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THE APPLICABILITY OF DISCOUNTS FOR LACK OF MARKETABILITY ON CONTROLLING OWNERSHIP INTERESTS

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The applicability of a discount for lack of marketability ("DLOM") in the valuation of controlling ownership interests of closely held companies has been debated in various courtrooms across the United States. Typically, an analyst determines whether a DLOM is applicable when valuing a controlling interest based on qualitative and quantitative factors. However, judicial acceptance of applying a DLOM on controlling interests has varied with each state, and it is important that the valuation analyst be aware of applicable case law within the relevant governing jurisdiction regarding this issue.

Introduction

The difference in price that an investor will pay for a liquid asset compared to an otherwise comparable illiquid asset may be substantial. This difference in price is commonly referred to as the discount for lack of marketability ("DLOM"). The DLOM measures the difference in the price of (1) a liquid asset (the benchmark price measure) and (2) an otherwise comparable illiquid asset (the valuation subject).

The measurement of the appropriate DLOM to apply continues to be controversial, particularly regarding valuations of closely held companies performed for gift and estate tax, shareholder litigation, buy-sell agreement, and family law purposes.[1] In particular, the application of a DLOM when valuing controlling ownership interests of closely held businesses continues to be debated in court across the country.

The Internal Revenue Service ("IRS") has opposed the use of a DLOM with mixed success. The U.S. Tax Court generally has allowed a DLOM to be applied on a controlling ownership interest in a closely held business, except when the subject company owns assets that are predominantly liquid. In these cases, a limited discount or no discount may be applied.

While controlling ownership interests in privately held companies suffer from illiquidity in a manner similar to noncontrolling ownership interests, courts have not widely accepted the application of a DLOM in the valuation of a controlling interest. The court cases *Barnes v. Barnes*, *Kakollu v. Vadlamudi*, and *Cloutier v.*

Commissioner illustrate the disparity in the acceptance of applying a DLOM on controlling interests.

Reasons to Apply a Discount for Lack of Marketability

According to the book *Best Practices*, a security holder can quickly sell most publicly traded securities at or near the last public trade price in a U.S. capital market.[2] The transaction typically includes a small commission cost.

The population of potential buyers for most private company ownership interests represents a small percentage of the population of potential buyers for publicly traded securities. In fact, it may be illegal for an individual or an issuer to sell private company securities to the general public without first registering the security offering with either the Securities and Exchange Commission or the state corporation commission. Such a registration is an expensive and time-consuming process.

NUMEROUS JUDICIAL DECISIONS HAVE AFFIRMED THE APPLICATION OF A DLOM IN THE VALUATION OF A CONTROLLING OWNERSHIP INTEREST USING A FAIR MARKET VALUE STANDARD.

Because of differences in the ability to sell or hypothecate a private company ownership interest (compared to publicly traded securities), empirical studies suggest that the DLOM valuation adjustment may be material.

The magnitude of the DLOM depends on the facts and circumstances related to the private company ownership interest. Certain engagement-specific factors may also affect the appropriate magnitude of the DLOM.

One specific factor that the analyst should consider is the level of value (i.e., controlling or noncontrolling) sought in the valuation engagement. Generally speaking, any DLOM applied to a controlling ownership interest should be less than the DLOM applied to a noncontrolling ownership interest in the same entity.

The selected DLOM is a function of both (1) the valuation methods and the valuation variables applied and (2) the level of value that is the objective of the assignment.

Illiquidity for a Controlling Ownership Interest

Controlling ownership interests in privately held companies suffer from illiquidity in somewhat the same manner as noncontrolling ownership interests. The marketability of an ownership interest—whether controlling or noncontrolling—is determined by the ability of the owner to quickly convert the ownership interest to cash, at low cost, and with some degree of certainty.

The value of a controlling ownership interest suffers some value decrement (compared with an otherwise comparable readily marketable security). This value decrement is due to the following two factors:

1. The absence of a ready private placement market
2. Flotation costs (which would be incurred in achieving liquidity through a public offering)

The business owner faces the following transaction risk factors when attempting to liquidate the controlling ownership interest:

1. An uncertain time horizon to complete the offering or sale
2. “Make ready” accounting, legal, and other costs to prepare for and execute the offering or sale
3. Risk as to the eventual sale price
4. Uncertainty as to the form (e.g., stock or cash) of the transaction sale proceeds
5. Inability to hypothecate the subject equity interest
6. Investment banker or other brokerage fees

Numerous judicial decisions have affirmed the application of a DLOM in the valuation of a controlling ownership interest using a fair market value standard.[3] However, this has been challenged in recent years, as discussed in this article.

Courts' Views on a Discount for Lack of Marketability

While the existence of a DLOM is observed within empirical data, it is one of the most contested areas of business valuation. In recent years, courts across the country have been mixed on their stance regarding whether the application of a DLOM when valuing a controlling ownership interest is appropriate.

For example, Tennessee family law courts experienced a period during which they did not allow the use of a DLOM when there was no indication of an imminent sale of a business. This conclusion was published in cases such as *Bertuca v. Bertuca*[4] and *Barnes*,[5] both of which relate to the valuation of assets in a family law dispute. In these cases, the family law courts affirmed not applying a DLOM to the value of a closely held company due to the lack of indication of an imminent sale of the subject business. These two cases left business appraisers in a predicament since the courts' treatment of a DLOM did not seem to match the fair market value standard.

In *Barnes*, the family law court ruled in favor of an appraisal that included a DLOM. However, the ruling was appealed, and the Tennessee Court of Appeals opined that the DLOM was not applicable due to the lack of indication of an imminent sale of the business. We discuss *Barnes* in greater detail below.

Barnes v. Barnes

LeAnn Barnes (the "Wife") and David Barnes (the "Husband") married in 1984. The Husband opened his dental practice in 1994, and the Wife quit her job as a nurse to work at his dental practice, Shelbyville Family Dentistry ("Shelbyville"). The Wife worked daily in an administrative role (scheduling appointments, handling bookkeeping, and making personnel decisions). After about three years, the Wife returned to her nursing job at the hospital and handled Shelbyville's bookkeeping from home.

In 2009, the Wife and Husband filed for divorce. The Wife appealed the trial court's decree on September 24, 2012, on a number of issues, including the valuation and application of discounts related to Shelbyville.

The Husband owned 100 percent of the professional corporation, David E. Barnes, DDC, P.C., that owned Shelbyville. Both the Wife and Husband presented testimony from expert witnesses who had prepared reports on the value of Shelbyville. The Husband also called a witness who criticized the valuation methodology used by the Wife's expert.

The Wife's expert calculated the value of Shelbyville using three valuation methods: (1) the summation of assets method, (2) the gross revenue multiplier method, and (3) the capitalization of earnings method. The Wife's expert averaged the three indicated values to arrive at a concluded value for Shelbyville. The Wife's expert then deducted the goodwill value attributed to the Husband. The Wife's expert valued the dental practice at $678,179 but stated that his valuation did not consider the debt owed by Shelbyville or the cash and accounts receivable.

TENNESSEE FAMILY LAW COURTS EXPERIENCED A PERIOD DURING WHICH THEY DID NOT ALLOW THE USE OF A DLOM WHEN THERE WAS NO INDICATION OF AN IMMINENT SALE OF A BUSINESS.

The Husband's expert estimated the value of the dental practice using two valuation approaches: (1) the asset-based approach and (2) the income-based approach (capitalized cash flow method). The Husband's expert relied only on the income-based approach and valued Shelbyville at $50,000. According to the Husband's expert, the company had a "deficit net worth" because its debt obligations exceeded its assets. In addition, the expert concluded that the company had little to no goodwill value because neither the Husband nor the associate dentist employed at Shelbyville was subject to a noncompete agreement. The Husband's expert also reduced the business value by 15 percent for a lack of marketability.

The trial court valued Shelbyville at $328,392. The trial court assigned greater weight to the Husband's expert value because it considered the practice's debt and accounts receivable and provided more industry data. The trial court opined that the Wife's expert's opinion was lacking because it did not consider the practice's debt and was arbitrary in its approach to the standards applied to estimate the practice's value. The goodwill of the practice also was overstated by the Wife's expert. The trial court accepted a DLOM of 15 percent attributable to the practice based on the Husband's expert's opinion.

The Wife appealed, claiming that the trial court erred in applying a 15 percent DLOM to the valuation of the dental practice (resulting in a downward adjustment of $57,951 to the value of Shelbyville).

The Court of Appeals found that the trial court erred in applying a 15 percent DLOM to the value of the Husband's ownership interest in the dental practice. The Husband's expert and the trial court had used an income-based approach, and the Court of Appeals stated that the Husband's ownership interest in Shelbyville did not suffer from a lack of marketability, unless a sale of the business was necessary or desirable. Therefore, the Court of Appeals added back the DLOM adjustment to the company value and ruled that the Husband should pay the Wife half the adjustment (i.e., $28,975.50).

Recent Developments

In 2017, the Tennessee legislature passed House Bill 348, which stated "considerations for a lack of marketability discount, a lack of control discount, and a control premium, if any, should be relevant," regardless of "whether the sale of the asset is reasonably foreseeable."[6] This bill, passed specifically to address the equitable division of marital property, changed Tennessee's view on the DLOM and how it applies to family law.

In contrast, in *Kakollu*,[7] an Indiana trial court ruled that it was not reasonable to include a DLOM because there was no intention to sell the business, along with other deficiencies. Srinivasulu Kakollu ("Kakollu") appealed the trial court's decree dissolving his marriage to Sraina Sowmya Vadlamudi ("Vadlamudi"). Kakollu claimed that the trial court erred in valuing his business, among other issues. The ruling to exclude a DLOM was upheld by the Indiana Court of Appeals.

Kakollu v. Vadlamudi

Kakollu and Vadlamudi married in 2010. In 2013, Kakollu opened Lakewood Family Dentistry ("Lakewood"). Vadlamudi assisted Kakollu with the opening and initial operation of Lakewood. Kakollu opened additional locations in five cities in Indiana, and his role was primarily to manage the clinics rather than serve patients. At the time of the divorce, Kakollu owned four established dental clinics and was preparing to open two more dental clinics.

In June 2018, Vadlamudi filed a petition for dissolution of the marriage. As presented in Table 1 below, Vadlamudi and Kakollu each submitted values for the business:

Vadlamudi's expert estimated the fair market value of four of the six entities on a controlling basis at $2,712,000 and did not apply a DLOM. Vadlamudi's expert did not value two entities (Lakewood Family Dental of Carmel, LLC and Lakewood Family Dental of Kokomo, LLC) because no financial information was provided. As of June 2018, those two locations were preparing to be opened. Vadlamudi testified that equipment and assets had been purchased for the entities and those values were used to arrive at the entity values.

Kakollu's expert estimated the fair market value of four of the six entities on a controlling, nonmarketable basis at $2,835,600. Kakollu's expert did not include the two start-ups in his overall business value.

Kakollu's expert applied a DLOM of 45 percent, although this DLOM was 60 percent higher than the highest discount generally approved by the IRS. However, Kakollu's expert mentioned in his report that dental practices are easily tradeable because of the ready

Table 1
Lakewood Business Values

Entity	Vadlamudi's Values ($)	Kakollu's Values ($)
Lakewood Family Dental, Inc.	1,181,000	NA
Lakewood Family Dental of Lafayette, Inc.	782,000	NA
Lakewood Family Dental P.C.	681,000	NA
Lakewood Family Dental of Anderson P.C.	68,000	NA
Total Controlling, Marketable Value of Businesses (rounded)	2,712,000	2,836,000
Less: DLOM - 45% (rounded)	NA	(1,276,000)
Total Controlling, Nonmarketable Value of Operating Businesses	**2,712,000**	**1,560,000**
Plus: Lakewood Family Dental of Carmel, LLC (cost basis)	192,587	-
Plus: Lakewood Family Dental of Kokomo, LLC (cost basis)	129,344	-
Total Value of Six Dental Practices	**3,033,391**	**1,560,000**

NA = Not available
Note: All entities were 100 percent owned and controlled by Kakollu.

market of dentists who graduate each year and could purchase the business. Kakollu's expert explained the 45 percent DLOM was based on the fact that 65 percent of the revenue generated by Lakewood was from Medicaid patients.

The trial court found several deficiencies in the application of the DLOM by Kakollu's expert, including the following:

1. There was no indication that Kakollu planned to sell Lakewood.
2. The assertion that 65 percent of revenue generated from Medicaid patients was based on undocumented statements made by Kakollu.
3. Kakollu's expert's report concluded that 65 percent of revenue was Medicaid-based because 65 percent of the company's patients were Medicaid beneficiaries. However, the trial court found this to be illogical because Medicaid procedures were less profitable than private-pay procedures, so the percentage of Medicaid patients should not reflect the percentage of Medicaid revenue.

Due to these deficiencies, the trial court relied on Vadlamudi's expert's value for four of the entities, plus the cost of assets purchased for the two new entities.

In 2021, Kakollu appealed, claiming that the trial court erred in its valuation of Lakewood by failing to apply any DLOM to the four Lakewood locations that were operational at the time of separation.

The Court of Appeals found that the trial court's decision did not err when it valued Kakollu's businesses, stating that the valuation was within the scope of the evidence and not clearly against the logic and effect of the facts and circumstances. It, therefore, upheld the trial court's decision.

Kakollu is another example of a court rejecting a DLOM when valuing a controlling ownership interest due to the lack of indication that the business would be sold. However, a DLOM analysis may also be rejected by a court for lack of support, as discussed in *Cloutier*.[8]

Cloutier v. Commissioner

Joseph R. Cloutier died on December 11, 1989. The Estate of Joseph R. Cloutier (the "Estate") owned a 100 percent interest in Corporation for General Trade ("CGT"). The principal asset owned by CGT was 100 percent of the stock in Thirty-Three, Inc. ("Thirty-Three"). Thirty-Three owned and operated an NBC television affiliate located in Fort Wayne, Indiana.

The Estate and the IRS Commissioner (the "Commissioner") agreed that the value of the CGT stock before discounts was $12.25 million. The Commissioner determined that no marketability discount was applicable, while the Estate argued for a 25 percent DLOM. Neither party relied on the stock prices of guideline publicly traded companies to value CGT.

The Estate petitioned the U.S. Tax Court to rule on the Commissioner's determination of a $1,212,230 deficiency in the federal estate tax of the Estate, using the expert report of R. James Alerding ("Alerding"). Alerding concluded a DLOM of 25 percent by attempting to apply factors cited in *Mandelbaum v. Commissioner* within his three-page report.

The U.S. Tax Court rejected Alerding's opinion as incomplete, unsupported, and, therefore, unpersuasive. The Court concluded that the stipulated value did not represent CGT's freely traded value because Alerding did not use the guideline publicly traded company method in his valuation, so a DLOM was not applicable.

Structuring the Argument for a Discount for Lack of Marketability

Barnes, *Kakollu*, and *Cloutier* demonstrate that courts have liberty to grant or deny DLOMs applied in the valuation of controlling ownership interests in a closely held business. Therefore, valuation analysts must be prepared to defend their application (or lack thereof) of a DLOM in the analysis. As shown in *Cloutier*, it is important for the valuation expert to provide an analysis of the selection of the DLOM that is reasonable and supported by the facts and circumstances specific to the subject company.

In *Mandelbaum*,[9] Judge David Laro cited nine specific (but nonexclusive) factors for analysts to consider in developing a DLOM (the "Mandelbaum factors"):

1. Financial statement analysis
2. The subject company's dividend policy

3. The nature of the subject company (including the history, position in the industry, and economic outlook)
4. The subject company's management
5. The amount of control in the transferred shares
6. Restrictions on the transferability of the stock (e.g., right of first refusal and transferee restrictions)
7. The holding period for the stock
8. The subject company's redemption policy
9. The costs associated with making a public offer.

While not strictly necessary for the analyst to address each Mandelbaum factor, he or she is required to consider qualitative and quantitative information about the subject company to estimate an appropriate DLOM. The application of a one-size-fits-all discount based on the medians of historical data is not an appropriate method for determining a DLOM.[10]

Conclusion

Over the years, courts have vacillated regarding the use of a DLOM in the valuation of a controlling ownership interest. The level of a privately held company's marketability depends on the facts and circumstances of the business and the sale. These facts could include the existence of put rights, dividend payments, the number of potential buyers that exist, the size of the business interest being sold, the availability of information, restrictive transfer provisions, and many other company characteristics.

Ultimately, when estimating a DLOM in the valuation of a privately held business, the valuation analyst should consider qualitative and quantitative factors specific to the subject company, as well as applicable case law within the relevant governing jurisdiction.

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1 Robert F. Reilly and Aaron Rotkowski, "The Discount for Lack of Marketability: Update on Current Studies and Analysis of Current Controversies," American Bar Association, 2007.

2 Robert F. Reilly and Robert P. Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis*, (New Jersey: Valuation Products and Services, LLC, 2019), 250.

3 Fair market value is defined by Revenue Ruling 59-60 as, "[t]he amount at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

4 Bertuca v. Bertuca, 2007 Tenn. App. LEXIS 690 (2007).

5 Barnes v. Barnes, No. M2012–02085–COA–R3–CV (2014).

6 Scott A. Womack, "Changing Tides on Lack of Marketability in Tennessee Courts," Mercer Capital, 2018.

7 Kakollu v. Vadlamudi, 2021 Ind. App. LEXIS 232, 2021 WL 3137204, (Ind. App. 2021).

8 Cloutier v. Commissioner, T.C. Memo 1996-49, 71 TCM 2001 (1996)

9 Mandelbaum v. Commissioner, T.C. Memo 1995-255 (June 13, 1995).

10 "Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals," IRS, September 25, 2009.