, appraisers must contemplate that the appropriate discount rate for the subject private company may be less than, equal to, or greater than those of the guideline public companies.
- Quite often, the subject private company is riskier than the public guideline companies [as was, apparently, the case for LSI]. For example, the subject company may be smaller, have key person risks, customer concentrations, or other risks not present in most or all of the selected guideline public companies … (*Integrated Theory*, pp. 132-133)

The SDSC recognized that courts (and business appraisers, of course) should consider appropriate valuation methods and all relevant information in reaching determinations of fair value.

Although the definitions of *fair value* provided by SDCL 47-1A-1301(4) and *Olsen* are not controlling, it is appropriate in this case to draw from them for guidance, as the circuit court did. This approach is supported by the comments to the Model Business Corporation Act ("MBCA"). The MBCA comments on which SDCL ch 47-1A is based, note that § 14.34 "does not specify the components of 'fair value,' and the court may find it useful to consider valuation methods that would be relevant to a judicial appraisal of shares under section 13.30."

The bottom line is that the SDSC recognized that customer concentration risks in a subject company that are not present in selected guideline companies warrant a downward adjustment to the public median (or average) multiples. These fundamental adjustments are necessary when developing values at the enterprise (financial control or marketable minority) level in statutory fair value determinations.

Conclusion

I have made what some might seem to think a large point about what might seem to be a small comment ("this decrease was not a discount"). However, it is a case in which the court was presented with potentially confusing evidence regarding valuation and reached the right (valuation) conclusion.

This case will likely be cited in numerous fair value determinations where there are risk differences between a subject private (or public, for that matter) company being valued in a statutory fair value proceeding. The same logic could, of course, be used to justify fundamental adjustments based on differences in expected growth.

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Chris began his valuation career in the late 1970s. He has prepared, overseen, or contributed to more than a thousand valuations for purposes related to M&A, litigation, and tax, among others.

In addition, he has served on the boards of directors of several private companies and one public company.

Chris has extensive experience in litigation engagements including statutory fair value cases and business damages and lost profits. He is also an expert in buy-sell agreement disputes.

Designations held include Accredited Senior Appraiser, Fellow (FASA) from the American Society of Appraisers, Chartered Financial Analyst (CFA) from the CFA Institute, and Accredited in Business Appraisal Review (ABAR) from the Institute of Business Appraisers.

In 2011, Chris was appointed to the International Valuation Professional Board of the International Valuation Standards Committee (IVSC). The role of the International Valuation Professional Board is to promote the development of the valuation profession globally. Prior to this appointment, Chris served as the Chairman of the Standards Committee of the American Society of Appraisers.

Chris is a prolific author on valuation-related topics and a frequent speaker on business valuation issues for national professional associations and other business and professional groups.

Books authored by Chris

- *Unlocking Private Company Wealth: Proven Strategies and Tools for Managing Wealth in Your Private Business* (Peabody Publishing, 2014)
- *Buy-Sell Agreements for Closely Held and Family Business Owners: How to Know Your Agreement Will Work Without Triggering It* (Peabody Publishing, 2010)
- *Business Valuation: An Integrated Theory, Second Edition* (John Wiley & Sons, Inc., 2008) with Travis W. Harms, CFA, CPA/ABV
- *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* (Peabody Publishing, LP, 2007)
- *Valuing Shareholder Cash Flows: Quantifying Marketability Discounts* (Peabody Publishing, LP, 2005)
- *Valuing Enterprise and Shareholder Cash Flows: The Integrated Theory of Business Valuation* (Peabody Publishing, LP, 2004)
- *Quantifying Marketability Discounts* (Peabody Publishing, LP, 2001, & 1997)
- *Valuing Financial Institutions* (Business One Irwin, 1992)

In addition to these books, Chris is a contributing author to *An Estate Planner's Guide to Revenue Ruling 59-60*, published by Peabody Publishing, LP in 2010; and *Valuation for Impairment Testing,* published by Peabody Publishing, LP, in 2001.

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