NYNJCT-BV.COM (TM)

203-325-2703 Business Valuation 203-434-4648

Summer 2016

Why are the New York courts at odds with other states in occasionally applying a Discount for Lack-of-Marketability in Oppressed Shareholder cases?

Why is the NYS Courts' interpretation of FairValue under the anti-minority oppression statutes at odds with most other states? In most states, the fair value of minority interests is calculated without applying any minority or marketability discount. New York state courts have, on the other hand, occasionally reduced the value of minority interests by a lack-of-marketability discount. That issue has been in the middle of related developments since the turn of the new year.

First, in December, 2015 a second court of appeal decision in the long-running New Jersey case *Wisnieski v. Walsh* [see the Fall, 2013 issue of this newsletter] modified its favorite's expert opinion by tacking a 25% DLOM on top of a 15% key person discount. The DLOM was ordered by the Court because of "bad behavior" of one of the parties. Clearly, courts by definition apply concepts of equity, i.e. what's fair to the parties, a concept which appraisers have no reason/business to take into account.

At this point, several practitioners - both in the legal and valuation professions pointed out that the New York position is not only at odds with most other states, but is also at odds with both the Model Business Corporation Act and the American Law Institute which formed the basis of most such statutes including New York's. After all, a remedy calling for a purchase by one of the parties at fair value should not include any discounts, lest it be prejudicial to one or both of them. A call was made to suggest that the appraisal community express that opinion or "teach the judges about fair value." As a profession, appraisers hardly speak with a common voice, seldom agreeing with one another on the level of discounts, and Courts may well have no interest in our opinions.

A published, nationally known appraiser has researched the New York fair value decisions, and attributes the deviation to *Beway*, a case decided 20 years ago, which the courts continue to apply despite its age and many intervening changes in most businesses. He called for a common framework without discounts, despite the fact that judges in fair value cases are more interested in equity than financial values.

New York, which tends to decide the largest fair value cases - think *AriZona* - then issued an opinion without a DLOM [Luigi La Verghetta v. Lawlor.] In this decision, the judge appeared to be receptive to the idea that no DLOM was required because the business would be unlikely to be sold by the controlling shareholders, so why penalize the holders for a potential lack of liquidity resulting from an unlikely event?

Perez v. Bruister An ESOP's legal saga after it paid more than FMV.

It took more than 5 years for the case to be decided by the U.S. circuit court for the southern district of Mississippi. The original lawsuit had been filed by the U.S. Department of Labor and the court ruled largely for the DOL, finding that the former owner had exercised undue influence on the ESOP and its appraiser and had obtained, as a result, $4.5 million in excess of the business's $13.9 million fair market value as determined by the court. The judgement also added statutory interest under state law. This represents a significant overage, which makes the transaction prohibited under ERISA, despite the fact that the owner abstained himself in voting for the purchases. In fact, meetings took place with the other trustees where direct influence was brought to bear. The lower Court rejected the DOL's proposed remedy [cancelling the transaction,] and instead ordered reimbursement, by the former owner, of the amount overpaid by the ESOP. The court also made all trustees liable. The trustees of the ESOP's trust were, besides the former owner, individuals closely associated with him. Further, the appraiser had a dubious past, had no valuation credentials, and was significantly influenced by the owner's attorney to prepare a high value appraisal.

First, the *Bruister* decision sounds a loud cautionary note for sellers, and individuals which are trustees for the ESOP but in fact are deferential to the seller. It is difficult to be an ESOP trustee, but a sound financial judgement and objectivity are required to work in the interest of the participants. The decision was appealed to the 5th circuit, which in 2016 left the decision stand. The underlying companies went out of business in 2008.

Now there is a middle-market general economic index!

The *RSM Middle Market Business Index* just made its debut. It is calculated by the accounting firm of the same name at 116.6 for the first quarter of 2016, up by 1.4 from December, 2015. The index is designed to measure business conditions for the middle market, which in this country is responsible for a large chunk of economic activity, employment [40 million jobs] and 1/3 of total gross revenues of the private sector. The index is being calculated quarterly with assistance by Moody's Analytics.

Florida Court revisits active-passive appreciation

The issue of active versus passive appreciation of business assets in the divorce context is growing in importance. A noteworthy Florida appeals court case *Witt-Bahls v. Bahls*, District Court of Appeal 4th District, issued February 3, 2016, further explores the scope of the appreciation. The issue became "does a non-owner spouse have a claim to the increased value of non-marital assets without showing marital effort or the use of marital assets to achieve the appreciation?"

In this matter, the husband did not own a business. Instead, before the marriage, he worked for a large company and, at that time, also bought a significant number of the company's shares using a bank loan. During his tenure at the company, he had some supervisory responsibilities, but also a few demotions. When he was eventually terminated, his stock holding was liquidated, which sold for substantially more than the balance of the loan used to acquire it.

The trial court determined that the stock was separate property and its appreciation was passive; it was, therefore not subject to marital distribution. The wife appealed the ruling, asking that "all appreciation in the stock of a company for which a spouse works is a marital asset." The court rejected that construction. Under existing law, the court said, the increased value of the stock of a company for which a spouse works can be marital asset subject to distribution. But it can be a non-marital asset, the crux of the matter being "whether the husband exerted the sort of 'effort' required to move the appreciation value from the non-marital category to the marital one." Generally, cases where the appreciation was found to be marital typically involve a family-owned business in which the stock-owning spouse holds a significant portion. In this Florida case, this was not the case. The company was not owned or operated by the husband nor the wife's family. The husband was, at best, a middle-manager and thus he did not contribute to the appreciation, and his wife has no right to any part of his stock's increased value.

Accordingly, whether the appreciation in a non-marital asset qualifies as a marital asset depends on both the nature of the asset/company and the position he/she holds there, according to Florida law. In other words, the issue is whether the owner spouse can switch the appreciation from the passive to the active column.

D & P increases its recommended ERP from 5% to 5.5% effective Jan. 31, 2016

Changes in the Duff & Phelps recommended Equity Risk Premium are not announced often; the last one from 5.5% to 5% goes back to February of 2013. But the significant upheaval in the public equity markets, particularly during the first half of 2015 and again in January, 2016 affected the ERP going forward, hence the D&P recommendation. When added to the heavily normalized cost of risk-free capital, it means that the minimal cost of equity capital for, say, the largest of corporations, is now 9.5%.

Now there is a formula to calculate the discount rate for the smaller entities

For businesses with sales of less than $10 million, the IPCLP or Implied Private Company Pricing Line is based on a regression of a database of business sales transactions. Accordingly, by entering revenues, one obtains the implied discount rate assuming a 0% and a 20% effective tax rate. The research was performed by Messrs. R. Dohmeyer and P. Butler some years ago and there are now peer-reviewed critiques of the methodology. From a practical standpoint, IPCPL provides a useful data point which, for one thing, is not dependent upon publicly-traded companies.

J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business communities from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder and corporate disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which may affect users. Court decision analysis is prepared from the perspective of a BV analyst, not from that of an attorney.

J.L. PIERSON, ASA
368 Heights Road # 2392
Darien, CT 06820

http://www.NYNJCT-BV.COM
(203) 325-2703
(203) 434-4648

Change Service Requested