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CONTROL CONSIDERATIONS IN THE VALUATION OF A 50 PERCENT OWNERSHIP INTEREST

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In valuations developed for gift tax, estate tax, and generation-skipping tax purposes or income tax purposes, valuation analysts may be asked to determine the fair market value of a 50 percent interest in a private company. The issues to consider and analyze in selecting appropriate valuation adjustments to apply in the valuation of a 50 percent interest often are unique compared with the issues in the valuation of a less than 50 percent interest (e.g., a 48 percent interest) or a more than 50 percent interest (e.g., a 52 percent interest or a 100 percent interest).

Introduction

Valuation analysts ("analysts") sometimes are retained to value a 50 percent ownership and/or voting interest in private companies for gift tax, estate tax, and generation-skipping tax (collectively "transfer tax") and income tax purposes. In such assignments, a key issue for analysts to typically consider and analyze is what level of ownership control the subject 50 percent interest does or does not have. That is, the level of ownership control consideration equates to how much influence the subject 50 percent interest has over the operations of the subject private company.

The level of ownership control consideration and analysis is particularly important when analysts apply and at least partially rely on the asset approach to business valuation for such assignments. That is because the initial value indication of the asset approach business valuation methods is typically on a controlling, marketable ownership interest basis.[1]

The level of ownership control consideration and analysis also usually is important when the initial controlling, marketable value indication is estimated through applying other approaches and methods, such as the market approach and guideline merged and acquired company method.

When the initial value indication is presented on a controlling, marketable ownership interest basis, analysts may consider applying valuation adjustments to the initial value indication to conclude the fair market value of the 50 percent interest in the closely held business on a noncontrolling, nonmarketable ownership interest basis.

Based on the facts and circumstances of each valuation assignment, analysts may apply a discount for lack of control ("DLOC") and a discount for lack of marketability ("DLOM") in concluding the fair market value of a 50 percent interest. This discussion focuses on issues that pertain to the DLOC because unique issues related to ownership control are important considerations when estimating the fair market value of noncontrolling 50 percent interests compared with other noncontrolling ownership interest percentages.

The Concept of Ownership Control

A general overview of the concept of ownership control and control rights is helpful before describing key considerations in the fair market valuation of a 50 percent interest in a private company.

THE VALUE OF OWNERSHIP CONTROL TYPICALLY DERIVES FROM THE OWNER'S ABILITY TO INFLUENCE THE PRIVATE COMPANY'S AFFAIRS BY EXERCISING WHAT ARE GENERALLY REFERRED TO AS THE PREROGATIVES OF CONTROL.

According to the business valuation textbook *Business Valuation Discounts and Premiums*, control in the context of business valuation is defined as "the power to direct the management and policies of a business enterprise."[2] According to the International Valuation Glossary – Business Valuation, control in the context of business valuation is defined as "a level of ownership having sufficient rights (e.g., voting) to direct the management policies, and disposition of a business."[3]

The owner of a noncontrolling ownership interest in a private company (1) lacks many of the so-called perquisites of ownership and (2) has limited or no control over the private company's operating, investing, and financing activities. A willing buyer contemplating the purchase of a noncontrolling business ownership interest from a willing seller would consider the economic disadvantages associated with that lack of ownership control.

The value of ownership control typically derives from the owner's ability to influence the private company's affairs by exercising what are generally referred to as the prerogatives of control. The prerogatives of control of an entity include, but are not limited to, the following:[4]

1. Appoint or change operational management
2. Appoint or change the board of directors
3. Determine management compensation and perquisites
4. Set operational and strategic policy and change the course of the business
5. Acquire, lease, or liquate business assets, including plant, property, and equipment
6. Select suppliers, vendors, and subcontractors with whom to do business and award contracts
7. Negotiate and consummate mergers and acquisitions
8. Liquidate, dissolve, sell out, or recapitalize the company
9. Change the articles of incorporation
10. Set one's own compensation (and perquisites) and the compensation (and perquisites) of related-party employees
11. Select joint venturers and enter into joint venture and partnership agreements
12. Decide what products and/or services to offer and how to price those products and/or services
13. Decide what markets and locations to serve, to enter, and to discontinue serving
14. Decide which customer categories to market to and which not to
15. Enter inbound and outbound license or sharing agreements regarding intellectual properties
16. Block any or all the aforementioned actions

The prerogatives of control available to a subject

interest's owner typically are considered when estimating a DLOC to apply to an initial controlling, marketable indication of value. However, the prerogatives of control do not have value in and of themselves. Rather, they may have value if the subject interest's owner is able to exercise the prerogatives of control to realize incremental economic benefits, such as if the subject interest's owner is able to enhance the cash flow available and/or lower the required rate of return on the investment of the subject interest.

The concept of tying the value of control rights (or lack thereof) of a particular subject interest in a company to the incremental economic benefits (or lack thereof) available to the owner of that particular subject interest through the exercise of control rights is described in professional business valuation literature.[5]

Control rights, if any, are typically a key variable affecting the fair market value of an interest in a private company. The control premium—or, inversely, the DLOC—depends on (1) an owner's ability (or lack thereof) to exercise any or all of a variety of rights typically associated with control and (2) an owner's ability (or lack thereof) to recognize incremental economic benefits through exercising rights typically associated with control.

As a result, the fair market value of a noncontrolling interest in a company is not necessarily a pro rata percentage of the value of the entire enterprise. The holder of a noncontrolling interest lacks control and may have little or no voice in the subject company's affairs. Similarly, the holder of a 50 percent interest also may have a limited voice in the subject company's affairs.

Ownership interests in private companies that control 50 percent of the outstanding equity are unlike absolute controlling or noncontrolling ownership interests. That is because a 50 percent ownership interest typically cannot take unilateral action, but such ownership typically can block action taken by others.

The Degree of Control Available to the Owner of a 50 Percent Interest

There are many factors to consider in analyzing the degree of control available to an owner of a 50 percent interest in a private company. These factors are typically unique to the facts and circumstances of each specific valuation analysis.

To start, it is important for the analyst to consider

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and analyze the prerogatives of control that are made available to an owner of a 50 percent interest—and any remaining interests—in the subject private company. This typically involves reviewing the relevant terms and provisions of the subject company's governing and organizational documents. It also may involve reviewing the relevant terms and provisions of any other contractual rights made available to the owners of the subject 50 percent interest and other remaining interests in the company. It is recommended that analysts seek assistance or guidance from legal counsel in analyzing the subject company's governing documents and contractual rights.

Some jurisdictions and some companies' governing and organization documents require a two-thirds—or even larger—supermajority vote to approve certain major actions, such as a merger, sale of all company assets, or liquidation of the company. Analysts should consider this when analyzing the degree of control available to an owner of a 50 percent interest in the subject company.

It may be helpful for the analyst to consider and analyze what control rights (or lack thereof) are granted to various ownership percentages in the subject company. For example, an analyst may consider and analyze control rights (or lack thereof) that would be present for the hypothetical owner of a supermajority interest, a simple majority interest, a 50 percent interest, and a minority interest in the subject company. The analyst may compare the differences, if any, in the control rights that are available to these different ownership groups.

Another factor to consider in analyzing the degree of control available to a particular 50 percent ownership interest is the distribution of the remaining 50 percent ownership interest.

If multiple owners make up the remaining 50 percent ownership interest, the analyst may consider the possibility that any of the remaining owners would join with the owner of the 50 percent ownership interest to take certain actions. The analyst may consider this possibility in the context of actions that require a simple majority vote (i.e., 50 percent + 1) or a supermajority vote (e.g., 66.7 percent).

Alternatively, one other owner may hold the remaining 50 percent interest in the company. In these cases, the two owners may be considered deadlocked in the sense that neither owner has absolute control of the subject company. That is, neither owner unilaterally can control the actions of the company, and each owner typically is able to block certain actions of the company.

A Deadlocked 50 Percent Interest

In the case where there are two deadlocked 50 percent ownership interests in a company, the deadlocked owners typically are not considered to be controlling owners. This is because each owner typically does not have control of the subject company. Rather, each owner is simply able to block or veto certain proposed actions of the subject company. The owner of a 50 percent interest in these deadlocked situations typically is considered a noncontrolling owner.

Little empirical evidence is available on the appropriate discounts or premiums that may be applicable in the fair market valuation of a deadlocked 50 percent interest in a company.[6] Furthermore, there is little empirical evidence on how best to apply a discount (to a controlling interest value) or a premium (to a noncontrolling interest value) when estimating the value of a 50 percent ownership interest in a private company, deadlocked or otherwise.

However, as discussed previously, it is generally accepted to tie the value of control rights (or lack thereof) of a particular subject interest in a company to incremental economic benefits (or lack thereof) available to the owner of that particular subject interest through the exercise of control rights. This applies to the valuation of a deadlocked 50 percent interest.

Incremental Economic Benefits of a 50 Percent Interest

In situations where the owner of the 50 percent interest subject to the valuation is deadlocked with another 50 percent owner, the analyst may consider the incremental value benefits, if any, of owning a 50 percent interest compared with, for example, a 48 percent (i.e., minority) interest. This may be helpful in ascertaining what value may be available to a hypothetical owner of a 50 percent interest that is not available to a hypothetical owner of a 48 percent interest in the same company.

In deciding whether there is any incremental economic benefit to being a deadlocked noncontrolling owner holding a 50 percent interest instead of a minority noncontrolling owner holding a 48 percent interest, the answer depends largely on the difference in rights afforded to a 50 percent owner versus a 48 percent owner. An evaluation of these rights helps determine whether there is a difference in the magnitude of any DLOC (and DLOM) that would be applicable to the two ownership interests. A nonproportionate economic benefit of owning a 50 percent interest instead of a 48 percent interest likely would indicate a material difference in the applicable valuation discounts.

IN THE CASE WHERE THERE ARE TWO DEADLOCKED 50 PERCENT OWNERSHIP INTERESTS IN A COMPANY, THE DEADLOCKED OWNERS TYPICALLY ARE NOT CONSIDERED TO BE CONTROLLING OWNERS.

If there is no material difference between what such ownership interests would be able to accomplish regarding major corporate actions, as well as the day-to-day operations and decision-making of the subject company, then there is more likely to be little material enhancement in value available to a hypothetical 50 percent owner.

In this case, the primary difference between a hypothetical owner of a deadlocked 50 percent interest and a hypothetical owner of a 48 percent interest is the ability of the deadlocked owner to block the other deadlocked owner from undertaking certain actions. However, a hypothetical minority owner holding 48

percent would be able to block certain corporate actions in circumstances where a supermajority vote is required.

Analysis of the Absence of Agreement between Deadlocked 50 Percent Owners

Analysts may also consider and analyze the hypothetical scenario of what would occur when two deadlocked owners of 50 percent interests are unable to agree on corporate matters and neither owner can force the company to take significant actions. Instead, each owner can block the company from taking certain actions, a power that either typically would not have if their ownership interest was less than 50 percent.

Analysts can perform an analysis to tie the 50 percent owner's blocking power to any material and quantifiable economic benefit. If the analyst performs such an analysis and is unable to tie the blocking power to any material and quantifiable economic benefit, it may cast doubt on differences, if any, between the magnitude of the DLOC applicable to a 48 percent interest and the DLOC applicable to a 50 percent interest.

Judicial Dissolution Analysis

In some jurisdictions, one way for owners to remedy a true corporate deadlock situation and realize a near-term return on their investment could be to seek a judicial dissolution. That is, some jurisdictions allow noncontrolling owners to sue for dissolution of the company if the owners can demonstrate a decision-making deadlock. Analysts should seek guidance from legal counsel as to whether this is a possibility for the subject 50 percent interest in the subject jurisdiction.

If judicial dissolution is an option, analysts may consider and analyze the hypothetical scenario where one deadlocked 50 percent owner pursues such a judicial dissolution. Particularly, analysts may consider whether current company management would continue to operate the company on a day-to-day basis. It may be feasible that current company management continues to operate as usual and the company continues business as usual in the near term.

In performing a judicial dissolution analysis, analysts may consider potential unfavorable consequences associated with a judicial dissolution. Such judicial dissolutions often have unique costs associated with them in the form of court fees, legal fees, and other

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professional fees. Compared with the sale of a company or its assets in the ordinary course of business, a judicial dissolution may have significantly higher professional fees and costs. In other words, a forced dissolution likely would have many of the same costs associated with an ordinary sale (i.e., make-ready costs, brokerage costs, etc.), but it also may have additional costs associated (i.e., additional attorney fees and court costs).

An ordinary sale of the company likely would involve substantial lead time to market the company, identity buyers, and negotiate the highest price, whereas a judicial dissolution may be limited to a narrow time frame. Because of time constraints, the company may not find its optimal market conditions, or its assets may not be sold for their maximum value.

An ordinary sale of a company also likely would be completed privately and have more informational symmetry between the company and prospective buyers. In a judicial dissolution, however, prospective buyers would have an information advantage, knowing that the owners must sell quickly. The forced-sale nature of the liquidation also typically would be public record. That would allow potential buyers to have more bargaining power than in an otherwise ordinary sale and may further limit the price at which a company would sell.

Under a judicial dissolution, a deadlocked owner may be able to gain liquidity relatively sooner, but this liquidity likely would come at a cost, namely (1) legal and other fees that may not otherwise be incurred and (2) a lower sale price due to the forced nature of the dissolution.

Certain legal cases have addressed the issue of appropriate valuation adjustments (i.e., a DLOC and DLOM) in the fair market valuation of 50 percent ownership interests in private companies for tax purposes.

Pierre v. Commissioner

On September 27, 2000, Suzanne J. Pierre transferred all membership interests in Pierre Family, LLC ("Pierre LLC") in four separate transactions to two separate trusts. First, a gift of a 9.5 percent membership interest was made to each trust. Second, moments after, a sale of a 40.5 percent membership interest was made to each trust.

Ms. Pierre engaged an analyst to estimate the fair market value of a 1 percent membership interest in Pierre LLC in connection with the transfers. As part of his analysis, the analyst concluded that (1) a 10 percent DLOC and (2) a 30 percent DLOM were appropriate.

The Internal Revenue Service ("IRS") challenged the transfers. The outcome of this tax dispute is summarized in the following opinions: (1) *Pierre v. Commissioner*[7] ("Pierre I") and (2) *Pierre v. Commissioner*[8] ("Pierre II").

THE TAXPAYER'S TESTIFYING EXPERT POINTED OUT THAT A 50 PERCENT INTEREST HAD THE ABILITY TO BLOCK THE APPOINTMENT OF A NEW MANAGER OF PIERRE LLC AND THAT A LESS THAN 50 PERCENT INTEREST WOULD NOT HAVE THIS ABILITY.

In Pierre I, the IRS argued that the transfers of the Pierre LLC membership interests were transfers of the underlying assets of Pierre LLC and not transfers of Pierre LLC membership interests. The taxpayer argued that the Pierre LLC membership interests were transfers of Pierre LLC membership interests. The Tax Court ruled for the taxpayer.

After Pierre I, two issues remained unresolved:

1. Whether the step transaction doctrine applied to the gift and sale transfers
2. If the step transaction did apply, whether the DLOC and DLOM applied by the taxpayer valuation expert were appropriate

In Pierre II, the IRS argued that the four transactions of Pierre LLC membership interests were really two transactions (i.e., one transaction of a 50 percent membership interest in Pierre LLC to each trust).

In Pierre II, the Tax Court opined that the step transaction doctrine did apply and, therefore, that the four transactions of Pierre LLC membership interests should be treated as two transactions, each of a 50 percent membership interest in Pierre LLC to the two trusts. The step transaction doctrine is beyond the scope of this discussion. This then led to the remaining issue of whether the DLOC and DLOM applied by the taxpayer valuation expert were appropriate.

In Pierre II, the taxpayer engaged a different analyst to provide testimony at trial. The taxpayer's testifying valuation expert applied a DLOC of 10 percent and a DLOM of 35 percent. It is noteworthy that the taxpayer only advocated for a DLOM of 30 percent at trial.

The taxpayer's testifying expert acknowledged that he only considered and analyzed the rights, privileges, and restrictions of a 40.5 percent membership interest and a 9.5 percent membership interest in Pierre LLC. Under testimony, the taxpayer's testifying expert pointed out that a 50 percent interest had the ability to block the appointment of a new manager of Pierre LLC and that a less than 50 percent interest would not have this ability. He testified that the DLOC applicable to a 50 percent interest would be reduced to 8 percent as a result of this blocking power.

In its decision, the Tax Court concluded a combined discount of 35.6 percent, or a DLOC of 8 percent and a DLOM of 30 percent.

Estate of Fleming v. Commissioner

In *Estate of Fleming v. Commissioner*[9], one issue was the value of a 50 percent interest in B & W Financial Corporation of Longview, Inc. ("B & W Longview"). On the date of his death on November 22, 1991, Thomas A. Fleming owned a 50 percent interest in the outstanding common stock of B & W Longview. The remaining 50 percent was owned by Mr. Fleming's wife, Jeanette.

In this case, the taxpayer and the IRS had experts testify at trial. The taxpayer's expert applied a combined DLOC and DLOM of 35 percent to the 50 percent interest in B & W Longview. The IRS expert applied a 10 DLOC and no DLOM. On brief, the taxpayer's expert did not insist

that a DLOC larger than 10 percent applied to the 50 percent interest in B & W Longview.

The Tax Court agreed that a DLOC and DLOM were applicable. In its opinion, the Tax Court did not explicitly state the DLOC and DLOM, but its conclusion of the fair market value of the 50 percent interest in the outstanding common stock of B & W Longview implied a combined DLOC and DLOM of 27.1 percent.

Summary and Conclusion

Analysts may be asked to estimate the fair market value of a 50 percent interest in a private company in valuations developed for tax purposes. The issues to consider and analyze in selecting appropriate valuation adjustments to apply in such a valuation often are unique compared with the issues in the valuation of a smaller interest (e.g., a 48 percent interest) or a larger interest (e.g., a 52 percent interest).

When valuing a 50 percent interest, the analyst should consider the level of value of the initial value indication. If the initial value indication is on a controlling, marketable ownership interest basis, the analyst may consider applying valuation adjustments in the form of a DLOC and a DLOM.

In such cases, analysts should consider and analyze the incremental economic benefits available to the owner of a 50 percent interest through the exercise of the available prerogatives of control.

The analyst also should consider the distribution of the remaining 50 percent interest.

If multiple owners make up the remaining 50 percent interest, the analyst may consider the possibility that any of the remaining owners would join with the owner of the subject 50 percent interest to take certain actions. Alternatively, one owner may hold the remaining 50 percent interest, and the two owners may be considered deadlocked. In these cases, the analyst may consider the following:

1. The difference in rights and privileges available to a deadlocked noncontrolling owner (i.e., the 50 percent interest owner) and a minority noncontrolling owner (e.g., a 48 percent interest owner)
2. A scenario where there is an absence of agreement between two deadlocked 50 percent interest owners
3. A scenario where there is a hypothetical judicial dissolution of the subject company

The Tax Court has allowed and recognized the appropriateness of a DLOC (and DLOM) for 50 percent interests in a private company in certain cases. It is important for the analyst to analyze the facts and circumstances of each case in making the appropriate valuation adjustments in the valuation of 50 percent interests in private companies for tax purposes.

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