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Closely Held Corporate Shares Require a **Discount**

But opinions differ on the assets to which it applies.

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ASCERTAINING the value of shares in a publicly traded company, such as Google, Coca-Cola or Johnson & Johnson, is a simple undertaking. MSNBC, CNN, Fox and the Internet are among the numerous sources available to investors that provide nearly real-time quotes of the latest prices those shares were traded for over public exchanges such as the New York Stock Exchange or NASDAQ. The presence of these national exchanges enables stockholders to immediately liquidate their shares for cash in a matter of minutes through a few clicks of a mouse or a single phone call.

But what about the thousands of privately held companies throughout New York whose shares are not traded on the NYSE or NASDAQ? These companies oftentimes only have a handful of shareholders, many of whom are family members or close friends.

Since shares in these companies are not routinely sold each day, there is no market to consult to determine the value of any one shareholder's interest. As a result, a unique form of litigation exists in New York whose purpose is to determine the fair value of an interest in a closely held corporation.

Such proceedings are referred to as appraisal proceedings or shareholder valuation proceedings, and they arise from a number of sources, including:

• shareholder dissolution proceedings in which the corporation elects to avoid dissolution by purchasing the petitioning shareholder's interests,

• dissenting shareholder cases, and

• divorce proceedings where one of the marital assets to be distributed is shares in a closely held corporation.

In several locations, the Business Corporation Law speaks of determining the "fair value" of a shareholder's interest. For example, in corporate dissolution proceedings based upon alleged oppression of a minority shareholder by the majority, BCL §1118 allows the corporation to avoid dissolution by buying the petitioning minority's interest. If the corporation and the petitioner are unable to agree on the price, BCL §1118(b) requires the court to "determine fair value of the petitioner's share."

Similarly, a shareholder who objects to some action the corporation is about to take may withdraw as a shareholder and receive "fair value" for his interest.[1]

Unfortunately for the courts and litigants, neither the Legislature nor professional valuation standards have defined "fair value." Courts have filled in the gap and defined it as the price that "a willing purchaser, in an arm's length transaction, would offer for the corporation as an operating business."[2] This broad definition leaves the courts with significant discretion to determine the value based upon the nature of the transaction and its effects on the corporation, valuation methodologies for determining fair value of similar corporations, and "all other relevant factors."[3]

One of the "other relevant factors" that has produced a significant amount of litigation is whether the court should discount the value of an interest in a closely held corporation to reflect the lack of a public market on which the shares can be sold. This discount reflects the illiquidity of the shares as compared with shares of similar companies that are traded over the NYSE or NASDAQ.[4]

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Since a shareholder cannot easily find a buyer to purchase the shares for cash, an owner of shares of a closely held corporation may be forced to hold the shares for longer than she desires.[5] A reasonable investor would consider this extended holding period in determining the price to pay for the shares. Therefore, the Court of Appeals has held that "fair value" determinations "must take into consideration inhibitions on the transfer of the corporate interest resulting from a limited market...."[6]

Factoring In the Discount

For example, in *Friedman v. Beway Realty Corp.*,[7] the Court of Appeals reviewed the trial court's application of the marketability discount to calculate the petitioner's interests in nine closely held corporations, which each had a single piece of real estate as its sole asset. Thus, the corporations at issue in *Friedman* had only tangible assets, but no intangible assets such as good will.

The Court remanded the case to the Supreme Court "for a new determination of the appropriate discount for unmarketability of petitioner's shares and a recalculation of fair value when that discount is applied to the proportionate *net asset value* of petitioner's stockholdings in the nine corporations." (Emphasis added).[8]

In the world of shareholder valuation proceedings and lack of marketability discounts, *Friedman* is significant because it clearly holds that the discount should be applied against the net asset value, regardless of the nature of the assets, and should be applied even where the only asset owned by the corporation is real property. (The Court of Appeals' decision in *Friedman* is noteworthy for another reason, not directly applicable to this article. In another part of its decision, the Court definitively held that a minority shareholder's interest should not be discounted for the additional reason that it represents a minority interest that is incapable of exercising any control over the management of the corporation).

In the Second Department

Despite this clear mandate from the state's highest court, the Second Department appears to have adopted a narrower application of the lack

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of marketability discount, one that is at odds with *Friedman* and the fundamental nature of stock ownership. In two cases, the Second Department held that the discount should only be applied against the value of a corporation's good will.

In *Cinque v. Largo Enterprises of Suffolk County Inc.*, 212 AD2d 608 (2d Dept. 1995), the panel reviewed the trial court's calculation of the petitioner's interest in Largo Enterprises of Suffolk County Inc. From the court's decision, it appears that Largo's sole assets were shares in another corporation, 133-135 Main Street Realty Corporation, which owned income-producing property.

The court held in unmistakable conflict with *Friedman* that the judicial hearing officer properly refused to discount the value of petitioner's shares in Largo Enterprises due to their lack of marketability since "[s]uch a discount should only be applied to the portion of the value of the corporation that is attributable to goodwill. Here, the value of the corporation is attributable solely to real property and cash." (Citation omitted).[9] Unfortunately, the Second Department made no effort to distinguish *Cinque* from the Court of Appeals' decision in *Friedman*.

Similarly in *Whalen v. Whalen's Moving & Storage Co. Inc.*, 234 AD2d 552, 554 (2d Dept. 1996), the Second Department determined that the Supreme Court should not have discounted the value of the corporation for lack of marketability of the shares. Citing *Cinque* as support for its conclusion, the court held that "[s]uch a discount should only be applied to the portion of the value of the corporation that is attributable to goodwill."

The Second Department's analysis appears to be premised upon the notion that there is always a market for tangible items, such as real estate, but there is no corresponding market for goodwill.[10] Therefore, tangible assets, unlike intangible ones, do not need to be discounted for a lack of marketability.

While this reasoning has a certain superficial appeal, it is based upon a fundamentally incorrect view of stock ownership.

A shareholder in a privately held corporation, or any corporation for that matter, does not have an ownership interest in any of the corporate assets. One's ownership of a corporation, and the corporation's ownership of its assets require separate valuation analysis. The assets owned by the corporation are distinct from its shares. (See *Sealy v. Clifton, LLC*, 68 AD3d 846, 846 (2d Dept. 2009) (holding that a member in an LLC does not have standing in his individual capacity to seek partition of property owned by the LLC)).

So for example, in the corporate dissolution setting where the corporation elects to purchase the petitioner's interest to avoid dissolution, title to the corporate assets will always remain in the name of the corporation. Title does not change to reflect the departure of the petitioner in the same way title to real property would change to reflect the sale of a joint tenant's interest.

Lessons From Lis Pendens Cases

The distinction between stock ownership and ownership of the corporation's asset, such as real estate, is highlighted in the line of cases addressing the propriety of a lis pendens.

5303 Realty Corp. v. O&Y Equity Corp. involved a transaction related to a sale of stock in a corporation that happened to own realty. The propriety of the plaintiff's lis pendens was at issue. The Court of Appeals stated as follows:

> It is well settled that the property interests of a shareholder and the corporation are distinct. "[T]he corporation in respect of corporate property and rights is entirely distinct from the stockholders who are the ultimate or equitable owners of its assets***even complete ownership of capital stock does not operate to transfer the title to corporate property and***ownership of capital stock is by no means identical with or equivalent to ownership of corporate property." To allow plaintiff here to have its notice of pendency would run counter to the *Brock* rule and muddle an otherwise clear concept.

5303 Realty Corp. v. O&Y, 64 NY2d 313, 323 (1984) (alterations in original), quoting *Brock v. Poor*, 216 NY 387 (1915).

Because of this clear distinction, courts have not permitted a plaintiff to file a lis pendens where the primary transaction related to the sale of stock in a corporation that owned real estate. Actions relating to the sale of stock involve personal property, not title to real estate. See id.; *Chambi v. Navarro, Vives & Cia, Ltd.*, 95 AD2d 667 (1st Dept. 1983); *Whittemore v. De Pasquale*, 8 AD2d 793 (1st Dept.), app den, 9 AD2d 616 (1st Dept 1959).

> The New York Court of Appeals' 'Friedman' decision is **significant** because it holds that the **marketability discount** should be applied against the **net asset value**, regardless of the nature of the assets, and even where the only corporate asset owned is **real property**.

The Second Department's refusal to apply the lack of marketability discount to tangible assets because a market always exists for those assets ignores the distinction between ownership of the corporation and ownership of its assets, and ignores the fact that stock ownership does not carry with it ownership of the corporation's assets. The Second Department's enunciation of the law incorrectly views the corporate shareholder as possessing an interest in the corporation's assets.

Shareholder valuation proceedings, whether under BCL §1118 or §623, involve the transfer of personal property, i.e., corporate stock. In *Friedman*, the Court of Appeals properly focused on the value of the shares rather than the value of the corporation's real estate holdings. In doing so, the Court upheld the trial court's rejection of the petitioner's calculation of fair value that simply applied the petitioner's percentage interest to the aggregate value of the corporations' real estate holdings.[11] The Court held that this methodology incorrectly viewed the shareholders as joint tenants in the real property rather than corporate shareholders.[12]

The *Friedman* Court adhered to its earlier decision in *5303 Realty Corp.* holding that a shareholder does not have an ownership interest in the corporation's property. All the shareholder has is a stock certificate.

Once the analysis is directed at the correct asset being valued, the shares, it is clear that the lack of marketability discount must be applied to the net asset value.

In *Hall v. King*, a decision extremely critical of the Second Department's holdings in *Cinque* and *Whalen*, Justice Stephen G. Crane applied the lack of marketability discount to the net asset value of all assets, tangible and intangible alike.[13] Correctly focusing on the corporate shares, Justice Crane held that the lack of marketability discount reflects the "'risk associated with illiquidity of the shares,'" not any of the corporation's assets.[14] Justice Crane's decision in *Hall* was upheld by the First Department, creating a conflict between the First and Second Departments.

Higher Guidance Needed

It is clear that the Court of Appeals needs to take a case dealing with the correct application of the marketability discount in order to resolve the differences of opinion and settle New York law on this topic once and for all. When it does, the Court should rely upon its prior decisions in *Friedman* and *5303 Realty* and focus its analysis on the corporation's shares, not the assets owned.

Viewed in the proper light, it is clear that the lack of marketability discount must be applied against the shares of all closely held corporations, regardless of the assets that the corporation owns, because there is no readily available market over which shares in those companies may be sold to others and converted to cash.

1. See NY BCL §623(e) (McKinney's 2010)
2. See *In re Pace Photographers, Ltd.*, 71 NY2d 737, 748 (1988), quoting *Matter of Blake v. Blake Agency*, 107 AD2d 139, 146 (2d Dept. 1985).
3. BCL §623(h)(4).
4. *Matter of Seagroatt Floral Co. Inc.*, 78 NY2d 439, 445-446 (1991).
5. Id.
6. *Amodio v. Amodio*, 70 NY2d 5, 7 (1987).
7. 87 NY2d 161 (1995).
8. Id. at 171.
9. *Cinque*, 212 AD2d at 609-10.
10. See *Hall v. King*, 177 Misc.2d 126, 134 (NY Sup Ct. 1998), aff'd, 265 AD2d 244 (1st Dept. 1999).
11. *Friedman*, 87 NY2d at 165.
12. Id.
13. *Hall v. King*, 177 Misc2d at 134.
14. Id.