



COMMERCIAL DIVISION UPDATE

Expert Analysis

Should 'Minority Discounts' Diminish Share Value Under Judicial Dissolution?

The New York Business Corporation Law (BCL) §1104-a(a) provides that holders of 20 percent or more of the outstanding shares of a closely held corporation have the right to petition for a judicial dissolution under "special circumstances."

Special circumstances are defined as instances when (1) the directors or those in control of the corporation have been found guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders; or (2) the property or assets of the corporation are being looted, wasted or diverted for noncorporate purposes by the controlling shareholder(s). N.Y. BCL §1104-a(a)(1), (2).¹

BCL §1118 is a defense mechanism which gives any nonpetitioning shareholder of the closely held corporation or the corporation itself the right to purchase the petitioning shareholders' equity interest at "fair value." If the purchasing shareholders cannot agree with the corporation upon "fair value," the court may make a "fair value" determination as of the day prior to the date of the filing of the §1104-a petition. N.Y. BCL §1118(a),(b).

The Controversy

Within the determination of "fair value," a term undefined by the statute, lies the controversy.

At the very heart of that controversy is the question of whether a "minority discount" should apply to diminish share value. In a recent case, *Murphy v. United States Dredging Corp.*, No. 2640-06, 2008 WL 2401230 (N.Y.



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Sup. Ct. Nassau Cty. May 19, 2008), Justice Ira B. Warshawsky of the commercial division attempted to clarify the distinction between a "marketability discount," a discount applied in stock valuation to compensate for the lack of a ready market for the shares, and a "minority discount," a discount applied in stock valuation to compensate for the lack of control enjoyed by a minority shareholder.

Generally, the factors to be considered in determining "fair value" are market value, investment value and net asset value.² When attempting to value stock in a closely held corporation, however, market value is largely insignificant because there is typically no ready market for the shares. If there were already an established market, valuation would be much simpler. Therefore, according to Justice Helen E. Freedman of the Commercial Division, a "marketability discount" should be applied to the determination of fair value of the closely held shares. See *Scott v. Spier*, No. 601230/2005, 2006 WL 5187003, at *7 (N.Y. Sup. Ct. N.Y. Cty. March 7, 2006) (Freedman, J.). Whether a minority discount, however, which serves to diminish the value of noncontrolling shares in a closely held corporation, should be applied to the fair value determination is a matter of some controversy. See *Blake v. Blake Agency Inc.*,

107 AD2d 139, 149 (2d Dept. 1985).

Net asset value (total assets less any intangible assets, less total liabilities, divided by the number of shares outstanding) is the standard for evaluating closely held manufacturing corporations or real estate and investment holding companies. *Murphy*, 2008 WL 2401230, at *12.

Methods of Calculating

Acceptable methods of calculating investment value (the value of an asset to its owner according to the owner's expectations and requirements), which is also a factor in determining the value of shares of a closely held corporation, include:

- (1) the discounted income approach, by which average corporate earnings measured over a number of years are capitalized and a multiplier is developed using the capitalization rate which is then applied to earnings;
- (2) capitalization of dividends, if the corporation has an appropriate dividend history; or
- (3) the comparative appraisal approach, which compares the closely held corporation in question to the price per earnings ratios of publicly-traded stocks of companies in similar industries that have similar financial situations.³

"Fair value" under the New York BCL has been defined judicially as the price which a hypothetical "willing purchaser, in an arm's-length transaction, would offer for the corporation as an operating business."⁴

The 'Murphy' Case

In *Murphy v. United States Dredging Corp.*, Justice Ira B. Warshawsky of the Commercial Division rejected the argument advanced by the petitioning shareholder that the "willing purchaser" test was inappropriate in a case

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under BCL §1118 because the corporation itself was an actual, not a hypothetical, "ready market" for the shares.

In *Murphy*, minority shareholders of U.S. Dredging Corp. (USD), a closely held corporation, petitioned for dissolution of the corporation pursuant to N.Y. BCL §1104-a on the ground that the controlling shareholders were oppressing the minority. In response, USD elected, pursuant to N.Y. BCL §1118, to purchase the shares of the petitioning shareholders, but since the parties could not agree on a buyout price, the Commercial Division held a hearing to determine the proper value of the shares.

The petitioning shareholders in *Murphy* also argued against the application of a marketability discount to the noncontrolling shares at issue in the case, claiming that the corporation had sufficient liquid assets available to pay fair value for the shares. In *Blake*, 107 AD2d at 149, the Second Department had held that a discount for the lack of marketability of a petitioner's shares in a closely held corporation is proper because there is no public market for the sale of shares of a closely held corporation, but "[n]o discount should be applied simply because the interest to be valued represents a minority interest in the corporation." According to the court in *Blake*, the application of BCL §1104-a was enacted for the protection of minority shareholders and should not result in a windfall to the corporation in the form of a discount when it elects to purchase the petitioner's shares under §1118.

Prior to *Murphy*, there was case law applying a "minority discount," per se, case law applying a "marketability discount," per se, and case law that seems to use the two terms almost interchangeably. See *Balk v. 125 West 92nd Street Corp.*, No. 100439/04, 2004 WL 5488325 (N.Y. Sup. Ct., N.Y. Cty. Aug. 11, 2004) (refusing to apply a "minority discount" in determining the fair value of shares under BCL §1104-a in the context of shares of a New York City conventional cooperative, where there is

a ready market for the shares); *Davenport v. Martin*, No. 11994-11527, 2002 WL 34077229 (N.Y. Sup. Ct. Erie Cty. Oct. 31, 2002) (treating the minority interest discount as one element of a proper marketability discount applied in a calculation of fair value); *Scott*, 2006 WL 5187003 (citing *Blake* for the proposition that "[l]oss of marketability discounts are also accepted practice in valuing closely held corporations"); *Hall v. King*, 675 NYS2d 810, 814 (N.Y. Sup. N.Y. Cty. 1998) (Crane, J.) (applying a lack of marketability discount, and defining it as a "discount to reflect the illiquidity of a petitioner's shares, i.e., that a potential investor would pay less for shares in a close corporation because they could not readily be liquidated for cash" (internal citation omitted)); *In re Brooklyn Home Dialysis Training Center Inc.*, 293 AD2d at 747 (applying a lack of marketability discount to the BCL §1118 valuation of the shares of a petitioning shareholder who held one-third the stock of a closely held corporation, and was one of three shareholders in the corporation, with no mention whatsoever of a "minority discount").

Within the undefined term, "fair value," lies the controversy. At the heart of that controversy is whether a "minority discount" should apply to diminish share value.

Analysis

The *Murphy* court went one step further than *Blake* or these other recent cases. In *Murphy*, the court applied a discount to the value of minority shares in a closely held corporation but called it a marketability discount, which is how it was framed by the parties, but also pointed out that between the two terms is usually a distinction without a difference. In *Murphy*, the Commercial

Division stated the following in reference to the bright line distinction drawn in *Blake* between a marketability discount and a minority discount: "Though this court has great respect for stare decisis, in most cases such as ours, the lack of marketability discount serves to cloak what is really a minority discount." *Murphy*, 2008 WL 2401230, at *14.

Therefore, the *Murphy* court decided to call it as it saw it. For what, in reality, does the lion's share of a marketability discount represent when determining fair value for the minority shares of a closely held corporation, but a discount reflecting the lack of control that afflicts the minority shareholder?

Conclusion

With this decision of a justice of the Commercial Division, perhaps subsequent court opinions will follow the lead of the *Murphy* court and make clear that the distinction between a marketability discount and a minority discount in cases such as these is often not a meaningful one.



1. Before dissolution is ordered under BCL §1104-a(a)(1) or (2), the court must consider whether liquidation of the corporation is the only feasible means by which petitioning shareholders may obtain a fair return on their investment, and whether it is reasonably necessary to protect the rights and interests of a substantial number of shareholders.

2. See *Murphy*, 2008 WL 2401230, at *12 (citing *Endicott Johnson Corp. v. Bade*, 37 NY2d 585 (1975)).

3. *Murphy*, 2008 WL 2401230, at *12; see also *In re Brooklyn Home Dialysis Training Center Inc.*, 293 AD2d 747, 747 (2d Dept. 2002) (applying the "investment value" approach to valuation of a closely held service corporation); *Matter of Cohen*, 636 NYS2d 994, 998 (N.Y. Sup. Ct. N.Y. Cty. Dec. 29, 1995) (Crane, J.) (applying the capitalization of earnings model of valuation, which was agreed upon by experts for both sides), *aff'd*, 240 AD2d 225 (1st Dept. 1997).

4. *Murphy*, 2008 WL 2401230, at *12 (quoting *Matter of Pace Photographers*, 71 NY2d 737, 748 (1988) (further internal citations omitted)).

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