Relevance of Discounts for Lack of Control and Lack of Marketability in Marital Dissolution Matters

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A discussion of the application of valuation discounts for lack of control and for lack of marketability in marital dissolution cases is predicated upon an understanding of (1) the standards of value commonly applicable in marital dissolution cases, (2) the valuation methods used and the resulting value level to which discounts are applied, (3) the specific control and liquidity facts and circumstances relevant with regard to the subject business interest, and (4) the relevant statutes and case law applicable in the jurisdiction in which the marital dissolution proceedings are taking place.

Introduction

Business ownership interests includable in marital estates can range from a small, fractional equity interest in a partnership, limited liability company, or corporation, to the total equity value of an entity. Further, the subject interest could be fully liquid, represented by stock in a publicly traded corporation, or relatively illiquid, represented by an equity interest in a private company.

Typically, valuation analysts ("analysts") are retained in a marital dissolution context to estimate the "value" of an ownership interest in a closely held company, based on the fact that the value of publicly traded equity is readily determinable in the marketplace. In such engagements, analysts are often faced with the challenge of determining the relevance, applicability, and level of a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM) when the subject interest represents a noncontrolling equity interest in a privately held company.

The following discussion identifies DLOC and DLOM considerations that analysts typically consider when rendering opinions in a marital dissolution context involving the valuation of a noncontrolling equity interest in a privately held company. Such considerations include the following:

- Standards of value
- Value estimates provided by different valuation approaches
- Rationale for a DLOC
- Rationale for a DLOM
- Diversity in the application of a DLOC and a DLOM

Standards of Value in Marital Dissolution Matters

Analysts define a standard of value as part of the valuation process. Two common standards of value used in business valuations of closely held businesses for marital dissolution cases are fair market value and fair value. Other less commonly used standards of value are book value, adjusted book value, going-concern value, investment value, and liquidation value.[1]

Because the standards of value applicable to marital dissolution matters vary on a state-by-state basis, legal counsel and analysts refer to a particular jurisdiction's statutes and case law to determine the appropriate standard of value that should be used.

Some jurisdictions use fair market value, while others reference the terms "fair value" or simply "value" in marital dissolution statutes. The full meaning of fair value depends on the context of its use. It may be dictated by the court with jurisdiction over the case. Typically, fair value as a standard of value precludes the application of noncontrolling discounts. However, in some cases, no further definition of these terms is provided.

For all federal and state tax matters, including estate taxes, gift taxes, inheritance taxes, income taxes, and ad valorem taxes, the applicable standard of value is fair market value.[2] The Internal Revenue Service (the "Service") defines fair market value as follows:

> The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.[3]

Fair value, though statutorily defined in most cases, is generally understood within the valuation profession to represent the pro rata, or allocated, portion of the total value of a company established on a controlling basis. Generally, the fair value of a subject interest is understood to be established absent the impact of a DLOC or a DLOM.

Based on the fair market value standard, many analysts apply discounts, such as a DLOC and a DLOM, to estimate the value of noncontrolling equity interests in marital dissolution settings. Based on the prevalence of the fair market value standard in the marital dissolution context, the focus of this discussion will be on fair market value and the relevance and application of a DLOC and a DLOM.

Even if a certain jurisdiction's applicable standard of value is fair market value, attorneys and analysts should still refer to relevant case law for guidance on the characteristics that comprise a particular standard of value. In reviewing past cases in a jurisdiction, an analyst may find that certain procedures, such as applying a DLOC or a DLOM, are disallowed in marital disputes in that particular jurisdiction.[4]

Value Estimates Provided by Different Valuation Approaches

In order to understand the economics principle behind applying a valuation discount to the equity value of an entity, consider that equity value is often estimated from the perspective of an investor who can directly buy or sell the underlying asset(s)— that is, from a controlling, marketable ownership perspective.

Depending on the specific valuation method applied, the generally accepted business valuation approaches will produce a value indication(s) with certain assumed ownership characteristics (e.g., controlling versus noncontrolling, marketable versus nonmarketable).

Ignoring any specific jurisdictional guidance relevant in a specific marital dissolution context, the appropriateness of applying a DLOC or DLOM is, in part, contingent upon the selected valuation method, as well as the ownership characteristics inherent in the subject interest.

For example, assume the subject interest in a business valuation engagement represents a noncontrolling, nonmarketable ownership interest. Further, assume the valuation approaches and methods relied on initially produce a value indication on a controlling, marketable basis. If the objective of the engagement is to estimate the fair market value of the subject interest on a noncontrolling, nonmarketable basis, typically it would be appropriate to consider the specific application of a DLOC and a DLOM—or an aggregate discount representing a combination of the two discounts—to the initial, indicated controlling, marketable equity value to achieve the engagement objective.

"A noncontrolling ownership interest in a company typically is subject to restrictions and to other limitations that are not reflected in the market value of the underlying assets owned by the entity."

Applying the subject interest ownership percentage to the total noncontrolling, nonmarketable equity value results in the fair market value of the subject interest on a noncontrolling, nonmarketable ownership interest basis.

Rationale for a Discount for Lack of Control

An ownership interest in a company that represents 100 percent of the equity value of the company usually provides the holder of the interest absolute, or total, control. Such a position typically affords the owner unilateral decision-making authority over the company, including valuable prerogatives of control that typically are not available to the owner of an interest representing less than a controlling ownership.

A noncontrolling ownership interest in a company typically is subject to restrictions and to other limitations that are not reflected in the market value of the underlying assets owned by the entity.

Some common prerogatives of control that are not available to the holder of a noncontrolling ownership interest include the ability to perform the following:

1. Select the management of the company
2. Determine management compensation and perquisites
3. Set investment policy and change the course of company business
4. Acquire and/or liquidate company assets
5. Borrow funds on the behalf of the company
6. Liquidate, dissolve, sell, or recapitalize the company
7. Declare and pay distributions

A noncontrolling ownership interest, in general, typically lacks these prerogatives of control. As a result, a noncontrolling ownership interest in the subject company is usually worth less, on a per-share or a per-ownership-unit basis, than an ownership interest that has unilateral control.

For example, the asset-based approach asset accumulation method generally produces a controlling ownership interest level of value. This is based on the premise that, typically, only a controlling-level owner has the prerogative to make decisions regarding the assets of the subject company. These decisions may include, for example, whether to replace or liquidate the subject assets or whether to put the subject assets to their highest and best use on a going-concern basis.

Noncontrolling shares that do not confer the authority to make such controlling-level decisions typically would sell at a discount relative to controlling shares due to lack of control. "If the application of the asset accumulation method encompasses (1) the value of all the financial assets, (2) the value of all of the tangible assets (at their highest and best use), and (3) the value of all the intangible assets, then a lack of control discount normally may be applied in order to indicate a noncontrolling equity ownership interest level of value."[5]

Rationale for a Discount for Lack of Marketability

The difference in price that an investor will pay for a liquid asset (i.e., stock in a publicly traded company) compared to an otherwise comparable, illiquid asset (i.e., stock in a nonpublic company) may be substantial. This difference in price is commonly referred to as the DLOM.

The DLOM measures the difference in the price of (1) a liquid asset (the benchmark price measure) and (2) an otherwise comparable, illiquid asset (the valuation subject).

In *Mandelbaum v. Commissioner*,[6] U.S. Tax Court Judge David Laro cited nine specific (but nonexclusive) factors to consider in developing a DLOM:

1. Financial statement analysis
2. Dividend history and policy
3. Nature of the company, its history, its position in the industry, and its economic outlook
4. Company management
5. Amount of control in the transferred shares
6. Restrictions on transferability
7. Holding period for the stock
8. Subject company's redemption policy
9. Costs associated with a public offering

The liquidity inherent in a particular subject interest typically does not reflect either a marketable or nonmarketable circumstance. Rather, marketability generally occurs on a continuum. Analyst judgment, based on consideration of the facts and circumstances in each case and relevant empirical data, typically serves as the foundation for the applicability and appropriate level of a DLOM.

Diversity in the Application of DLOC and DLOM

The application and acceptance of a DLOC and DLOM in a marital dissolution context varies in court systems from state to state. In *Montisano v. Montisano*,[7] an Ohio case, the appeals court affirmed the lower court's decision to disallow a DLOC or DLOM for the husband's noncontrolling position in a closely held travel company, despite the fact that the noncontrolling position was subject to a restrictive buy-sell agreement.

In a separate Ohio case, *Caldas v. Caldas*,[8] the appellate court upheld the trial court's decision to accept the husband's expert's report, which applied a 75 percent DLOM to a subject interest in a closely held company on the grounds that (1) the company had section 8A preference due to the husband's noncontrolling status and (2) the company relied upon the husband's security clearance in obtaining government contracts. The appellate court affirmed that the decision to discount the subject interest for lack of marketability was reasonable considering the risky nature of the business.

After the valuation date, but prior to trial, the husband's security clearance was revoked. The appellate court noted that the fact that the security clearance was lost indicates that the business did involve a high degree of risk.

In re the Marriage of Mann,[9] an Iowa case, the court of appeals upheld the trial court's valuation of husband's insurance sales and financial planning business on a hypothetical investor standard. Further, the court determined that the application of a DLOM was appropriate to account for the fact that the husband's business was a "small, sole proprietorship dependent upon its relationship with a single, large corporate entity."

In *Kussatz-Jakobson v. Jakobson*,[10] a Minnesota case, the trial court accepted the husband's expert's application of a lower DLOM based on the husband's testimony that he had no current intent to sell the business. The court of appeals upheld the trail court's valuation.

In *Berenberg v. Berenberg*,[11] another Minnesota case, the trial court disregarded the price set by an extant buy-sell agreement. The court opted to uphold a higher value with the rationalization for doing so being that another family member in the business had sold shares at a value above the specified buy-sell price. The court also applied a 35 percent combined DLOC and DLOM to account for restrictions on the ability to sell the subject interest. The court of appeals upheld the trail court's decision.

In re the M*arriage of Tofte*,[12] an Oregon case, the wife's expert argued that a 35 percent DLOM was inappropriate for the following reasons:

1. The annual return to the business, in the form of a yearly bonus to the husband, was sufficient to compensate for lack of marketability.

2. The discount was inappropriate since the husband had no intent to sell the business.

The appeals court affirmed that the application of the 35 percent discount was appropriate citing the following:

1. Oregon courts have applied noncontrolling and marketability discounts without regard to whether there is an intent to sell the subject interest or not.
2. The husband's bonus was not related to the number of shares held and, therefore, had no bearing on the discount.

In another Oregon case, *In re the Marriage of Batt*,[13] the wife appealed the application of a 25 percent DLOM in determining the value of the husband's interest in the family farming business. The wife argued that the husband had no intent to sell the business, and if the farming business interest was sold, it would be to family members or there would be a sale of the entire property by all of the co-owners of the farming operation. Based on these assumed circumstances, a DLOM was inappropriate.

The appeals court referred to *Tofte v. Tofte* in considering the lower court decision, citing that Oregon courts previously have held that the absence of an intent to sell the subject interest does not necessarily render a DLOM to be inappropriate.

However, the court also referred to *Barlow v. Barlow*,[14] another case involving a family farming business. The court stated that the underlying assumption for discounting is that only part of the stock (or interest) will be sold and that the remainder will be held by other shareholders (or members). The court quoted *Barlow* stating, "when that assumption is not supported by the evidence, a discount my not be proper." The court considered the similarities and differences between the *Barlow* facts and the *Tofte* facts and concluded that a DLOM was not appropriate based on the facts in the *Batt* matter.

Conclusion

Based on the small sampling of marital dissolution cases discussed, it is clear that business valuations completed in a marital dissolution context are situation-specific engagements. Such engagements require customized evaluation by legal counsel and analysts. Furthermore, the applicability of a DLOC and a DLOM in a marital dissolution context will vary depending on the state.

Application of such discounts requires consideration of factors such as (1) the applicable standard of value and (2) the valuation methods allowed and the resulting value basis to which discounts are applied.

Analysts should develop an understanding of the control and liquidity facts and circumstances regarding the subject interest that serve as the foundation for a particular DLOC and DLOM. Additionally, analysts may confer with legal counsel and refer to relevant statues and case law for guidance regarding the application of a DLOC and DLOM on a jurisdiction-by-jurisdiction basis.

Notes:

1. Robert E. Kleeman Jr., R. James Alerding, and Benjamin D. Miller, *The Handbook for Divorce Valuations* (New York: John Wiley & Sons, 1999), 7.
2. Shannon P. Pratt, "Defining Standards of Value," *Valuation* 34, no. 2 (June 1989).
3. Treasury Regulation Section 25.2512-1.
4. Allied Business Group, "Business Valuation Issues in Divorce" (February 2014).
5. Robert P. Schweihs, "Levels of Control," Willamette Management Associates *Insights* (Autumn 2011).
6. Mandelbaum v. Commissioner, T.C. Memo 1995-255 (June 13, 1995).
7. Montisano v. Montisano, No. 15915, 1993 WL 208324 (Ohio Ct. App. June 16, 1993).
8. Caldas v. Caldas, No. 20691, 2005 WL 2077783 (Ohio Ct. App. Aug. 19, 2005).
9. In re the Marriage of Mann, No. 01–1514, 2002 WL 31310022 (Iowa Ct. App. Oct. 16, 2002).
10. Kussatz-Jakobson v. Jakobson, No. C5-03-143, 2003 WL 22289924 (Minn. Ct. App. Oct. 7, 2003).
11. Berenberg v. Berenberg 474 N.W.2d 843 (Minn. Ct. App. 1991).
12. In re the Marriage of Tofte, 134 Or. App. 449, 895 P.2d 1387 (1995).
13. In re the Marriage of Batt, 149 Or. App. 517, 945 P.2d 517 (1997).
14. Barlow v. Barlow, 111 Or. App. 179, 826 P.2d 18 (1992).

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