MARKETABILITY DISCOUNTING ISSUES
for ESOP ACQUISITIONS OF MINORITY SHARES

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Introduction

When an independent financial advisor is hired to assist an owner in selling a business business, one expects that advisor to help secure the best possible deal (e.g. highest price) available. Of course if you're the buyer of that same company, you expect your advisor to help you determine and negotiate the lowest possible purchase price for the shares of that company. Unfortunately some consultants who serve as financial advisor to ESOP fiduciaries seem to miss this point and inform their clients that they need not take into account a full discount to reflect the limited marketability of the minority interest shares that are involved in a transaction.

The concern is that fiduciaries who are responsible for looking after the interests of the employees they represent may be overpaying for the shares they are buying. This would be a "prohibited transaction".

Marketability discounts are intended to reflect a hypothetical buyers' concerns regarding the absence of a ready and available market when they decide, in turn, to sell. The word "hypothetical" underlies this discussion, as the Internal Revenue Service and the Courts have repeatedly required that the willing buyer and seller contained in the long-standing definition of "fair market value" be hypothetical and not a specific buyer who might have other benefits associated with the ownership of the interest being acquired.

Standard of Value

The standard of value to which this paper applies is the fair market value of non-marketable minority interests Underlying the definition of fair market value is the concept" of a hypothetical" investor. Both the Internal Revenue Service and the Courts have repeatedly required that the willing buyer and seller contained in the long-standing definition of “fair market value” be hypothetical.

From the point of view of the fiduciaries the issue should be simple. Do they want to put themselves into a situation where they might at some future date have to argue that they did not purchase the shares on the lowest possible basis? For if they have not taken into account the lack of liquidity of the shares they are purchasing, they have not purchased those shares at their lowest basis.

Put Option Argument

The so-called put option that is granted to the ESOP’s employee participants is an insubstantial reason not to discount the value of the shares. The argument that the existence of the option reduces or eliminates the inherent lack of liquidity in closely-held minority interests is at best specious and misguided and at worst fallacious and dangerous. After all, the fiduciaries that make the decision to purchase those shares for an ESOP trust have no put option.

The fiduciaries cannot cause the company sponsoring the Plan or the seller to repurchase the shares. Getting to the heart of the matter, the put option is not an attribute of the shares but, rather, of the ESOP itself. There is a fundamental difference between the terminated ESOP participant having the right to sell his or her shares after receiving a distribution of stock and a put option that is part and parcel of the security itself. A put is “a contractual right that entitles the holder, at his option, to sell the stock to a specified party at some time or under some specified circumstances, at the price or mechanism for determining the price specified in the contract.”

In the case of an ESOP trust’s ownership of minority shares, there is no contractual right entitling the fiduciary-buyer (responsible for making the decision as to whether to purchase the shares) of the shares to sell the stock to any party, at any time, or at any price. The shares are subject to a put only after the ESOP buys them and then, at some unspecified future dates, distributes them to participants.

The ESOP cannot turn around and sell the shares to a third party at a price that includes a value for the put since the next buyer would not have that contractual right and wouldn’t pay for it. Why would an informed and willing hypothetical investor pay for an attribute from which he could never benefit? The answer is that in the “real world” he would not.

Although securities can be designed so as to contain a put provision, a seller of stock to the ESOP typically has no put on his shares. Therefore, the seller would not and should not expect to be paid for what he does not own.

Any hypothetical, willing and informed third party investor who might be willing to purchase the shares would unquestionably expect and demand such a discount. ESOP fiduciaries are in this precise situation and should not make a purchase of minority shares unless the purchase price includes an adjustment to reflect the limited marketability of those shares.

The ESOP cannot turn around and sell the shares to a third party at a price that includes a value for the put since the next buyer would not have that contractual right and wouldn't pay for it. Hence, the ESOP should not be forced (or allowed) to pay for the put as though it was an asset of the seller when, in fact, it is an attribute of the ESOP and the ESOP should not pay for what it alone *brings to the table*.

Size of the Marketability Discount

The size of the specific discount is subjective and accordingly is certainly open to discussion. There is no predictive model that can be employed to objectively and accurately quantify the discount to be applied in any given (ESOP or non-ESOP) valuation circumstance. However, there is no justification for an appraiser to use a lower discount level in an ESOP valuation than there is in an appraisal for any other purpose where the standard of value is the same. Put another way, a hypothetical buyer in an ESOP situation should not pay more for the same security at the same point of time than would a hypothetical buyer conjured up for an estate tax valuation. If the discount for limited marketability is smaller in the ESOP scenario than in the estate tax scenario, then the ESOP presumably would be paying more for the same stock than would the conjectural estate tax buyer.

Empirical studies have quantified discounts applied in the context of a hypothetical investor purchasing closely-held shares. As stated above, there is a considerable subjectivity that is brought to bear in the selection of the actual percentage to be applied. Generally, the studies indicate that mean discounts to account for the limited marketability associated with closely-held minority shares have ranged from approximately 23 percent to approximately 45 percent. Considering all of this and whether it is referred to as a "discount for limited marketability", "liquidity adjustment" or "allowance for illiquidity," it is difficult to see how no discount or a discount of 5 percent or 10 percent is anything more than window dressing.

And, since the guideline standard is unquestionably fair market value that presumes a hypothetical investor where one of the key criteria is the market for those shares, why would (and how could) an independent appraiser/financial advisor opine that the acquisition of such shares (valued with little or no regard as to their marketability) would not be in excess of their fair market value?

So-called Marketable Minority Interest

Despite the fact that it has been clearly shown that the ESOP fiduciary should not pay more for the shares than would a hypothetical third party, too many appraisers have applied the concept of a “marketable minority interest” for too long. Since the ESOP does not have the right to put its entire holding back to the employer, the concept of a marketable minority interest is indefensible and unfair to the ESOP participants. The U.S. Court of Appeals for the Seventh Circuit found this to be the case in Eyler v Commissioner of Internal Revenue. In this case the court found that even with the presence of a put option, the valuation in question was in error because a discount for marketability had not been applied.

Importantly, the IRS more recently has applied the Eyler case in audit situations to challenge appraisals for ESOP transactions involving minority interests when a marketability discount is zero or deemed too small.

What is sometimes lost in the process of putting together a transaction is that sellers of minority holdings are not hurt by the application of a marketability discount versus what they could obtain from a third party. In fact, since many are selling to an ESOP with the intent of obtaining Section 1042 tax deferred treatment --- often allowing them to permanently defer capital gains taxes --- the sellers are already receiving bonus value over what they would receive by selling to a hypothetical third party. It is inappropriate and unnecessary to induce them to sell their minority interests by offering what amounts to a premium price by not reflecting the shares’ inherent limited marketability in the valuation of the shares.

Department of Labor Rules Are Out of Date

When Congress enacted ERISA in 1974, the Congress directed the Department of Labor to establish rules governing the conduct of an independent appraisal. In 1988 proposed regulations pertaining to the definition of adequate consideration were issued by the Department of Labor (DOL). In 1992 the DOL announced that it was no longer working to finalize these rules. The proposed regulations, which are now approaching twenty years old, indicate that in the conduct of an independent appraisal, one may apply a lower than average marketability discount in cases where there is a put option and sufficient liquidity to make repurchases. The regulations use the words "diminish" and "reducing" and avoids the word "eliminate", at least indicating official prohibition at the time of their issuance against using a zero percent discount to reflect the limited marketability of the shares being valued.

It certainly appears clear that the Department of Labor misunderstood the definition of “fair market value” as it relates to the necessity to construct a valuation with the hypothetical investor in mind. It is highly probable that should the DOL ever finalize its regulations, the words "diminish" and "reducing" may come out and there will be more emphasis on the hypothetical investor issue. Irrespective of whether the DOL ever finalizes the regulations, the IRS seems likely to continue to concentrate on the inclusion and the appropriate size of a discount for marketability.

It is unwise for the appraiser or the fiduciary to rely on the proposed regulations (as they were originally issued and currently exist) as a rationale or safe-harbor to exclude or minimize a discount for the limited marketability associated with closely-held shares for purposes of a valuation in connection with an ESOP's acquisition of a minority interest.

Appraiser's Role

The work product of the qualified independent appraiser is designed to provide assurance to the Plan fiduciaries that the ESOP is not acquiring employer securities in excess of their fair market value. In this sense, the appraiser acts as financial advisor to the ESOP fiduciary. Even if the ESOP fiduciary is sophisticated in ESOP valuation issues, he still relies on the appraiser to do what needs to be done in order to affirm that the ESOP is not entering into a prohibited transaction when it acquires shares. It is the appraiser's obligation to stay informed and to keep the clients informed on important developments that can affect their decision to rely on the conclusions contained in the appraisal.

This role is not played properly when the appraiser writes into the engagement letter a provision that the appraisal will be determined on the so-called "marketable minority interest" basis and then writes a limiting condition into the appraisal report that the appraiser has been directed to determine the value on a "marketable minority interest basis."

In fact, in the face of the IRS position in the Eyler case, a valuation opinion rendered on a marketable minority interest basis may even be reckless and may put the fiduciaries in a precarious position in terms of their potential liability; one in which they ought not be.

Conclusion

The only times the appraiser (or anyone else) knows with certainty whether the opinion rendered is correct is when the Company is sold or if a court renders a decision on value. Absent a sale of the firm or a court decision, it is the obligation of the independent appraiser to act ethically in the determination of a fair and reasonable price upon which ESOP purchases can occur. Clearly, the financial advisor who represents the ESOP fiduciary (and hence the employees who are not in position to represent themselves) should not be arguing for the highest value but for the lowest. As part of this process, the ESOP appraiser needs to determine and include a marketability discount which takes into account the full definition of fair market value including the assumption of a hypothetical investor before the opinion should be relied upon by the fiduciaries of the ESOP.