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OPPRESSED SHAREHOLDERS' RIGHTS CAN AFFECT ESTATE AND GIFT TAX VALUATIONS

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Minority shareholders are provided statutory rights frequently overlooked in estate and gift tax valuations. Although designed to protect minority shareholders from oppressive controlling shareholders, these rights should be carefully considered during business valuations in other settings, such as estate and gift taxation. The potential for the legal exercise of special minority shareholder rights could affect the discounts assigned to the minority interest.

Professionals that perform business valuations (or draft or review shareholder agreements and corporate bylaws) in the context of estate and gift tax matters would normally look to the rights of the shareholder to affect the value of the interest being appraised. One area frequently not considered in valuation reports for such interests is "frozen out," or oppressed, shareholder interests. Oppressed shareholders are restricted by controlling shareholders' policies from participation in management, whereas dissenting shareholders oppose a transaction initiated by the controlling shareholders.

Summary of New York State Law

In 1979, the New York State Legislature enacted sections l104-a and 1118 of the Business Corporation Law (BCL) to ameliorate the problem of minority shareholders being frozen out of corporate management. Section 1104-a gave the holders of 20% or more of the outstanding shares of a corporation the right, when the other shareholders or directors engaged in oppressive conduct, to petition the court for dissolution. The counterweight to that right is provided in section 1118, which permits the other shareholders or the corporation to buy such shares at fair value.

The statute failed to provide guidelines to determine fair value, leaving the courts to play a significant role in the development of principles. *Matter of Taines [Taines v. Gene Barry One Hour Photo Express, 123 Misc. 2d 529 (Sup. Ct., N.Y. Co. 1983)]* stated that, in fair value proceedings of closely held corporations, the court is free to adopt its own method of valuation so long as it is based on recognized criteria and the facts of the case.

On February 25, 1985, the Appellate Division Second Department rendered two decisions. In one, *Matter of Fleischer [Fleischer 107 AD 2d 97 (2d Dept 1985)], the* court applied a 25% lack of marketability or liquidity discount based on multiplying various components of the corporation's income by an average price to earnings ratio of comparable publicly traded companies. It added the resulting figure to the adjusted net assets and marketable securities of the company.

In Matter of Blake [Blake v. Blake Agency 107 AD 2d 139 (2d Dept 1985)], the same court stated that three factors should be considered in arriving at fair value–market value, investment value, and net asset value–and that the weight accorded to each depends upon the circumstances of each case. It set the overriding rule that the value of a corporation should be determined on the basis of what a willing purchaser, in an arm's-length transaction, would offer for an operating business, rather than for a business being liquidated.

The *Blake* court contended that market value in a closely held company is of little or no significance because the shares of stock are not traded on any public market and that, other than bona fide offers to acquire all the shares, the sale of stock of a closely held corporation does not usually qualify as an arm's-length transaction because the sale usually involves corporate officers, employees, or family members. The court further stated that net asset value is generally the standard applicable in evaluating manufacturing corporations or real estate and Investment holding companies and is the appropriate standard for the case. Finally, the court indicated that investment value was appropriate in this case. Furthermore, investment value is usually a function of the earning power of a corporation that should be calculated by a "discounted income approach," the capitalization of dividends, or a comparative appraisal approach.

The court's standard of value, investment value, although similar to fair market value as understood in the context of estate and gift taxation, is not the same. Investment value is based on a particular investors individual requirements and not the hypothetical buyer under the fair market value standard. Most importantly, the court ruled that no discount should be applied to the minority interest itself but only to the lack of marketability of nontraded stock.

In 1991, the Court of Appeals decided the seminal case, *Matter of Seagroatt* [*Seagroatt Floral Company, Inc, 78 N.Y.S. 439* (2d Dept 1991)], which involved a decision appealed from the Third Department. The court enunciated the rule that fair market value, being a question of fact, would depend upon the circumstances of each case and stated that because the intent of the law was to help shareholders of closely held companies without ready markets for their shares, the valuation method should include the risk associated with the lack of liquidity of the shares, which the court reflected in the capitalization rate.

In 1995, the Second Department decided *Matter of Cinque [Cinque v. Largo Enterprises of Suffolk County, Inc, 212 AD 2d 608 (2d Dept 1995)]. The entity was a* real estate company and, consequently, the court held that lack of marketability should only be taken into account for goodwill and not for hard assets such as real estate and cash. The Second Department upheld that theory in *Matter of Whalen [Whalen v. Whalen's Moving & Storage Co. Inc., 234 AD 2d 552* (2d Dept i996)].

In 1998, the First Department decision *in Matter of Hall [Hall v. King, 177 Misc.* 2d 126 (Sup, Ct., N.Y. Co. 1998)] concluded that the Second Department had erred in applying the marketability discount to only intangible assets in *Cinque.* Justice Stephen Crane argued that the decision in *Cinque* was contrary to the Court of Appeals decision in *Seagroatt* and the Second Department's own previous decisions in *Blake* and *Fleischer.* Therefore, *Hall* held that the lack of marketability should be taken against the aggregate net asset value of the corporation and not solely for corporate goodwill, because it was an adjustment for the risk associated with lack of liquidity of the shares.

Hall was upheld by the First Department in a ruling which stated that it was appropriate to use the net asset method to value an ongoing wholesale antique reproduction business *(697 NYS 2d, 1st Dept 1999). The* court also stated that a 25% discount for lack of marketability applied to all of the corporate assets in light of the absence of a non-compete clause between the parties.

Shareholder agreements are frequently used to provide, or limit, shareholders' rights pertaining to the sale, value, and transfer of a business interest. Such rights or limits would be applicable to all shareholders, including those that receive their shares from gift and estate transfers. Although it might appear that such agreements could provide relief from the statutes, the courts have held that provisions in shareholders' agreements that restrict shareholders' rights under BCL 1104-a and 1118 are unenforceable because they run counter to public policy.

Valuation of a Minority Discount

Determining a minority discount in a closely held company depends upon the right to exercise "prerogatives of control." These rights include appointing management, determining policies on executive compensation and perquisites, setting policies, changing the course of the business, and declaring or paying dividends.

In the valuation of a minority interest for lack of control in a closely held company, the degree of control of the interest being valued has to be considered. The rights associated with the holders of the interest that cannot exercise any "prerogatives of control" are worth less than an interest in a company in which the holder of the interest can participate in the management of the entity. These rights will vary from company to company even if the pro rata percentage of ownership interest is identical.

A dollar value can readily be assigned to certain prerogatives of control. If the holder of a controlling interest increases her compensation or if the corporation acquires a perquisite for her personal benefit, that value can be determined. The benefit can be divided by the economic income of the enterprise to find the minority discount, or part of it, if additional discounts for other factors were warranted.

A controlling shareholder who increases her compensation to excess or takes personal benefits from the corporation could violate minority shareholder rights under tile BCL. In such situations, the legal rights of the minority shareholders with more than 20% ownership may increase the value of their interest. In addition, a company whose management tempers its self-interest and distributes adequate amounts of profits to minority shareholders will generally have smaller minority interest discounts. Companies that exclude these shareholders from management would conversely have greater minority interest discounts. The dollar amount of the diversion of corporate funds to the controlling shareholders is directly related to the amount of the discount.

Whether a minority shareholder's interest should be adjusted for any excess compensation or perquisites diverted by the controlling shareholders depends on whether the interest is greater than 20%; as a result, the pro rata value of a 25% interest could be greater than a 15% interest.

One right of the controlling shareholders beyond the scope of the BCL is the ability to manage the capital structure of the enterprise by taking on debt. Business valuators appropriately add the long-term liabilities (and, in some cases, all debt) when valuing the controlling interest or "the value of the company." In valuing a minority interest, on the other hand, debt capacity is not an addition to value.

The IRS believes that state rights are important criteria in the valuation process. When valuations are audited in states where oppressed shareholders have recourse, IRS agents are expected to be familiar with the state law regarding shareholder rights. The position of the minority shareholder in these states is somewhat analogous to minority shareholders in a well-run publicly traded company (before marketability discounts and without considering restrictions included in a shareholder's agreement). *The Valuation Training for Appeal Officers* specifically states that a numerical minority or majority interest may not represent actual control. Furthermore, it states that state law may require a specific percentage to make decisions (or lack thereof) or compel liquidation.

Integration of Marketability Discounts

In addition to the discount for lack of control, a second type of marketability discount recognizing the degree of liquidity, could affect the value of the minority interest. The marketability discount for lack of liquidity adjusts for the time and risks associated with the sale of a closely held company. Generally, the marketability discount for a minority interest with no expectation of cash flow will be greater than a minority interest with a large expectation of cash flow. Stocks with low dividends typically suffer more from a lack of marketability than stocks with high dividends. The greater the dividend yield (or interim return) the lower the marketability discount. In the case of Mendelbaum *(Bernard Mendelbaum et al v. Comm'r*, TC Memo 1995-2), the court outlined a marketability discount based on dividend policy and amount.

If the application of section l104-aand section 1118 increases the dividends available to a minority Interest shareholder, the marketability discount would decrease. However, if the company does not have the cash available and there are no perquisites paid to the controlling shareholder, these sections would have no effect on the marketability discount. Although the New York courts have considered discounts of 25% without consideration of any costs and risks of litigation, the discount could be considerably greater.

Combination with Other Minority Shareholders

Under Treasury Regulations section 25.2512-3, an interest must be valued in an arm's-length transaction to a hypothetical willing buyer. The regulations and court cases have determined that corporate control among family members is not to be considered. Revenue Ruling 93-12 clarifies, however, that minority interests should be considered with respect to other, non-family, shareholders. If there is more than one minority shareholder, a minority interest could have “swing vote” characteristics, as discussed in Private Letter Ruling 9436005.

The BCL statutes provide that an action can be brought by multiple shareholders, provided the entire interest is greater than 20%. A minority shareholder planning an action should strongly consider allying with other minority shareholders. However, there might be little practical application for valuations of minority interests within the context of estate and gift tax valuations. If the valuation is for a less than 20% interest, the buyer has to arrange with another existing shareholder to bring an action. If a parent owns an 80% interest in a business, a child owns 10% and the other, non-family owned 10% interest is the subject of the valuation, it would be implausible for a potential willing buyer to expect an alliance with the child against the parent.

Conversely, if there are separate unrelated owners of the closely held business, the alliance of minority shareholders seems more plausible. It should also be considered whether the hypothetical willing buyer could anticipate establishing such a relationship with an existing minority shareholder.

Synthesis

The potential for a reduced minority discount for interests of greater than 20% in closely held companies in states that provide oppressed shareholders rights could provide a planning opportunity for intergenerational transfers of interests. If a greater value were applied to the minority shares, the controlling interest would have a lesser value, allowing more shares to be given to the younger generation.

Another possibility is the transfer of several interests totaling less than 20% over several years. Each interest would be valued without regard to BCL sections l104-a and 1118. Over time, the junior family member would accumulate more than a 20% interest. Furthermore, as a junior family member becomes involved in the management of the family business, the differences in the pro rata value of the minority interest discount between a greater and lesser than 20% interest could be diminished.

A greater than 50% interest is usually considered controlling, and, in general, valuation theory does not adjust for the degree of control for such interests. However, the value of an interest greater than 80% would seem to have a greater per share value than one that is less, because such an interest would not be subject to an oppressed shareholder action. ف