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Expert Analysis

Second Department Adopts New Rules On Lack-of-Marketability Discounts


By **Douglas A. Cooper** And **Matthew F. Didora**

Despite intense criticism, the Appellate Division, Second Department, has stood apart from the Court of Appeals and other courts in its application of the lack-of-marketability discount when determining the value of closely held corporations. This discount takes into account the illiquidity of the shares due to the absence of a public market in which the shares can easily be converted into cash.[1] Given the illiquidity, a reasonable investor in an arms-length transaction would generally pay less for the shares of a privately held corporation than those of a comparable public corporation.

Until recently, the Second Department has refused to apply the discount to any of a corporation's tangible assets. In *Cinque v. Largo Enterprises of Suffolk County Inc.*, 212 AD2d 608 (2d Dept. 1995), *Whalen v. Whalen's Moving & Storage Co. Inc.*, 234 AD2d 552 (2d Dept. 1996), and *Cohen v. Cohen*, 279 AD2d 599 (2d Dept. 2001), the Second Department held that the lack-of-marketability discount should only be applied to the value of the corporation that is attributable to goodwill. This limitation is significant because in the case of a real estate holding company or LLC whose sole assets are cash and real estate, the Second Department would not apply the discount, choosing instead to equate the value of the shares with the value of the corporation's assets.

These decisions have been resoundingly criticized. For example, Justice Stephen G. Crane, prior to joining the Second Department, wrote in *Hall v. King*, 177 Misc.2d. 126, 134 (NY Sup Ct 1998), that *Whalen* and *Cinque* were "incorrectly decided insofar as the limitation of the discount is concerned." Similarly, Justice Ira B. Warshawsky, one of the Commercial Division justices in Nassau County who is bound by the holdings of the Second Department, nonetheless argued that *Whalen*, *Cinque*, and *Cohen* fail to appreciate that the fundamental purpose of the lack-of-marketability discount is to account for the illiquidity of the shares and not any particular asset. On at least two separate occasions, Justice Warshawsky applied the lack-of-marketability discount to the entire value of corporations whose primary assets were real estate, specifically rejecting *Whalen*, *Cinque*, and *Cohen*.

Recently in *United States Dredging Corp. v. Murphy*, 74 AD3d 815 (2d Dept 2010), the Second Department appears to have conformed its lack-of-marketability jurisprudence with Justice Warshawsky's analysis and those of other courts. On appeal from Justice Warshawsky's decision in *U.S. Dredging Corp.*, the Second Department affirmed Justice Warshawsky and held that "the law does not limit the application of a lack-of-marketability discount to the goodwill of a corporation in all instances." While not expressly overruling its prior decisions in the *Cinque* line of cases, the *Murphy* decision marks a dramatic shift in the court's approach to the lack-of-marketability discount and proves Justice Warshawsky to be a soothsayer.

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This article analyzes the Second Department's decision in *U.S. Dredging Corp.*, as well as Justice Warshawksy's decision which was on appeal, and forecasts in what, if any, circumstances it is appropriate to limit the discount to goodwill only.

Valuation Proceeding

Several of U.S. Dredging Corp.'s shareholders (collectively holding 36.77 percent of the company's outstanding stock) commenced a proceeding to dissolve the corporation pursuant to the minority-owner oppression statute, Business Corporation Law §1104-a. In response, the corporation made a BCL §1118 election to purchase the minority shareholders' interests. Following that election, the corporation and minority shareholders were unable to agree upon the value of the 36.77 percent interest, necessitating a BCL §1118 valuation proceeding that was tried before Justice Warshawsky.

As of the valuation date, U.S. Dredging Corp.'s primary assets were real estate and cash. In addition, U.S. Dredging had other sundry assets, such as dredging equipment, automobiles, and contingent claims. It does not appear that U.S. Dredging had any goodwill.

At the valuation hearing, both the minority shareholders and the corporation offered testimony from business valuation experts, resulting in a "battle of experts." While both experts utilized the cost or net asset value and income approaches to determine the fair value of U.S. Dredging, the competing experts, as is typical in such battles, differed on the application of these methodologies. The petitioners' expert calculated the fair value over two times the value determined by the corporation's expert. Among the causes for the wide discrepancy was the experts' differing applications of the discount for lack of marketability.

The minority shareholders' expert refused to apply the discount for two reasons: First, since the corporation was compelled to purchase the petitioners' shares as a result of the BCL §1118 election, there was in fact a "ready market" in which the petitioners' interests could be sold. Second, no discount was permitted by U.S. Dredging's shareholders' agreement.

On the other hand, the U.S. Dredging's expert applied a 15 percent lack-of-marketability discount to the entire value of the corporation.

Discount Applied

In analyzing the competing testimony, Justice Warshawsky specifically rejected the petitioners' "ready market" analysis as a basis to decline applying the discount. Justice Warshawsky held that he was bound to follow the prior case law utilizing the "hypothetical willing buyer" standard and further concluded that a corporation following a BCL §1118 election does not meet this standard.

Having found that no market exists for petitioners' shares, Justice Warshawsky held

DOUGLAS A. COOPER *is a senior partner and chair of the litigation department at Ruskin Moscou Faltischek in Uniondale.* MATTHEW F. DIDORA *is an associate in the litigation department. Ruskin Moscou served as counsel to the petitioners in 'Jamaica Acquisitions Inc. v. Shea' discussed in this article.*

that "it is quite clear that a discount for lack of marketability is appropriate in determining Fair Value. The only issue is what is the appropriate amount." Justice Warshawsky applied a 15 percent discount, which the court noted was less than discounts applied in other cases where the corporate values were reduced by as much as 25 percent.

Justice Warshawsky's decision to apply the lack-of-marketability discount is noteworthy because of the cases the court cites in support of its holding and, more importantly, the ones it does not. On the one hand, Justice Warshawsky acknowledges that a trial court is bound to follow binding precedents, yet the court appears to have selectively relied upon the Second Department's decision in *Blake v. Blake Agency Inc.* and altogether ignored *Cinque*, *Whalen*, and *Cohen*.

Specifically, Justice Warshawsky buttressed his decision to apply a marketability discount on *Blake*, where the Second Department recognized that a lack-of-marketability discount is appropriate when calculating the value of a closely held corporation. However, Justice Warshawsky disregards perhaps the most controversial aspect of the *Blake* decision (which lead to the decisions in *Cinque, Whalen,* and *Cohen*) where the Second Department applied the discount only to the value of the corporation attributed to goodwill.

Had Justice Warshawsky followed the application of *Blake* in its entirety, the court would have been compelled to reject U.S. Dredging's application of the lack-of-marketability discount. This certainly would have been the result had Justice Warshawsky followed *Cinque* and it progeny. Unfortunately, Justice Warshawsky declined to explain his philosophical disagreement with *Cinque, Whalen,* or *Cohen*.

However, several months later, in *Jamaica Acquisition Inc. v. Shea*, an appraisal-rights proceeding to determine the value of dissenting shareholders' interests in a corporation that owned real estate, Justice Warshawsky took the opportunity to do so. In that case, Justice Warshawsky specifically held that the lack-of-marketability discount should be applied to "tangible as well as intangible assets; in other words, the 'entire enterprise.'"

Analyzing *Cinque, Whalen,* and *Cohen*, Justice Warshawsky correctly noted that the Second Department's decisions conflict with the underlying purpose of the discount. In *Friedman v. Beway*, the Court of Appeals recognized that the lack-of-marketability discount was designed to reflect the illiquidity of the shares, not the corporation's assets. Thus a reasonable investor would consider this as a factor when determining the price to pay for the shares.

Justice Warshawsky concluded that by limiting the application of the discount to goodwill only (as opposed to the entire value of the business), *Cinque, Whalen*, and *Cohen* were inconsistent with the Court of Appeals' decision in *Friedman*. Those three cases failed to understand that the discount exits because the shares cannot easily be sold and converted to cash.

Finally, Justice Warshawsky noted that several other Second Department decisions such as *Brooklyn Home Dialysis Training Center Inc.*, 293 AD2d 747 (2d Dept 2002), and *Matter of Joy Wholesale Sundries Inc.*, 125 AD2d 310 (2d Dept 1986), tacitly authorized application of the marketability discount to assets other than goodwill.

Second Department

The well-reasoned critiques of *Cinque*, *Whalen*, and *Cohen* by Justice Warshawsky in *U.S. Dredging* and *Jamaica Acquisition* and Justice Crane in *Hall v. King* (the latter of which was affirmed by the First Department) cried out for a response from the Second Department. Unfortunately, the parties in *Jamaica Acquisitions* settled beforehand; however, *U.S. Dredging* survived long enough to travel to 45 Monroe Place in Brooklyn.

There were several issues before the Second Department on appeal from Justice Warshawsky's decision. While the entirety of the Second Department's decision is noteworthy, this article focuses only on the court's limited discussion of the lack-of-marketability discount.

The court started its analysis by noting that the risks associated with the illiquidity of shares should be considered when determining the fair value of a close corporation. From that starting point, the Second Department concluded that Justice Warshawsky "properly applied a lack-of-marketability discount of 15 percent, on the ground that the Corporation was a close corporation."

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Finally, in an apparent departure from *Cinque, Whalen*, and *Cohen*, the court held that "the law does not limit the application of a lack-of-marketability discount to the goodwill of a corporation in all instances." Among the cases cited by the Second Department to support this conclusion were *In re Brooklyn Home Dialysis Training Center* and *In re Joy Wholesale Sundries*, which Justice Warshawsky also relied upon in *Jamaica Acquisition*. No other analysis or discussion was offered, and we are left to read between the lines, or more accurately, at the other cases cited by the court to ascertain the full impact of the court's decision.

As an initial matter, it is apparent that the court was not willing to outright overturn *Cinque*, *Whalen*, and *Cohen*. If it intended to do so, it clearly could have. But the court's citations to Justice Crane's decision in *Hall v. King* and its scathing criticisms of the prior case law decisions as well as the First Department's decision on the appeal of Justice Crane's analysis, wherein the court applied the lack-of-marketability discount to all of the corporate assets, at the very least suggest that the Second Department is willing to altogether abandon the *Cinque* line of cases and bring its decisions in line with the Court of Appeals and First Department.

Moreover, the court's recognition that the purpose of the lack-of-marketability discount is to account for the illiquidity of the shares—a point which was repeatedly emphasized by Justice Warshawsky—leaves hope that the Second Department is finally focusing its analysis on the shares, not the corporation's assets.

Conclusion

By directing its analysis on the shares and their illiquidity, the Second Department's lack-of-marketability analysis should more consistently apply the discount in all types of valuation proceedings—including those involving real estate holding companies and single purpose LLCs that own real estate.

In that case, the limited universe of cases in which the court left open the possibility of restricting the discount to goodwill only should be reserved for valuation proceedings in which the minority shareholder can demonstrate a ready and willing market of purchasers beyond the corporation itself and its majority shareholders who can acquire the shares. And given the prevalence of clauses in shareholder and operating agreements limiting individuals' abilities to transfer their interests and the general absence of a market for shares of non-public companies, those cases will be extremely rare.

1. *Amodio v. Amodio*, 70 NY2d 5, 7 (1987).