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Fair Value Remains Challenging Determination for Trial Courts

Fred D. Weinstein
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The determination of the "fair value" of a shareholder's interest in a closely held corporation under BCL §1118 and BCL §623 has proven to be an especially complex and challenging task for the courts. The term "fair value" is not defined by either statute, and it has been left to the courts to establish guidelines to determine the fair value of shares for which there is no readily available market and to apply those guidelines to the unique factual circumstances of each case. As was observed by a federal appeals court in *Okerlund v. United States*, 365 F3d 1044, 1052 (Fed. Cir. 2004), "[t]he valuation of a closely held company is an inexact science (some might say an art)."

In its recent decision in *Murphy v. United States Dredging Corp.*, 2010 NY Slip Op 04794, 903 N.Y.S.2d 434, the Second Department addressed two particularly thorny issues that trial courts have repeatedly confronted in business valuation cases—the impact of a prospective liability for unrealized capital gains (commonly referred to as built-in capital gains or BIG) and whether a marketability discount is to be applied to the value of both tangible assets and the goodwill of a business. While the court's decision in *Murphy* provided some clarity as to how these issues will be addressed in future valuation cases, it did not establish a bright line rule with respect to either issue.

Since the calculation of liability for a BIG and the application of a marketability discount are often two of the most significant factors in determining fair value, there will be continued litigation battles in the future over these facets of valuation. The *Murphy* holding will affect how practitioners prepare for trial in valuation cases, and obtain necessary evidence to support their positions. As discussed below, practitioners will have to dig deeper to find out if and when a respondent corporation intends to sell assets. In addition, the testimony of expert witnesses will become more important than ever.

The 'Murphy' Decision

The petitioners in *Murphy* collectively owned 36.77 percent of the shares of United States Dredging Corp., which was a subchapter C corporation. They filed a petition for dissolution pursuant to BCL §1104-a, claiming that those in control of the corporation had engaged in acts of oppression. The respondent corporation subsequently elected, with leave of court, to purchase the petitioner's shares pursuant to BCL §1118, and a trial ensued to determine the fair value of those shares. Inasmuch as United States Dredging Corp. was a C corporation that primarily owned appreciated real estate, its real estate holdings were subject to an unavoidable BIG tax upon sale.

At trial, the corporation contended that the entire tax liability of \$11.6 million should be deducted in calculating fair value of the shares. For their part, the petitioners contended that the adjustment for the BIG tax should be limited to approximately \$3 million based on the present value of the liability, which they argued would not be incurred by the corporation for 19 years, the projected holding period for the real estate.

In its decision, the trial court sustained the petitioners' present value analysis, noting that fair value could not be determined on the basis of a presumed immediate liquidation of the corporation's assets but had to be determined instead on the basis of the presumed continued operation of the corporation as a going concern.¹ Since there was no indication of imminent plans by US Dredging to sell any of its real estate assets, the trial court agreed that it was appropriate to determine the likely holding period for its real estate and proceeded to calculate the liability for the BIG on the basis of a 19-year holding period.²

In upholding the trial court's present value analysis with respect to the BIG on appeal, the Second Department acknowledged that its holding was contrary to the valuation analysis utilized by the U.S. Court of Appeals for the Eleventh Circuit in valuing an investment holding company for estate tax purposes in *Estate of Jelke v. Commissioner of Internal Revenue Serv.*, 507 F3d 1317, cert denied 129 S. Ct 168.³ In *Jelke*, the court sustained the estate's deduction of the entire prospective \$51 million BIG tax liability in determining the value of the estate's interest in the company, which was a C corporation, and rejected the IRS' position that the BIG liability should be only \$21 million on the basis of a present value analysis which assumed a 16-year holding period. The *Jelke* court opined that a present value analysis would require the court "...to either gaze into a crystal ball, flip a coin, or, at the very least, split the difference between the present value calculation projections of the taxpayers on the one hand, and the present value calculation projections of the Commissioner, on the other."⁴

Although the Second Department acknowledged the contrary holding in *Jelke*, it did not provide its own rationale for its endorsement of the present value analysis or explain why the *Jelke* rationale was inapplicable. It can only be inferred that it approved the rationale articulated by the trial court, which was that the determination of fair value must be on the basis of the value of a company as an operating business and not one that is in the process of liquidation.

This rationale was further implied by the Second Department's reference to the First Department's holding in *Wechsler v. Wechsler*, 58 A.D.3d 62 as inapposite.⁵ In *Wechsler*, the court endorsed the *Jelke* approach in valuing the husband's interest in an investment holding company, which was a C corporation, but the Second Department distinguished *Wechsler* by observing that none of the experts at trial in the *Wechsler* case endorsed a present value analysis for the BIG, and the husband admittedly was going to have to liquidate a portion of his interest each year to pay the distributive award to the plaintiff.⁶

Thus, the Second Department rationale for its holding appears to be that it is only where liquidation is presumed, as it was in *Jelke*, or necessary, as it was in *Wechsler*, that the entire BIG would be deducted in valuing a business.

Nonetheless, the *Jelke* court's blunt critique of present value analysis underscores the difficulty of the task that lies ahead for trial courts. Where there is a BIG tax that is unavoidable, the court will need to determine the business plan of the Corporation and the likely holding period for its assets. As part of that analysis, there would also need to be an assessment of the liquidity of the business and its ability to pay the resulting judgment without selling any of its assets.

To be sure, a gaze into a crystal ball will not be needed where a BIG tax is completely avoidable as it is for corporations that are formed as subchapter S corporations or as a real estate investment trust (REIT), since there is no tax at the corporate level for these entities on sale of appreciated assets. However, if a C corporation is converted to an S corporation or a REIT, the Internal Revenue Code imposes a 10-year holding period before a BIG is completely

avoidable.⁷ Thus, a court must still in such an instance assess the likely holding period to determine the applicability of a liability for a BIG.

Such was the case, for example, in *Matter of Jamaica Acquisition v. Shea*, 25 Misc.3d 1212A, 901 N.Y.S.2d 907 (in which the author was trial counsel for seven of the eight dissenting shareholders), where three bus companies that were C corporations were converting to a REIT upon approval of a proposed merger. The trial court ultimately rejected the companies' contention that a \$58 million dollar liability for the BIG tax should be deducted, finding that the BIG tax was completely avoidable and would be avoided based on the repeated pronouncements of the company that it would hold its real estate assets for the requisite ten years to assure avoidance of the BIG.⁸

Against this background, a practitioner representing a shareholder seeking fair value should seek leave of court to obtain documents relevant to the company's retention of its assets, historically and for the future, as well as the deposition of the financial officer with knowledge of the company's plans. Leave of court is necessary because valuation proceedings are special proceedings for which discovery is not available absent a court order.⁹

Marketability Discount

In its decision, the Second Department also addressed a question that had previously placed it in conflict with the First Department—whether a marketability discount should be applied only to the value of goodwill, if any, of a business. The application of a marketability discount in fair value cases is based on the reality that "the shares of a closely held corporation cannot be readily sold on a public market." *Matter of Blake*, 107 A.D.2d 139, 486 N.Y.S.2d 341, 350 (2d Dept 1985). In *Blake*, the marketability discount was applied only to the value of goodwill in the company because the court concluded it was "unnecessary" to apply it to "net tangible value" since the company had assets that would leave it with "sufficient working capital, even after it has paid petitioner the fair value of his shares."¹⁰

The implication of the *Blake* holding was that a discount for illiquidity would not extend to the tangible assets of a business where there was sufficient liquidity to pay the determined fair value to the shareholder. Out of this holding came a long line of Second Department cases limiting the application of a marketability discount to the value of goodwill, if any, in a corporation. *Whalen v. Whalen's Moving & Storage Co. Inc.*, 234 A.D.2d 468, 651 N.Y.S.2d 579 (2d Dept. 1994) ("...a [marketability] discount should only be applied to the portion of the value of the corporation that is attributable to goodwill" (internal citations omitted)); *Cinque v. Largo Enterprises of Suffolk County Inc.*, 212 A.D.2d 622 N.Y.S.2d 735 (2d Dept. 1995) (Appellate Division held in valuation proceeding under BCL §1118 that judicial hearing officer properly refused to apply discount for lack of marketability in instance where "...the value of the corporation is attributable solely to real property and cash"); *Cohen v. Cohen*, 279 A.D.2d 599, 719 N.Y.S.2d 700 (2d Dept. 2001) (Appellate Division affirmed the determination of the trial court in a matrimonial action not to apply marketability discount to value assets consisting solely of real property); *Wagner v. Dunetz*, 299 A.D.2d 347, 749 N.Y.S.2d 545 (2d Dept. 2002) (Appellate Division affirmed trial court's decision not to apply marketability discount in matrimonial action to the value of spouse's interest in a private medical practice).

The approach reflected in the foregoing Second Department holdings was not followed in the First Department and was roundly criticized by Judge Stephen Crane in *Hall v. King*, 177 Misc.2d 126, 675 N.Y.S.2d 810. Judge Crane expressed the view that an application of the marketability discount based on the liquidity of a business' assets as opposed to the liquidity of its shares was entirely wrongheaded and was not consistent with Court of Appeals precedent governing a marketability discount or even cases decided by the Second Department itself.¹¹ Notably, in its decision in *Murphy*, the Second Department cited *Hall v. King* as authority for its holding that the application of a marketability discount is not limited to goodwill "in all instances."¹² In doing so, the court appeared to be accepting the criticism leveled by Judge Crane against its prior holdings. However, the court left the door slightly ajar when it implicitly suggested that there may be factual circumstances where limiting a marketability discount to the value of goodwill may be appropriate.

Given the court's endorsement of Judge Crane's opinion in *Hall*, it is hard to envision when such a circumstance might exist. Nevertheless, the refusal to rule out such a limitation on the application of a marketability discount altogether ensures that trial courts will still have to grapple with the issue in the future.

Conclusion

By declining to apply the approach advanced in *Jelke*, the Second Department ensured that trial courts adjudicating the fair value of the shares of a business with assets subject to a BIG will need to determine when an asset is likely to be sold and a BIG liability will be incurred. Additionally, the determination of when assets will be sold will also require a determination of whether sufficient liquidity exists to pay the amount of the fair value award to the shareholder.

Furthermore, although the Second Department has now aligned itself with other appellate courts in refusing to limit the application of a marketability discount to the value of goodwill, if any, the court did not categorically reject such a limitation, thus ensuring the issue remains one to be considered by litigants, their counsel and their experts in future valuation cases. Given these variables, it would be wise for practitioners to pursue discovery relevant to these factual issues by obtaining leave of court pursuant to CPLR §408 and, in the case of dissenting shareholder proceedings, pursuant to BCL §623(h)(4).

Fred D. Weinstein is a litigation partner at Kurzman Eisenberg Corbin and Lever. He was trial counsel for seven of the eight dissenting shareholders in 'Matter of Jamaica Acquisition v. Shea,' one of the cases discussed in this article. Fred D. Weinstein is a litigation partner at Kurzman Eisenberg Corbin and Lever. He was trial counsel for seven of the eight dissenting shareholders in 'Matter of Jamaica Acquisition v. Shea,' one of the cases discussed in this article.