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CLIENT ALERT**HOW TO VALUE A CLOSELY-HELD BUSINESS****PRACTICE AREAS**

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ATTORNEYS

JOHN A. DIENNER, III
RAYMOND A. FYLSTRA
CLARKE "MAC" GILLESPIE, III
NOËL P. GOUDREAU
BARRY P. KALTENBACH
ROBERT C. KIMMETH, JR.
DANIEL J. KUBASIAK
GERALD E. KUBASIAK
BERNARD G. PETER
MANUEL J. PLACENCIA, JR.
MICHAEL J. QUINN
STEVEN J. ROTUNNO

When you have a family or closely-held business, issues regarding the value of the underlying ownership interest often arise. The need to determine the "value" of a closely-held business interest comes up in a variety of situations, including the valuation of a departing owner's interest, and valuation of an owner's interest for federal estate or gift tax purposes. Thus, when one of the owners of the Kohler Co. (a well-known manufacturer of plumbing fixtures) died in 1998, owning 12.85% of the company stock, the question was "how much is the stock worth?" The family reported the stock as worth \$47 million, while the IRS thought the stock was worth \$144.5 million. It was ultimately a battle of appraisers, with the family's appraiser convincing the tax court that the family's appraised value was the correct one, mainly because the family's appraiser was able to better support the value it reported.

VALUATION FACTORS

Factors to be considered when valuing the ownership interest of a closely-held business can include: nature and history of the business; book value and financial condition; economic outlook for the specific industry; and market price of publicly traded stocks in same or similar line of business. These facts and circumstances are then applied to the valuation methodology. There are three traditional methodologies used in valuations: (1) the income approach, where value is based on an economic benefit stream to be received in the future; (2) the market approach, where value is based on reference

to other transactions; and (3) the cost or asset approach, where value is based on fair market value of all assets and liabilities.

VALUATION DISCOUNTS & PREMIUMS

Once all facts and circumstances are factored into the chosen valuation methodology, the next question becomes whether the value should be adjusted up or down to reflect certain premiums or discounts. The most common premium is a "control premium," which can be applied when the owner has the voting power to control the company business. There can be as much as a 30% "control premium" added to the value of an interest. Discounts are the opposite of premiums, and can be used to substantially decrease the value of an interest. The two most significant discounts are the "minority discount" and the "marketability discount." A "minority discount" is based on the theory that the minority owner lacks voting power and cannot control the business of the company, and therefore that owner's interests are worth less than the majority owner's interest. A "marketability discount" is based on the theory that closely-held interests are generally not readily transferable because no ready market exists. When taken together, these two discounts can total 40% or greater decrease in value. Whether discounts will be applied is often a matter of whether "fair value" or "fair market value" is being determined. When "fair value" is being determined, discounts are generally not applied.

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Two First National Plaza | 20 South Clark Street | 29th Floor | Chicago, Illinois 60603
312.630.9600 [voice] | 312.630.7939 [fax] | www.kftrlaw.com

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VALUATION OF A CLOSELY-HELD BUSINESS

“FAIR VALUE” VS. “FAIR MARKET VALUE”

Many states' statutes give minority owners the power to dissent from certain company actions, such as a merger, and to instead receive “fair value” for their interests. Similarly, many states' statutes give minority owners the power to demand that the company redeem the owner's interests for its “fair value” in certain circumstances. “Fair value” is a legally created standard that is not necessarily the same as the market's determination of value. In Illinois, the “fair value” of stock is defined as “the proportionate interest of the shareholder in the corporation, without discount for minority status or, absent extraordinary circumstances, lack of marketability, immediately before the consummation of the corporate action to which the dissenter objects excluding any appreciation or depreciation in anticipation of the corporate action, unless exclusion would be inequitable.” Thus, absent special circumstances, no discounts would be applied in the valuation of stock when dissenters or minority rights come into play. Unfortunately, there is no similar statutory language regarding interests in limited liability companies. Thus, it is unclear whether, in Illinois, discounts would be applied to limited liability company interests.

In either case, however, if there is a definitive written agreement addressing the valuation of the interest of a departing owner, that agreement will control and will override the language of the applicable statute. Absent such an agreement, there is always a risk that the owners will disagree as to the

appraisal standards and criteria to apply, which in turn brings the possibility of a lawsuit. Illinois courts have very broad discretion in determining “fair value,” and such discretion gives the court wide latitude. Although the question of how to value a closely-held business interest is a familiar one in American courts, courts are all over the board with their determinations and there is never a guarantee of a good outcome.

Unlike “fair value,” the determination of fair market value will consider market realities. The “fair market value” is the price a hypothetical willing buyer would pay a hypothetical willing seller, neither under any compulsion to buy or sell, and both having knowledge of the relevant facts. Discounts are generally applied in a “fair market value” analysis. Under federal tax law, the value of a gift or a decedent's gross estate is based on the “fair market value” of the gift or of the property owned by the decedent on the date of death. However, the application of the “fair market value” standard is not straightforward, and the IRS often takes a dim view of “fair market values” asserted on returns, leading the IRS to frequently challenge such values. A review of tax cases makes clear that, to sustain the appraised value as reported on a return, that value should be supported by appraisers who are experienced in valuing closely-held businesses, familiar with the underlying company, and follow uniform, national appraisal standards.

WHAT YOU CAN DO

Proper business and estate planning can help minimize the risk of litigation on the issue of valuation of closely-held business interests. To learn more about this issue and others affecting closely-held businesses, please visit Gerald E. Kubasiak's new blog at <http://www.jerrysblawg.blogspot.com>.

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