Application of Discounts in Valuation of Interests in Privately Held Entites

By Mitch Reichman

When representing high net worth individuals in divorce proceedings, frequently one of the assets is an ownership interest in a privately held business or professional practice. Establishing a value for the business can be one of the most hotly contested aspects of the divorce. Standards, or definitions, of value have been developed as a framework for answering the question of what a business is worth in a judicial context. The two recognized standards of value are fair market value and fair value aka investment value.

Conceptually, value is a continuum. It ranges from value being established between a hypothetical willing buyer and a seller (the fair market value) to value to the holder which is established by the asset being valued as not sold but maintained (fair value). Generally, lack of control and marketability discounts is applied when the fair market standard is used; these discounts are not applied when the fair value standard is adopted. Frequently, the parties argue about whether these discounts should apply and the magnitude of them when the value of a business is at issue in a divorce.

The starting point in an expert's analysis is to determine the value of a 100 percent, controlling, marketable ownership interest in the business. Then the expert, and ultimately the court, must determine if under the particular facts of the case it is appropriate to apply any discount to that value conclusion. The most common valuation discounts arise from the basic concepts of control and marketability. Discounts for lack of control (DLOC) attempt to quantify the level of risk assumed by a non-controlling shareholder. This discount is often referred to as a minority share discount, but it is important to note that majority shareholders can also lack full control, or meaningful control. Discounts for lack of marketability (DLOM) attempt to quantify the degree to which there are risks resulting from the time and uncertainty for an ownership interest to be converted into cash.

Mitchell Reichman is an Arizona State Bar board certified family law specialist and attorney at the Phoenix law firm of Jaburg Wilk. He is a board member of the executive council of the Arizona State Bar family law section and rated AV Preeminent by Martindale-Hubbell. Mitch has been named a Best Lawyer in America by Best Lawyers continuously since 2013, Arizona Top 10 Family Law Lawyer by Arizona Business Magazine and a Southwest Super Lawyer continuously since 2009. For more information, visit www.jaburgwilk.com.

Discounts for Lack of Control

To determine whether a DLOC should be applied to the subject ownership interest the valuation expert seeks to determine if the holder of that interest can unilaterally exercise the "prerogatives of control." The most significant are the following abilities:

- Make distributions from the business, in other words, the ability to take money out of the business.
- Sell the company.
- Determine management compensation.
- Replace management.

Conceptually, DLOC also ties to the definition of fair market value. For an investment to be attractive to a non-controlling investor, the willing buyer of a non-controlling ownership interest would expect a per share price discount from what he or she would pay for a controlling ownership interest. Secondly, that willing buyer would consider the advantages and disadvantages arising from the degree of control afforded by the subject ownership interest.

Discounts for Lack of Marketability

In almost every divorce case, the spouse who is awarded the ownership interest in the business has no immediate intention of selling that interest. Valuation experts typically use the standard of whether or not the holder of the interest can sell the ownership interest and realize cash within three business days to determine whether the interest is "marketable," and this is the starting point when considering whether a DLOM should be applied. In the context of business valuations, the terms "marketability" and "liquidity" are often used imprecisely or interchangeably. Most analysts capture both elements in a DLOM.

The factors that support a DLOM include:

- Uncertain time horizon to complete the sale.
- Cost to prepare for and execute the sale.
- Risk concerning the eventual sale price.
- Non-cash and deferred transaction proceeds.

While these factors are presented in the context of considering the propriety of a DLOM applied to non-controlling interests, the same rationale supports application of a DLOM to a controlling interest in a private company. This continues to be an unresolved and somewhat controversial issue.

Courts Provide some Guidance

Division One of the Arizona Court of Appeals, in *Schickner v. Schickner*, recognized the trial court's authority to consider, on a case-by-case basis, whether discounts should be applied when determining the value of a business in the context of a divorce, governed by the broad standard of whether it would be "appropriate" given the overall mandate of equitable distribution. Reviewing cases from various jurisdictions demonstrates that whether it is appropriate to apply either discount is very fact specific.

The *Schickner* court specifically mentioned whether or not the spouse has any immediate intention to sell as a factor to consider, and courts in other jurisdictions have similarly identified it as a relevant factor. The court in *Schickner* recognized the lack of marketability as a factor to be considered in whether a discount was appropriate *without specifically recognizing* that the discounts for lack of control and lack of marketability are typically analyzed and presented separately by experts.

Because the courts have broad authority and the published decisions are case and fact specific, predicting whether the court will adopt a standard of value that includes application of discounts for lack of control and lack of marketability will continue to be a challenge in every case.