

CONTROL PREMIUMS

Virtually every day lawyers in divorce cases attempt to value interests in closed corporations. They carefully analyze the facts and law to achieve the highest valuation for their client. Yet, one of the most important arguments available to maximize a non-owning spouse's interest is rarely utilized, however, it has strong foundation not only in law, but in economics and has been recognized in both the literature and case law in New Jersey. Applying a valuation premium for a controlling interest in a closed corporation reflects the common sense principle that control of a business entity is, by itself, an added element of value and, as such, is compensable under our equitable distribution statutes. It is a separate and distinct element of value which has been expressly recognized in divorce practice and in every day economic transactions.

It is clear that the touchstone in valuing closed corporations is Revenue Ruling 59-60. Therefore, it is important to initially examine that Revenue Ruling to see if it supports this argument. The Revenue Ruling, while observing that no general formula may be given that is applicable, indicates there are certain "general approaches, methods and factors which must be considered in valuing such securities" (emphasis added). One of the mandatory approaches, methods or factors under Revenue Ruling 59-60 is the premium for control as analysis of the Ruling clearly demonstrates. In Sec. 4.02(g), the Revenue Ruling

specifies the principle and the entire paragraph is set forth with emphasis:

(g) Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock. (emphasis added)

This concept of control as constituting an independent added element of value is predicated on very real economic factors. The controlling owner of a business is in a position where a determination can be made for any, or all, of the following:

- A. Whether a business is to be sold.
- B. Whether there is to be a refinancing of the business debt and, if so, the extent of the refinancing and the terms.
- C. If there is to be a refinancing, whether any of that refinancing is to be distributed to other shareholders or maintained by the corporation.
- D. Whether there should be a dividend payment and, if so, the dates of payment and the amounts.

- E. The salaries and perks of employees and all owners including the rights of minority owners to such perks.
- F. The determination as to whether new shares should be issued which would have the practical effect of further increasing the minority position of a shareholder.
- G. The terms of any potential sale including the economic reality of a linkage between a purchase price and a consulting contract for the person in control. The controlling shareholder who receives a consulting contract for \$250,000.00 a year is clearly benefitted but the remaining shareholders receive, as a matter of practicality, a reduced price since the overall package is impacted upon by the consultant contract.
- H. Differing allocations of a purchase price have differing tax consequences which may be important to an individual owner. The person in control has the ability to fashion the contract in the most advantageous manner possible.
- I. The hiring, or firing, of family members in a business.

These options of the controlling shareholder in a corporation are of real value as any minority owner will sadly admit. They are significant, material, and predicated not on theoretical legal concepts but have their foundation in our free market economy and are as real, and inevitable, as sunrise and sunset.

The converse of the majority premium is the minority discount. The two principles are interrelated and it is fascinating to observe how courts have dramatically recognized the economic viability of both principles. The validity of one validates the converse. In a 1975 article in the Journal of

Taxation, an analysis of court awards was made in cases involving minority discounts. Between 1930 and 1950 the average minority discount courts imposed was 17%, which increased to 24% between 1950 and 1970. Significantly, between 1970 and 1975, according to the article, the average discount increased to 34%. Dants, "Courts Increasing Amount of Discount for a Minority Interest in a Business", 43 J. Tax 104 (1975). A later article confirmed the same trend observing that "in the actual marketplace, the typical discount is not of token size, but of substantial magnitude". In some instances, that discount was 78% of book value which is obviously different than fair market value. See H. Calvin Coolidge, "Survey Shows Trends Towards Larger Minority Discounts", Estate Planning (September, 1983).

In examining the case law across the country the trend concerning control premiums is unmistakable. In the case most cited by the Internal Revenue Service, Estate of Salsbury v. Comm., 34 TCM 1441 (1975), the Tax Commission found an appropriate control premium to be 38.1%. See also Estate of Hall v. Comm., 34 TCM 648 (1975); Estate of O'Connell v. Comm., 37 TCM 822 (1978); Estate of Dooley v. Comm., 31 TCM 814 (1972); Estate of Grootemaat v. Comm., 38 TCM 198, 205 (1979).

Commentators have also recognized the importance of a control premium, linking the question of control with the power to participate in the management of the business. As one commentator observed in the University of Pennsylvania Law Review:

"Ownership of shares in a closely held corporation may conveniently be analyzed as composed of three elements of value: the right to a proportionate share of the net wealth of the corporation, or asset value; the right to a proportionate share of distribution from the corporation, or income value; and proportionate participation in the management of the enterprise, or control value." (emphasis added) See Feld, "The Implications of Minority Interest and Stock Restrictions in Valuing Closely Held Shares", 122 U. Pa. L. Rev. 934, 936 (1974).

Feld's view is supported by other commentators as well. See Smith, "Closely Held Stocks; Corporation Control Gains Importance as Element of Stock Valuation", 4 TAX'N. + LAW. 78 (1975).

Fellows and Painter, "Valuing Closed Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome", 30 Stan. L. Rev. 895, 909 (1978).

Another commentator observed that an additional theory to justify the control premium was the relationship between control and corporate performance. According to this commentator control is valuable as a type of insurance against the risk of investing one's assets in an enterprise:

"The most important reason a purchaser might pay a premium for controlling shares, and one that has to be met squarely, is that an investment in controlling shares is a more promising, or at least a safer, investment than in non-controlling shares for the simple reason that it will enable the investor to implement what he believes to be the best policies in management of his investment." See Andrews, "The Stockholder's Right to Equal Opportunity in the Sale of Shares", 78 Harv. L. Rev. 505, 526 (1965).

This view has been supported by the Courts. See Dahlgrin v. U.S., 553 F. 2d 434 (5th Cir. 1977).

The premium, aside from finding generalized support from Courts across the country and with commentators, has expressly and explicitly been recognized in New Jersey by both our trial and Appellate Courts. In Lavene v. Lavene, 162 N.J. Super. 187, 196 (Ch. Div. 1978), an early but important equitable distribution case (on remand from the Appellate Division) Judge Arnone reviewed the procedure to be followed in valuing closely held corporations. Lavene, which has repeatedly been cited by other cases, expressly acknowledged that the element of control is "an important factor". Yet, perhaps the most interesting reported decision is Bednar v. Bednar, 193 N.J. Super. 330, 334 (App. Div. 1984), where the Appellate Division reversed primarily for valuation date questions. Yet, an additional reason for the reversal was the trial court's 35% reduction in value of the business which the Appellate Court characterized as "inappropriate". The Court noted that such a reduction factor should be used only when valuing a minority interest. In fact, the Court went on to observe that there may be an "enhancement of value" by reason of Defendant being "the sole operating partner" - the precise facts in this case. On remand the trial court, heeding the admonition of the Appellate Division, imposed a 10% control premium as opposed to the 35% reduction in value it previously utilized, a spread of 45%.

An entirely separate rationale for utilizing control premiums is the economic reality that with control comes the ability to engage in self-dealing. Self-dealing is best defined as the use of the controlling shareholder's power over corporate management in ways benefitting himself at the expense of minority shareholders.

How often have we seen the controlling shareholder (a) lease property to the corporation, not at fair market value, but at a rental that, surprisingly, just happens to equal the carrying charges for the property, (b) receive a salary that exceeds any reasonable compensation thus receiving what is, in essence, a dividend in which your minority owner client should have shared, (c) have a cohabitant on the payroll at a salary level so high that one wonders what the compensation is truly for. The possible areas of self-dealing are numerous and reflect the real world reasons why control equates to money.

The issue of adjustments in value from percentage ownerships (up or down) is an issue that has not adequately been addressed, either by our Courts or, I believe, the every day practicing lawyer. Hopefully, some of the foregoing comments will highlight the issue and it will, therefore, be a hot tip for your future use.