VALUATION Trends
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FAQ on DLOM: Answering Your Most Basic Questions on Marketability Discounts

"I am coming to the business valuation industry from a legal (or accounting) background, and am confused by the seemingly high discount rates proposed for lack of marketability/liquidity. Aren't some of these already built in to an appropriate discount rate, whether that's straight out of Ibbotson's or a built-up rate?"

That's a common question when appraisers and attorneys first approach discounts for lack of marketability (DLOM). In general, the application of discounts (or premiums) depends on how an appraiser has valued an entity—and valuation is largely a two-step process. First, the entity is valued as a whole, as though a controlling (100%) interest were freely marketable. The value of a partial interest is then calculated by adjusting the entity value, either by applying a discount or a premium. In the most general terms, an interest is worth more if it is readily marketable—and worth less if it is not.

Quantifying the DLOM

"What about the status of pre-IPO studies on marketability? Which of the studies has been holding up in court and why? And what is the current status of the Bajaj *data?"*

Because the DLOM cannot be observed independently, appraisers must quantify the discount primarily from three pricing studies:

(1) Restricted stock studies, which measure the difference between the price at which private placements of the restricted shares (from publicly traded companies) trade during the restrictive period to the market price for the same, unrestricted shares;

(2) IPO studies, which compare the post-IPO share prices with the prices at which the same shares sold prior to the IPO; and

(3) Acquisition studies, which estimate the DLOM by comparing acquisition prices for public and private companies.

Estimating DLOM usually involves taking the average or median results of these three studies, as applied to the subject company. As with any fact-specific issue, courts rarely accept a simple average or "benchmark" of the range of discounts provided by the studies. In fact, in the "landmark" *Mandelbaum v. Commissioner* (1995) decision, the Tax Court identified nine factors to consider in determining a benchmark DLOM:

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

Unfortunately, post-*Mandelbaum* cases have failed to provide coherent guidance on how to best approach or weight each of the nine factors; appraisers and attorneys must now identify and correlate the attributes of the companies in the studies with those of the subject company.

Finally, few (if any) court cases have relied on pre-IPO data as a primary method of selecting the discount. In *McCord v. Commissioner* (2003), the Tax Court cited with approval the study by IRS expert Mukesh Bajaj, it has not uniformly accepted his theory since—or his 7% DLOM conclusion.

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Must-read Opinion on Tax-Affecting, DCF Discounts, and More

***Delaware Open MRI Radiology Associates, P.A. v. Kessler, et al.,* 2006 Del. Ch. LEXIS 84 (April 26, 2006)**

This recent opinion from the Delaware Chancery Court reads like a treatise on how to price a closely-held business, and includes the Vice Chancellor Strine's own valuation analysis, derived from expert testimony as well as leading texts on business valuation. The highlights of this "must read" opinion appear below.

Radiologists form company to own and operate MRI centers

A group of radiologists formed Delaware Radiology to own MRI scanning centers and capture the additional revenues. Various disputes led the doctors to split into two discrete blocks of shareholders: the majority group, which controlled 62.5% of the company; and the minority group, which owned 37.5%. Further in-fighting led to the majority forming an acquisition company to "squeeze-out" the minority in a forced merger. The fairness of the price as well as the merger became the focus of this litigation.

"This case is another progeny of one of our law's hybrid varietals," the Vice Chancellor noted, "the combined appraisal and entire fairness action." The question for both claims essentially came down to one—the financial fairness of the merger:

> Put simply, I must determine the fair value of Delaware radiology's shares on the merger date and award the Kessler Group a per-share amount consistent with their pro rata share of that value.

As "fair value" is, by now, "a jurisprudential concept that draws more from judicial writings than the appraisal statute itself," the Court examined the company as a going concern on the merger date, considering all relevant, non-speculative data. That included the respective expert opinions offered by both parties—which contained "widely divergent" estimates of value while "supposedly using the same well-established principles of corporate finance."

> Such a judicial exercise, particularly insofar as it requires the valuation of a small, private company whose shares do not trade in a liquid and deep securities market, using a record shaped by adversaries whose objectives have little to do with reaching a reliable valuation, has, at best, the virtues of a good faith attempt at estimation. That is what I endeavor here.

Expert valuations nearly $20 million apart

Three disputed issues accounted for the "wide divergence" of expert valuations: (1) the treatment of MRI "reading" and management fees; (2) the company's expansion plans, at the time of the merger, from two to five MRI centers; and (3) the treatment of the company as an S Corporation.

At trial, the majority group had relied on the same expert it had used to set the merger price. This expert had used a discounted cash flow analysis that: (1) accepted the reading and management fees as proper expenses of the company; (2) attributed "no value" to the company's known expansion plans; and (3) tax-affected its earnings as if it were a C Corp rather than an S Corp. Applying "high" discount rates of 21.4% and 22.4% to the two MRI centers, the expert reached a value of $6.8 million for the company, or $17,039 per share.

The minority group's expert also relied on a DCF analysis. But he: (1) reduced excessive management fees and treated the majority of reading fees as profit to the company rather than expenses to the MRI centers; (2) included an estimate of the two proposed new centers (without estimating the fifth and most speculative); and (3) did not tax affect the company's earnings at all. This expert also used a lower discount rate to arrive at a value of $26.4 million for the company, or $66,074 per share. The Court reviewed each element as follows:

1. *Reading and management fees.* To cut the minority shareholders from company revenues, the majority had paid MRI reading fees to another group in the range of 15%-20%. The majority argued that this range represented fair market value, but the Court ultimately looked to Medicare reimbursement rates, finding reimbursement for MRI fees closer to 13.7%.
2. *The company's expansion plans.* The Court found it "abundantly clear" that the "operative reality" of the company included plans to expand from two to four MRI centers, and included these values into its overall conclusions. More difficult was the fifth center, which was still in the "idea" stage at the time of the merger. The question was clouded by the majority stockholders' "resistance" to discovery about the fifth center, which left the Vice Chancellor "harboring serious doubts" about the bona fides of its document production, but few doubts about including some value for the fifth center.

Continued to next page...

More troublesome still was the majority expert's complete exclusion of all three projected centers from his valuation report, testifying that it was his "fundamental belief" that the projections were not relevant if the entities hadn't opened their doors by the merger. This was a "jarringly novel view of corporate finance," according to the Court, "in which the value of McDonald's does not include the revenues it expects to make from the new franchises it will open."

3. *Tax-affecting the S Corp earnings.* In treating the company as if it were a C Corp, the majority's expert made the "standard move" of applying a 40% corporate tax rate to its earnings. The problem: There was absolutely no evidence that the small but highly profitable company would ever convert to a C Corp. Its shareholders—all in premium tax brackets—placed a substantial value on the company's tax status as an S Corp. The merger had deprived them of these benefits; and the majority's valuation approach "denied [them] the value they would have received as continuing S Corp stockholders," ensuring the merger price was lower than fair value.

By contrast, in relying on the "operative reality" of the S Corp company, the minority expert did not tax affect its earnings as a going concern. However, this approach overstated the value of the S Corp at the stockholder level, as upon its sale an S Corp receives no premium over a C Corp from "a universe" of C Corp buyers, and a market-based analysis using C Corporation comparables is misleading. "In other words," the Court explained, "I am not trying to quantify the value at which [the company] would sell to a C corporation; I am trying to quantify [its] value... as a going concern with an S corporation structure."

Treatise on tax affecting

To capture the precise advantage of the S Corp to the minority shareholders, the Court considered the difference between the value that a minority member would receive if the company was a C Corp, and the value received as an S Corp. In its undertaking, the Court "embraced" the leading Tax Court cases (*Gross, Heck* and *Adams*), which have "given life to the advantages of S corporation status by refusing to tax affect the... earnings at all." It also relied on the factual realities to depart from precedent:

> My difference with these prior decisions is at the level of implementation rather than at the level of principle. Certainly, in this context when minority stockholders have been forcibly denied the future benefits of S corporation status, they should receive compensation for those expected benefits and not an artificially discounted value that disregards the favorable tax treatment...But the minority should not receive more than a fair S corporation valuation. Refusing to tax affect at all produces such a windfall...The amount that should be the basis for an appraisal or entire fairness award is the amount that estimates the company's value to the [minority] as S corporation stockholders paying individual income taxes at the highest rates—an amount that is materially more...than if the [company] were a C corporation.

To accurately capture this value, the Vice Chancellor estimated what an equivalent, hypothetical "pre-dividend" S corporation tax rate would be, assuming annual earnings of $100 and highest marginal tax rates, according to this table:

	C Corp	S Corp	S Corp Valuation
Income before tax	$100	$100	$100
Corporate tax rate	40%	--	29.4%
Available earnings	$60	$100	$70.60
Dividend/personal income tax rate	15%	40%	15%
Total, post-tax distributions	$51	$60	$60

This calculation allowed the Court to treat the S corporation shareholder as receiving the full benefit of un-taxed dividends by equating its after-tax return to the after-tax dividend to a C corporation shareholder. "I will therefore apply an effective tax rate of 29.4% to the earnings of Delaware Radiology to measure with the greatest practicable precision the fair value of the [minority's] interest in the going concern value."

Court performs its own DCF analysis—with a last word for analysts

Having determined the major inputs, the Court conducted its own discounted cash flow analysis, including the "challenge" of computing a "proper" weighted average cost of capital. After a detailed and thorough analysis, drawing from the more "credible and well-grounded" aspects of the parties' valuations, the Court determined that the company was worth $13.3 at the time of the merger, or a per-share value of $33,232, thereby supporting its finding that the merger itself was unfair.

Of equal import is the Court's praise for valuation report by the minority's appraiser. The Vice Chancellor commended him for approaching his task "in a conservative and restrained manner that, although still reflecting a desire to advance his clients' objectives, reasonably took into account factors limiting the value" of the company.

Another Reason to Retain BV Experts: Independent Directors Liable For Improper Securities Disclosures

***The Rockies Fund, Inc. v. Securities and Exchange Commission,* 2005 U.S. App. LEXIS 24521, (November 15, 2005)**

The Rockies Fund managed a portfolio of businesses—one of which (Premier) issued a 1983 prospectus that required shareholders to discount restricted shares from the unrestricted market price.

Ten years later, the Fund participated in Premier's initial offering, holding 100,000 shares of its restricted stock and an additional 750 unrestricted shares, which accounted for 10% to 40% of the Fund's assets.

However, in six quarterly reports to the SEC, the Fund listed all of its Premier shares as unrestricted, and used the quoted market price to value its holdings.

Fund used "slipshod" valuation methods

Examining the quarterly filings, the SEC found that the Fund overvalued its Premier shares by failing to comply with the 1983 prospectus and also generally accepted accounting principles, which call for discounting restricted stock.

The prospectus had endorsed four methods of valuation—none of which the Fund used, according to the SEC. Instead, "unmoored from its prospectus, the Fund used an ad hoc process that mainly consisted of rubber-stamping" the recommendations from one of its independent directors, who had allegedly relied on advice of counsel.

The Fund claimed that even if it had "technically overvalued" Premier stock, it caused no material or actual harm to potential investors. This directly contravened the SEC's allegation, that the public overvaluation of the Fund's largest asset provided significant misinformation to investors.

Citing the Fund's "inconsistent and slipshod" valuation methodology, the SEC found that the Fund directors had shown a reckless disregard for the accuracy of Premier's stock valuations, and that reliance on a single director—or an attorneys' advice, was no excuse.

"Such a haphazard process for valuing the largest holding of the Fund constitutes an 'extreme departure from the standards of ordinary care' that should have been obvious to all the Fund's directors," as it was to the SEC, and later, on review, to the U.S. Court of Appeals.

Ruling extends liability for misclassification

Although the *Rockies Fund* doesn't break new legal turf in the arena of fund valuations—it does extend liability for financial disclosures, finding the independent directors responsible for misclassifying the vast majority of Premier shares as unrestricted.

The directors admitted the mislabeling—but claimed that it was neither material nor purposeful. However, the SEC (and the U.S. appeals court) found differently, holding that the misclassifications affected the value of the holdings and the Fund's financial statements, causing the holdings to appear more liquid than they really were.

As for the requisite intent, the Fund directors demonstrated "reckless indifference" and "extreme recklessness." The SEC had found it "implausible" that the Fund directors could have overlooked the misclassification of its largest asset in six SEC filings.

The Appeals Court confirmed, finding that absent "extreme abdication of ordinary care… an attentive director would have rectified the error." Or they should have hired an independent valuator.

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