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# Marketability Discounts in New York Statutory Fair Value Determinations

**By Gregory A. Barber, CFA**

As a securities analyst observing the discussion between appraisers, attorneys, and the courts regarding the applicability of marketability discounts in statutory shareholder buyouts, one can't help but feel the discussion has become an increasingly entangled series of misunderstandings, miscommunication, and inconsistencies. Appraisers appear to try earnestly to get the courts and attorneys to understand the valuation concepts, and when and how marketability discounts are applied, but it seems the parties are locked in either a state of perpetual disagreement or misunderstanding. Based upon a review of the leading New York cases, though, it seems only some of the courts may have misapplied marketability discounts. Some courts appear to have a clear understanding of when and how to apply marketability discounts, and believe it's what the language of the statute requires. And some New York courts now appear to be considering the broader impact of their decisions on entrepreneurial behavior in general. This factor can tip the balance in favor of not applying marketability discounts in general, but at the same time, introduce uncertainty for appraisers.

## The Statute Language

New York Business Corporation Law (NYBCL) § 1104-a[1] allows holders of 20 percent or more of the votes of all outstanding shares of a corporation to "present a petition of dissolution on one or more" grounds, including (1) the "directors or those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders" and (2) the "property or assets of the corporation are being looted, wasted, or diverted for non-corporate purposes by its directors, officers or those in control of the corporation." The statute also grants the court wide latitude when deciding whether to proceed with the involuntary dissolution to consider

whether "liquidation of the corporation is the only feasible means whereby the petitioners may reasonably expect to obtain a fair return on their investment . . . ."

As an alternative to involuntary dissolution, NYBCL § 1118 allows "any other shareholder or shareholders or the corporation" at any time within 90 days after the filing of the petition to "elect to purchase the shares owned by the petitioners at their fair value . . . ." If the parties are unable to agree to a fair value, the court may stay the proceeding to dissolve the company and determine "the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed, exclusive of any element of value arising from such filing . . . ." The NYBCL does not provide a definition of fair value, leaving the determination to the courts. The New York courts routinely apply marketability discounts to company shares in determining fair value, and stand with only a few other jurisdictions in doing so.

## Leading New York Cases

### *Blake v. Blake Agency*

One of the most-cited and earliest cases that addresses the applicability of marketability discounts in § 1118 proceedings is *Blake v. Blake Agency* (*Blake*).[2] The case, an appeal from the Supreme Court, concerned the valuation of a 25 percent interest in a small insurance brokerage company, Blake Agency, Inc., located in Queens County. The holder of the interest sought dissolution under § 1104-a and the corporation elected to purchase the interest in a timely manner under § 1118. Justice Thompson's opinion for the appellate panel disallowed a minority discount on the shares because "§ 1104-a was enacted for the protection of minority shareholders, and the corporation should therefore not receive a windfall in the form of a discount because it elected to purchase the minority interest . . . ."[3] However, a discount for lack of marketability of 25 percent was allowed "because the shares of a closely held corporation cannot be readily sold on a public market. Such a discount bears no relation to the fact that the petitioner's shares in the corporation represent a minority interest."[4]

From an appraiser's perspective, these statements raise a number of questions, an exploration of which may resolve some of the apparent misunderstandings of when marketability discounts are applied and how they are measured. But before that, let's examine the support for this position referenced in the case. In support of this position, the *Blake* court cited two articles, *Valuation of Business Interests*[5] and *Valuing Closely Held Corporations and Publicly Traded Securities with Limited Marketability: Approaches to Allowable Discounts from Gross Values,*[6] and one court case, *Ford v. Courier-Journal Job Print. Co. (Ford).*[7]

Haynsworth in *Valuation of Business Interests* does not appear to share the court's view that discounts should be applied in squeeze-out valuations, as he also states in his article that in

> some situations, however, no discount is proper. For example, it would be inappropriate to impose a discount in a dissenters' rights case or in a case where a minority interest has been improperly squeezed out of the business. Allowing discounts in these situations would undercut the purpose of dissenters' rights statutes to give minority shareholders the fair value of their shares, and it could also encourage squeeze outs.[8]

In addition, Lyons and Whitman in *Valuing Closely Held Corporations and Publicly Traded Securities with Limited Marketability: Approaches to Allowable Discounts from Gross Values* say that "when control of a business is for sale . . . we believe that as long as businesses are truly solvent . . . there are always markets for control blocks of stock. Given several months, or say a year's time, buyers virtually always can be found for such control positions."[9] Lyons and Whitman go on to state the generally held belief for minority positions in closely held companies that "there may be no market existing or creatable for such minority interests."[10] The authors also say that "as a general rule, and in the absence of compelling evidence to the contrary, where control shares exist, no discounts from gross value should be logically taken to account for a lack of marketability . . . ."[11]

> When conducting a valuation of an interest in a company it is important to differentiate among the characteristics of the company, the interest, and the market into which the interest is sold.

The *Ford* case cited in *Blake* was a dissenting stockholders action decided by the Kentucky Court of Appeals. In the case, common shareholders holding 12.8 percent of the shares voted against a sale transaction and demanded payment of the fair value of their shares. Although the *Ford* court ultimately agreed to a 25 percent marketability discount in the valuation of Courier-Journal Job Printing Company, a close reading of the opinion suggests the court was using the marketability discount as a method of applying different weights to the valuation methods considered. The court states that the marketability discount used by the appraisers "merely indicates that the appraisers gave some weight to the market value of the stock in computing the fair value thereof, which they are free to do."[12] The market value approach used by the

appraisers examined sales of *minority* shares between officers of the company, which, with informed buyers and sellers, would have considered both the *minority* position the shares represented as well as the illiquid nature of the investment. But seeing no contradiction, the *Ford* court goes on to state that "[n]or do we feel that the [marketability] discount herein was applied merely because of the minority position of the appellants."[13] In support of the size of the marketability discount the appraisers cited studies conducted on *minority* interests in what appears to be restricted stock common shares, again seeing no contradiction in applying marketability studies of *minority* interests with an interest that is not discounted for its minority position, which can only be a majority or controlling position.[14]

Before returning to the *Blake* court's key statements and getting too nuanced in our critique of the support cited, let's shed more light on an appraiser's perspective. To begin simply, when conducting a valuation of an interest in a company it is important to differentiate among the characteristics of the company, the interest, and the market into which the interest is sold. All three of these features can have a material impact on the value of an interest. But to reach a fair value conclusion that is supported, defendable and explainable it is helpful, as much as possible, to keep these features separate.

Companies, of course, come in all shapes and sizes. Investors generally pay higher prices for businesses that are characterized by low risk and are expected to grow annual cash flow quickly. There are dozens of characteristics any investor (minority or majority) will consider in assessing these two basic features, such as the experience and record of company management and the historical growth in cash flow, but the important distinction to remember is these are all characteristics *of the company*.

Interests in companies are generally divided between controlling or majority interests (over 50 percent of the voting power) and minority interests (under 50 percent of the voting power).[15] If an investor controls the company he or she can select the board, choose the company's strategic direction, pay oneself a reasonable, but generous, salary, among other benefits. But most important for our discussion, the controlling shareholder can elect to sell the company or its underlying assets. Controlling interests in *publicly traded* companies *usually* sell for more on a per-share basis than the *minority interests* traded on stock exchanges.[16] The additional share price paid for control is called a control premium. The mirror image of the control premium is called the discount for lack of control and unfortunately, ambiguously, also called a minority discount. Controlling interests in *closely held* companies sell for more than their *minority* interests on a per-share basis also because those minority shares would have even less value than the marketable, exchange-traded minority shares.[17] Finally, a *controlling interest* in a private company also would sell for more on a per-share basis than the minority interest in an *identical* publicly traded company.[18]

Having an organized market for *minority* shares, such as the New York Stock Exchange or the NASDAQ, provides liquidity for investors and allows them to exit their investments, reducing the investor's risk. Without such a market *minority* shareholders in private companies suffer from increased risk and logically pay a lower price for their shares. Restricted stock studies compare the prices paid for *minority* interest – shares unable to be sold on the public stock exchange with the price of the freely traded *minority* shares *of the same company* to develop a measure of the discount for a lack of marketability for *minority* interests. Pre-IPO studies attempt to determine the appropriate marketability discount for closely held *minority* shares by examining the difference between a company's pre-IPO price and its IPO price.

Controlling interests of *both* closely held and publicly traded companies are usually sold in an informal market created by intermediaries.[19] Depending on the size of the company, the intermediary is either an investment banker (larger transactions) or a business broker (smaller transactions). In either case, the sale process usually takes a few to several months. To a buyer of 100 percent of a publicly traded company, there is no ongoing liquidity in the form of a publicly traded security. Since all the shares have been purchased by one buyer, there are no shares to trade and the company is delisted from the

stock exchange. Buyers of controlling interests of publicly traded companies enjoy no benefit of liquidity relative to control purchasers of private companies with respect to the *market* on which the interest could eventually be sold.

With this perspective in mind, let's return to the *Blake* court's statements. The first statement that "§ 1104-a was enacted for the protection of minority shareholders, and the corporation should therefore not receive a windfall in the form of a discount because it elected to purchase the minority interest . . ." leads appraisers to conclude the interest is not going to be discounted for its minority status, so the 25 percent interest being appraised in Blake Agency must be the pro-rata share of the value of a 100 percent controlling interest.

The second statement that a discount for lack of marketability of 25 percent was allowed "because the shares of a closely held corporation cannot readily be sold on a public market" is confusing because, if the *Blake* court is valuing the company on a controlling basis and controlling or 100 percent interests are not sold on the public markets, why is the comparison to the public stock market being made? The speed with which minority shares sell on the stock exchange seems irrelevant to the sale of a controlling interest in Blake Agency.

The final statement that "[s]uch a discount bears no relation to the fact that the petitioner's shares in the corporation represent a minority interest" seems to be made to distinguish the marketability discount applied to be one appropriate for a controlling interest, versus a minority interest, presumably because the company will take several months to sell. Taken together, the *Blake* court statements seem to say a marketability discount should be applied to a controlling interest in Blake Agency because it will take longer to sell the *entire* company than a *minority* interest in Blake Agency, if the company were publicly traded.

It is true that the sale of the *entire* company will take longer than a sale of *minority* shares, if the minority shares were traded on a national stock exchange. As stated above, it will take about five to seven months to sell the whole company, but only a few days to sell a very small interest, if it were traded on a stock exchange. So the key question, if we accept the *Blake* court's view that a marketability discount is correctly applied, is what discount *from the value of the entire company*, if any, is appropriate because the controlling interest will take several months to realize liquidity?

When determining marketability discounts it's very important to examine the sales of interests with similar characteristics, i.e., if you are applying a marketability discount to a privately held *minority* interest, you should look at liquidity discount studies for *minority* interests. It also helps to examine the discounts in companies with similar company characteristics (size, industry, level of profitability, and importantly, the level of dividends or distributions). And likewise, if you are determining a marketability discount for a *controlling* interest, it is best to examine studies of liquidity discounts for *controlling* interests. Again, similar company characteristics make the analysis better. In addition, the length of the period of illiquidity is very important to consider for both minority and majority interests. To look at marketability discount studies for shares that will be illiquid for two years and apply them to shares that have a six-month expected holding period would materially overstate the marketability discount.

Examining marketability discounts of *minority* interests *that have a few months until they are freely tradable* to a *controlling* interest that also has a few months until liquidity certainly would provide a better indicated marketability discount than the one selected by the *Blake* court, which didn't seem to apply much analysis in the selection of the discount.[20] But using minority interest marketability studies for controlling interests is a poor substitute for an analysis of marketability discounts in controlling interests in companies with similar characteristics and similar expected holding periods. Controlling interests, for the reasons discussed above, are generally more attractive than minority interests, and logically would not suffer from marketability discounts as high as those seen for minority interests. The appropriate analysis would examine the sales of *controlling* interests that could be sold immediately with sales of *controlling* interests that are sold in the normal time period of a few to several months. The problem is that no studies or analysis is possible because there are *no* controlling interests that sell within a few days because even if a buyer stands ready to buy the target company, the due diligence and negotiation of the merger or sale agreement takes time.[21]

Most appraisers however, in my experience do not apply marketability discounts to controlling interests outside of a statutory fair value proceeding as the *Blake* court proposes. This is for several reasons. First, the marketing or holding period is relatively short, just a few months, so the adjustment for marketability is viewed to be quite small and immaterial relative to the value conclusion. Second, and perhaps of more consequence, the holder of the controlling interest enjoys the earnings of the company and other benefits of control over the marketing period, offsetting the lack of dividends that a minority shareholder usually experiences. Most of the companies in the minority-interest restricted stock and pre-IPO studies referenced to develop marketability discounts (including those in the case cited by *Blake*, i.e., *Ford*) are in companies that are *not* paying dividends.

Finally, also consider that any holder of illiquid stock, whether holding a minority restricted stock interest that can only be sold in one year or a majority interest which could be sold in six months, is exposing his or her capital to negative company events that could occur over the holding period. This creates uncertainty around what the stock price will be when liquidity is available or when the

company is ultimately sold. In the same way, the minority shareholder that has elected to dissolve a company under § 1104-a and is being bought out under § 1118 is exposed to, as part of an unpredictable appraisal process, the risk that the value of his or her interest is unknowable and may not be realized for many months, and sometimes for years. Viewing the entire statutory buyout process as a whole, it seems to be applying a double burden to assess the petitioner's shares a marketability discount *as well as* subject them to an unpredictable statutory buyout process lasting much more than a few months.[22]

and *Blake*.[28] However, the language in *Pace* and *Blake* differs and says value "should be determined on the basis of what a willing purchaser, in an arm's length transaction, would offer *for the corporation* [emphasis added] as an operating business, rather than as a business in the process of liquidation." As stated above, the entire corporation could be sold in a few months through the retention of an intermediary, such as an investment banker, and would transfer with it all the benefits of control. The petitioner's minority interest would likely not be saleable at all. Conspicuously absent in the *Seagroatt* opinion was any discussion of the inapplicability of a minority discount, as there was in *Blake*. The *Seagroatt* court seems to be taking the position that fair value should take into consideration the minority nature of the interest and its lack of marketability.

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***In re Seagroatt Floral Co, Inc.***

The next leading case chronologically is *In re Seagroatt Floral Co., Inc.* (*Seagroatt*).[23] The facts in *Seagroatt* followed a pattern typical of dissolution cases. Two corporations involved in growing and distributing cut flowers were held by the seven grandchildren of the founder. Dissention arose among the owners and two of the shareholders, each owning approximately 17 percent of the common shares of both companies, petitioned the court seeking a dissolution under § 1104-a, alleging oppressive behavior against the directors. Each corporation timely elected to purchase the shares under § 1118 and the Supreme Court stayed the dissolution proceedings and referred the matter to a referee to ascertain the fair value of the stock. The referee, in turn, valued the two companies together and applied a 25 percent discount for lack of marketability. The decision was appealed and the Appellate Division set aside the 25 percent marketability discount because the appraiser stated the "fact that it's a closely held company" had been considered in his selection of the company's capitalization rate.[24] The Court of Appeals agreed and refused to overturn the decision with respect to the marketability discount. In the opinion the Court of Appeals made a number of comments that provided a great deal of insight into its view of marketability discounts, as well as other associated valuation issues.[25]

The *Seagroatt* court's view of fair value was different, and arguably would result in a lower value, than the *Blake* court's perspective. The *Seagroatt* court said the "objective of a proceeding under Business Corporation Law § 1118 including the one now before us is to determine what a willing purchaser in an arm's length transaction would offer *for petitioners' interest in the company* [emphasis added] as an operating business."[26] In support of this statement the court cited *In re Pace Photographers* (*Pace*)[27]

Consistent with the first statement, the *Seagroatt* court goes on to say minority shareholders in close corporations are unlikely to find prospective buyers for their shares and it "follows that, whatever method of valuing an interest in such an enterprise, it should include consideration of any risk associated with illiquidity of the shares."[29] Again Haynsworth's *Valuation of Business Interests* is cited generally and *O'Neal's Close Corporations* specifically.[30] As discussed above, Haynsworth does not seem to share the court's view that discounts should be applied in squeeze-out valuations. In addition, although a copy of the third edition of *O'Neal's Close Corporations*, which was cited, is no longer available, the 2004 edition provides a balanced review of the relevant dissolution cases across the country addressing the illiquidity discount and doesn't appear to be an endorsement of the application of a marketability discount in the context of a statutory dissolution. O'Neal and Thompson state that "in a majority of states with decisions on this point the appreciation of such a discount is rejected."[31] They go on to state that it "seems particularly inappropriate to apply such a discount when a shareholder is selling to a person or family that owns all or must [sic] of the other shares of the corporation."[32] In support of the discussion above regarding *Blake*, they also state that while "the lack of a market affects the ability to sell minority shares in a company, the market for all of a company's assets or shares or for a controlling interest operates differently and may not be adversely influenced by the fact that the company's shares are not traded."[33]

The *Seagroatt* court clearly views fair value as the value of the petitioner's interest in an arm's-length sale taking into account the lack of marketability of the interest. After reviewing the court's language closely, many appraisers might think they should apply a minority discount as well. That the Court of Appeals in *Seagroatt* is attracted by the notion that the discounted value is the correct measure is not really surprising. Ignoring shareholder statutory rights for a moment, outside of an actual control transaction, minority interests in private companies usually have little value to third parties even when operated by honest, capable, fair-minded majority owners.[34] It could be argued that the value received by the petitioner in *Seagroatt* was above what could have been realized in a sale of the interest to an unrelated third party, especially if the grounds for the § 1104-a petition were accurate. It is only with the presence of fraudulent or oppressive behavior, or the looting or wasting of corporate assets by the majority, together with consideration of what is equitable to the parties as individuals *and* good public policy, that an observer begins to understand why other undiscounted values might, on balance, be the better remedy.

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### *Friedman v. Beway Realty Corp.*

The *Beway*[35] decision is not a § 1118 case, but since the Court of Appeals expressed in the opinion that "there is no difference in analysis between stock fair value determinations under Business Corporation Law § 623, and fair value determinations under Business Corporation Law § 1118"[36] the case is relevant to our discussion. The case involved petitioners who voted their shares against the consolidation of nine corporations invested in real estate into a single partnership. The petitioners timely elected their appraisal rights under § 623 and asked the Supreme Court to determine the fair value of their shares. The Supreme Court and the Appellate Division both refused to apply a minority discount, but did apply a 21 percent marketability discount. The respondent's expert had recommended a 45 percent marketability discount based upon restricted stock studies of *minority* common shares, which the Supreme Court had adjusted down. The Court of Appeals accepted the lower courts' determination on the minority discount, but sent the discount for lack of marketability back for a new and likely higher determination.

The *Beway* court expressed a strong opposition to minority discounts, saying they were "inconsistent with the equitable principles developed in New York decisional law"[37] and that "imposing a minority discount . . . would result in minority shares being valued below that of majority shares, thus violating our mandate of equal treatment of all shares of the same class."[38] The Court of Appeals for the first time extends its language to include consideration of the impact of its decision on corporate activities in general, saying "a mandatory reduction in the fair value of minority shares to reflect their owners' lack of power in the administration of the corporation will inevitably encourage oppressive majority conduct."[39] The *Beway* court also returns to the definition of fair value detailed in *Blake*, saying courts should "determine the minority shareholder's proportionate interest"[40] in the corporation, that is, "what a willing purchaser, in an arm's length transaction, would offer for the *corporation* as an operating business."[41] Contrary to the extensive support cited for the *Beway* court's position on minority discounts, there is no support cited for the application of the marketability discount. However, the *Beway* court clearly thought one was appropriate since it sent the marketability discount back for reconsideration, saying the Supreme Court erred in reducing the marketability discount to 21 percent.

As was the case with *Blake*, it's hard to know if the court believed: (1) because the sale of the entire company would take several months a discount for lack of marketability was appropriate; or, (2) it should treat the interest as controlling for purposes of considering the minority discount, but as a minority interest for application of the marketability discount. If the latter is true, the court has created a value that doesn't exist in the real world, one that takes part of its characteristics from controlling interests, and part from minority interests in private companies. And this "split personality" of the New York court approach is what appraisers find so confusing. In valuing a particular interest, appraisers are trying to simulate how a market would react to an interest offered for sale. That interest can be either a controlling interest, a minority as-if-publicly-traded interest, or a minority, private interest. It can't be two different types of interests at the same time. Appraisers use discounts and premiums to move the values indicated by the valuation methods applied to reach the desired end point or "level of value."

But the foundation upon which all the analysis is constructed is the nature of the interest itself, or the qualities of the interest that have been defined (i.e., value a minority interest in a private company as its pro-rata share of the value of the entire company). But the New York courts in refusing to apply a minority discount, but then applying a marketability discount suitable for a minority interest, effectively are claiming the interest has attributes of two different types of interests – it is both a controlling and a minority interest at the same time. Although you *could* define such a value, such interests don't exist in actual markets between unrelated, informed parties.

It is also interesting to note that the *Beway* court saw no inconsistency in refusing to apply a minority discount because it "would result in minority shares being valued below that of majority shares"[42] but allowed a significant marketability discount which would yield a lower value for the minority shares, exactly what it had just refused to allow on principle. Allowing the majority to purchase the minority shares at a 21 percent or 30.4 percent discount from the value of the whole company *would allow* the majority to elect to sell the whole company within a few months with a significant profit on the discounted minority shares they just purchased. From a broader perspective, it doesn't matter what the discount is called; as long as the majority can sell the company for more it is a discount that violates the "mandate of equal treatment of all shares of the same class."[43]

Also of note is that almost all of the cases cited by the *Beway* court in support of its decision not to apply a minority discount also chose not to apply a marketability discount. Of the seven cases cited, five explicitly addressed the marketability discount and declined to apply it for the *same reasons* the minority discount was refused.[44] Of the two other cases, one could be interpreted as declining to apply a marketability discount as well, but the language isn't explicit.[45] The other case involved the valuation of a 90.2 percent interest in a business in a divorce and no marketability discount was applied.[46] These five decisions, which include four state Supreme Court decisions and one appellate court decision, saw no reason to differentiate between a marketability and minority discount as they both produce the same unequitable result, i.e., minority shares being valued below that of majority shares.

## A Broader Perspective

To be candid, valuing an asset whose value changes depending on who holds it presents a thorny problem for the courts. A review of dissolution cases from the highest courts across the nation revealed a number of reasons they were opposed to applying a marketability discount. An often repeated reason was that applying the discount would be contrary to the purpose of the statute, i.e., to protect minority shareholders.[47] Other reasons cited were that discounts were not appropriate in inter-family transfers[48] or that discounts encourage corporate squeeze-outs and shouldn't be encouraged with a financial incentive.[49] The Rhode Island Supreme Court in *Charland v. Country View Golf Club* took the practical view that if the dissolution had been allowed to proceed, all the shareholders would have received the same amount, so no discount should apply.[50] Finally, the Indiana Court of Appeals in *Wenzel v. Hopper* believed that the dissolution proceeding and buyout created liquidity for the minority shareholder, so no liquidity discount was appropriate.[51]

The courts that applied marketability discounts were both unusual cases. In *Munshower v. Kolbenheyer*, the Florida District Court of Appeal applied a marketability discount relying "on New York case law as persuasive in this matter"[52] without any further discussion or comment. In *Balsamides v. Protameen Chemicals*,[53] the Supreme Court of New Jersey found itself in the unique position of deciding what fair value meant when the oppressed shareholder was buying out the oppressing shareholder. The *Balsamides* court was convinced by the expert that a marketability discount of 35 percent was appropriate because the *entire company* could only be sold for the discounted amount. The testimony of the expert that seemed to convince the court was, from an appraiser's perspective, doubtful. The expert stated that "whether you apply a marketability discount to one hundred percent of the shares of stock, fifty percent of the shares of stock, or twenty percent of shares of stock, the marketability discount would be the same."[54] As discussed above, this statement appears to contradict the fact that controlling interests are much more attractive and marketable than minority interests in private companies. Important in the *Balsamides* court's reasoning seemed to be that it didn't "want to afford a shareholder any incentive to oppress other shareholders."[55] And it is this consideration – the incentives and penalties that the law provides for business owners, investors and entrepreneurs – that brings a much broader and, for some, a helpful perspective to the marketability discount discussion.

There is an area of study in economics that seeks to understand the role of entrepreneurs in the economy. The most recent major contribution to this area of study was by William J. Baumol in 1990. He theorized that entrepreneurial individuals (i.e., business owners) have a choice to devote their labor toward private-sector wealth creation (e.g., product innovation, moving production to more profitable products), or toward securing wealth redistribution through political and legal processes (e.g., lobbying government to protect their industry, lawsuits).[56] The former activities are viewed as productive (creating new wealth) and the later as unproductive (redistributing existing wealth, and in some cases destroying existing wealth). Oppressive behavior on the part of majority shareholders seeking to squeeze out the minority at a discounted price would fall into the unproductive category. Baumol hypothesized that how "the

entrepreneur acts at a given time and place [in history] depends heavily on the rules of the game – the reward structure in the economy – that happens to prevail."[57] The "rules of the game" from an entrepreneur's perspective include the legal and judicial system. Baumol went on to propose that entrepreneurs are always present in societies, but societies that don't provide a "constructive and innovative script" for them are likely to find their growth atrophied.[58] Although Baumol's work is difficult to prove conclusively, other authors have conducted economic research that supports his theory.[59]

Seen from the entrepreneurial economist's perspective, oppressive behavior of majority shareholders should, at a minimum, not be rewarded with the opportunity to purchase minority shares at a discount. This would qualify as behavior that does not create wealth or contribute to the growth of the economy as a whole. Further, some oppressive behavior by majority shareholders does not appear much different from theft (e.g., grossly excessive salaries, the individual purchase of company assets well below value) and should be discouraged.

Alternatively, there are unusual instances where the oppressing shareholder is the *minority*. Imagine a scenario where an unrelated investor buys the shares of a family business from a minority shareholder at a price that reflects both discounts for lack of control and marketability. The investor then engages in a campaign to pressure the majority shareholders to purchase his shares by alleging the majority takes excessive salaries and threatening to disqualify the company for S-Corporation status by transferring the shares to an ineligible shareholder. If the majority is simply trying to operate and grow the business in a fair manner, respectful of the duties to, and rights of, all the shareholders, the behavior of the minority would be viewed as unproductive by entrepreneurial economists. Again, considering the incentives structure of the economy and society as a whole, it doesn't seem the oppressing minority should be rewarded for his behavior through the purchase of his interest at an undiscounted price, as it represents simply a redistribution of wealth and no new wealth creation. In fact, from the incentives perspective, one could argue the buyout price for this investor should reflect *both minority and marketability discounts*, a similar value as it was purchased for. Again, the instances where the minority shareholder is the oppressor seem to be the exception.

The current New York statutory scheme is ill-suited to allow for the consideration of shareholder behavior when determining a remedy. Under NYBCL § 1118, the election to purchase the petitioning shareholder's shares is almost always made before there can be any finding by the court that there are grounds for dissolution under § 1104-a. Once the election to purchase the shares is made, New York courts have viewed their role as simply determining the fair value of the minority shares without regard to shareholder behavior.[60] Such a statutory scheme, when combined with New York's rather consistent application of a significant marketability discount, allows for oppressive behavior on the part of the majority to be rewarded. From an incentives perspective, the New York statutory scheme and the courts are encouraging unproductive behavior on the part of entrepreneurs. Although one could imagine a discounted value for an oppressed minority shareholder is a remedy relative to receiving virtually nothing on the open market for his or her shares, from a broader perspective, it's hard to imagine the New York legislature intended to *reward* oppressive majority behavior when it enacted § 1104-a and § 1118.

From an appraiser's perspective, a flexible role for discounts in fair value determinations in general creates uncertainty as each case has its own facts. Whether discounts apply to the valuation may not be known until after the appraiser has done his or her work. But this uncertainty can be addressed by providing the court values with and without discounts. As the application of discounts is primarily a matter of law in any event, it seems better to leave the discount decision to the court. If the role of the courts is viewed as simply to contribute to the "rules of the game" for entrepreneurs and investors and to maximize wealth-creation behavior, the debate of whether to apply discounts in shareholder buyouts becomes a little less difficult. ■

1. Although some New York courts have stated that they consider the definition of fair value under NYBCL § 623 (appraisal or dissenter's rights actions) to be the same as fair value under § 1118, when making very nuanced distinctions between what is equitable and good public policy, it is better to confine the discussion to a single, similar action. So I will confine my discussion to § 1118 dissolution actions. Admittedly, however, in the case of minority shareholder oppression or "squeeze-outs," the distinction between methods used by the majority which trigger appraisal rights versus dissolution rights is sometimes a matter of form, and the underlying public policy and equity issues are very similar.

2. *Blake v. Blake Agency*, 107 A.D.2d 139 (App. Div. 1985).

3. *Id.* at 149.

4. *Id*.

5. Harry J. Haynsworth IV, *Valuation of Business Interests*, 33 Mercer L. Rev. 457 (1981–1982).

6. William P. Lyons and Martin J. Whitman, *Valuing Closely Held Corporations and Publicly Traded Securities with Limited Marketability: Approaches to Allowable Discounts from Gross Values,* 33 Bus. Law. 2213 (July 1978).

7. *Ford v. Courier-Journal Job Print. Co.,* 639 S.W.2d 553 (Ky. Ct. App. 1982).

8. Haynsworth, *supra* note 5, at 489.

9. Lyons and Whitman, *supra* note 6, at 2226.

10. *Id. at* 2227.

11. *Id*.

12. *Ford*, 639 S.W.2d at 556.

13. *Id.*

14. *Id*.

15. In practice, the level of control of an interest is viewed on a continuum. A 100 percent interest, for example, is more attractive than an 80 percent interest as the 80 percent interest must always be concerned with meeting its fiduciary duties to the minority shareholders.

16. Buyers of controlling interests are normally divided between financial and synergistic. Financial buyers are those that do not have existing operations and include private equity and hedge funds. Synergistic buyers are

operating companies that may be able to realize operating synergies with the target company. Although it's generally true that controlling interests sell at a premium to the exchange-traded stock price, there are times when the public market prices shares above the price control buyers are willing to pay.

17. However, because arm's-length, minority-interest sales of privately owned companies are extremely unusual, and if they do occur, are rarely reported, there are no studies to support this assertion.

18. Appraiser's often note that in control transactions private companies sell for lower multiples of earnings (a cheaper price) than their publicly traded counterparts. Although the research is not definitive, this is likely caused by the private companies having less attractive company characteristics (i.e., a lack of audited financial statements, less experienced management, slower earnings growth, less product and geographic diversification). In addition, buyers of publicly traded companies can often reduce or eliminate the target's standalone public company costs (such as executive and board member compensation, audit fees, and costs associated with internal controls), giving the impression they are paying more (i.e., a higher multiple) on a current earnings basis.

19. Controlling interests in private companies are sometimes sold on an exchange through a public offering, but this is a small number of transactions compared to the investment bank/business broker market.

20. The *Blake* court seems to have relied on the discount used in *Ford*. The *Ford* court relied upon the expert that appears to have cited restricted stock discount studies of minority shares where the restricted shares could not be sold for a period of two years (*Ford*, 639 S.W.2d at 556).

21. Ideally, the study would include 100-percent-interest sales of the *same* company in a process that took a few days and also several months, but this "dual reality" does not exist in the real world.

22. The petitioner also usually receives interest from the valuation date during the § 1118 process, similar to a controlling shareholder receiving dividends and other benefits during the sale of a controlling interest into the market by an intermediary, making the two positions reasonably analogous.

23. *In re Seagroatt Floral Co. Inc.*, 78 N.Y.2d 439 (1991).

24. *Id.* at 447.

25. Perhaps more significant as the *Seagroatt* court's direct comment on the applicability of marketability discounts is the court's interpretation of the statutory language with regard to the going-concern versus liquidation issue and whether shareholder misconduct is a consideration under § 1118. However, in the interest of brevity and focus, these topics will need to be addressed at another time.

26. *Seagroatt,* 78 N.Y.2d at 445.

27. *In re Pace Photographers, Ltd.*, 71 N.Y.2d 737, 748 (1988).

28. *Blake*, 107 A.D.2d 139, 146.

29. *Seagroatt,* 78 N.Y.2d at 445.

30. F. Hodge O'Neal and Robert B. Thompson, *O'Neal's Close Corporations* § 9.34, at 162–63 (3d ed. 1993).

31. F. Hodge O'Neal and Robert B. Thompson, *O'Neal and Thompson's Close Corporations* § 9.32, at 231 (Rev. 3d ed. 2004).

32. *Id.*

33. *Id.* at 232.

34. There are exceptions to this general rule. Some private technology/Internet companies have broad public awareness and a large shareholder base created by the exercise of options by their employees. Shares of these companies are exchanged by accredited investors by companies such as SharePost, Inc. and SecondMarket Solutions Inc. (purchased by NASDAQ).

35. *Friedman v. Beway Realty Corp.*, 87 N.Y.2d 161 (1995).

36. *Id*. at 168.

37. *Id.* at 167.

38. *Id.* at 169.

39. *Id.*

40. *Id.* at 168.

41. *Id.* (quoting *In re Pace Photographers, Ltd.*, 71 N.Y.2d 737, 748 (1988)).

42. *Id.* at 169.

43. *Id.*

44. *Cavalier Oil Corp. v Harnett*, 564 A.2d 1137, 1145 (Del. 1989) ("Discounting individual share holdings injects into the appraisal process speculation on the various factors which may dictate the marketability of minority shareholdings. More important, to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result."); *Hickory Cr. Nursery v. Johnston*, 167 Ill. App. 3d 449, 455 (1988) ("Lastly, though Johnston's expert stated that a discounting of Johnston's interest would be in the range of 10% to 35% if it were marketed to an outsider as a minority interest and Hickory Creek's expert applied a minority discount of 25% in his unadjusted formula analysis, we find such discounting does not apply in the instant case when a minority interest is being assumed by the remaining shareholders resulting in a substantial pro rata increase in their share and control of the corporation."); *Woodward v. Quigley*, 133 N.W.2d 38, 44 (Iowa 1965) ("Plaintiffs cited *Felder v. Anderson, Clayton & Co., Del. Ch.*, 159 A.2d 278, 285, in which the court apparently approved a 10 percent discount from the average multiplier "for certain reasons, such as the lack of marketability of the stock, etc." In view of our interpretation of the purpose of the statute, we decline to follow the Delaware court in this position, if it, by this statement, approved such a discount."); *In re McLoon Oil Co.*, 565 A.2d 997, 1003 (Me. 1989) ("The referee expressly rejected Lido's contention that he should discount the full value of each company because of the minority status and lack of marketability of the Dissenters' stock. On appeal Lido's only serious challenge to the referee's finding of fair value is directed at the referee's recognition of the Dissenters' full proportionate interest in the whole value of each company, free of any minority or nonmarketability discount. We find Lido's arguments for such discounts unpersuasive. In our view application of those discounts would run directly counter to our appraisal statute's purpose of protecting dissenting shareholders."); *Rigel Corp. v. Cutchall*, 511 N.W.2d 519, 526 (Neb. 1984) ("We are persuaded, however, that in the event of a merger, neither a minority discount nor a deduction for lack of marketability is to be given in determining the fair value of a dissenter's shares under the provisions of § 21-2080. Only by not doing so can the statutory policy of fully compensating a dissenting minority shareholder be achieved.").

45. *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477, 487 (1979) ("According to that approach, the minority shares would then have to be valued in relation to what they would bring in the open market, with an appropriate reduction for the fact that they do not give their purchaser control of the corporation. Further, if, as was apparently the case here, the controlling shareholder has been using his position to insure that no benefits, such as dividends or employment, ever accrue to the owners of the minority shares, then an argument could be made that the value of the minority shares should be reduced even further, perhaps to zero. Thus, the very misconduct and unfairness which provoked the minority shareholders to seek involuntary dissolution could, in this manner, be used to further oppress them. This, the statutory scheme before us cannot be read as condoning.").

46. *Eyler v. Eyler*, 492 N.E.2d 1071, 1074 (Ind. 1986) ("Regardless whether using the date of separation, or using any other date through the completion of the final hearing, the shares constituting the 90.2% share of the business were at all said times held in joint ownership and not burdened by the factors which may warrant consideration of the "minority interest" discount.").

47. *Advanced Commc'n Design v. Follett,* 615 N.W.2d 285, 292 (Minn. 2000); *Morrow v. Martschink,* 922 F. Supp. 1093, 1105 (D.S.C. 1995).

48. *Morrow,* 922 F. Supp. at 1104; *Wenzel v. Hopper*, 779 N.E.2d 30, 39 (2002).

49. *Advanced Commc'n Design,* 615 N.W.2d at 292; *Wenzel,* 779 N.E.2d at 39.

50. *Charland v. Country View Golf Club, Inc.,* 588 A.2d 609, 613 (R.I. 1991).

51. *Wenzel,* 779 N.E.2d at 39.

52. *Munshower v. Kolbenheyer,* 732 So. 2d 385, 386 (Fla. Dist. Ct. App. 1999).

53. *Balsamides v. Protameen Chem.*, 734 A.2d 721 (N.J. 1999).

54. *Id*. at 737.

55. *Id*. at 738.

56. William J. Baumol, *Entrepreneurship: Productive, Unproductive and Destructive*, 98 J. Polit. Econ. 893 (1990).

57. *Id*. at 894.

58. *Id*.

59. Russell S. Sobel, *Testing Baumol: Institutional quality and the productivity of entrepreneurship*, 23 J. Bus. Venturing 641 (2008).

60. *Pace*, 71 N.Y.2d at 746.