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The Whole May Be Worth Less Than the Sum of Its Parts

IN THE context of a marital dissolution, New York's Equitable Distribution Law often requires determination of fair market value of spousal interests in closely held companies. This presents a challenge to the valuator since there is no public market for spousal interests in closely held companies. Hence their value must be determined by separate financial analysis.

This challenge, however, is not unique to an experienced valuator who, in determining the fair market value of spousal interests in closely held companies for matrimonial purposes, will often refer to the guidelines used in valuations for estate and gift tax purposes.

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Thus, as a general proposition, the rubric of Revenue Ruling 59-60, the willing buyer-willing seller rule, together with a list of factors to consider in determining fair market value, will apply.

Under New York's Equitable Distribution Law, the court generally will value assets as of the commencement date of the lawsuit but may value them on any other date it deems appropriate.¹

When called upon to value a spouse's interest in a diversified company, e.g. with independent affiliates or subsidiaries, a valuator may reach a conclusion that the matrimonial judge may find perplexing and the non-titled spouse just plain unfair: the diversified company may be worth less than the sum of its parts.

In performing a financial analysis of spousal interests in a going business, the valuator will consider a variety of

analytical approaches, some or all of which may be applicable to the interests under scrutiny.

Going Concern

Going concern valuation analysis of business interests, the most frequently used of these, considers several of methodologies. A valuator may select one or more of these methodologies based upon factors unique to the enterprise.

The most commonly used of these methodologies is comparative company analysis. Under this approach a valuator compares the financial performance of the company in question against that of an array of usable entities for comparative purposes. These entities are generally public, and where controlling interests are to be valued, recent transactions involving comparable interests are used in order to draw inferences of value based on multiples of revenues, earnings or assets.

The comparatives are picked by identifying the SIC Code (the Standard Industrial Classification Code of the U.S. Department of Commerce) of the company in question and consulting specialized computer database or hard copy sources, to find public comparatives in the same SIC Code.

From the large number of companies found in the search, it is necessary to winnow out those not sufficiently comparable by reason of size, nature of business or other elements.

It is often necessary to make accounting adjustments on the company

to be valued on items like inventory accounting and depreciation to create apples and apples comparisons between that company and the comparatives.

Once the comparatives have been picked and all necessary financial adjustments made, the historic financial performance of the company to be valued is compared to the comparatives in terms of growth in revenues and profits, profit margins, returns on equity and assets, balance sheet liquidity, debt/equity and other ratios.

From these comparisons one can determine how well or poorly the company has fared against the comparatives and assign a proper multiple of revenues, earnings or assets based upon the multiples of the comparatives. The drawback of this approach is that some privately owned companies will have few or no usable comparatives.

Discounted Cash Flow

Discounted cash flow analysis discounts a company's net free cash flows over an extended period at an appropriate risk rate and adds a terminal value computation to reflect the value of the theoretical perpetuity of the company's cash flows.

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Net free cash flows are defined as net income, plus depreciation and amortization minus capital expenditures. These net free cash flows are discounted over a five to 10 year period. The discount rate is determined by developing the company's weighted average cost of debt and equity capital.

Terminal value is typically expressed as a multiple of the company's net free cash flow in the final year of cash flow, discounted to present value at the rate used to discount the cash flows.

Non-Going Concerns

Among the non going concern forms of analyses, liquidation value analysis may properly be used where liquidation is in process or foreseeable or where the company is worth more dead than alive.

A second form of non going concern analysis involves developing a fair value balance sheet for the company in question. In such analysis, each asset and liability on the company's balance sheet is converted from cost to market. From this value, discounts for liquidation costs including taxes, legal, accounting and appraisal fees and the time it takes to liquidate must be considered.

The company, or, in the case of a diversified company, each affiliate, must be valued using one or more of the approaches just described to arrive at freely traded minority interest value.

To this value, there may be, in the case of control blocks, an addition to freely traded minority interest value in the form of a control premium whose amount depends on the size of the block, the attractiveness of the company and other factors.

Control premiums are determined by considering premiums paid in sales of control of companies in the same or similar SIC code as the subject company at dates as close to the valuation date as possible or, absent such data, control premiums more generally applied.

While premiums from zero to in excess of 100 percent may be found, control premiums for public companies are often 30 percent-50 percent in excess of freely traded minority interest value.

Smaller premiums are often found when valuing controlling interests in private companies, presumably because of the limited marketability of the shares of such companies.

In the case of minority non-control-

ling interests, a discount from freely traded minority interest value for lack of marketability and minority interest often attaches.

One means by which to quantify the discount is to examine the discounts observable in private placements of minority interests of publicly traded stock.

While a wide range of discounts and occasional premiums are seen, the median of such discounts are most often 20 percent-30 percent from the freely traded minority interest value.

However, since the companies studied in these private placements are public, such placements typically come with registration rights and the ability to sell under Rule 144. Thus, minority interests in closely held companies often carry higher discounts, often 35 percent-40 percent from freely traded minority interest value, to take into account the inability of holders of such interests to avail themselves of the liquifying features resulting from registration rights and the ability to use Rule 144.

Diversified Company

In the case of diversified companies, freely traded minority interest value may properly be reduced to reflect the fact that the hypothetical buyer of the block of stock in question is unlikely to equally desire each corporate affiliate.

Assume hypothetically Lorco, a company with three wholly owned subsidiaries, Luxco, a lighting equipment manufacturer, Landco which owns commercial real estate and Lesco which leases railway boxcars.

Each of Luxco, Landco and Lesco should be valued using the methodologies described above, with parent company expenses allocated to each as a percentage of revenues, profits or assets to arrive at freely traded minority interest value.

However, it is unlikely that any buyer of all of Lorco would have an equal interest in Luxco, Landco and Lesco because their businesses are so diverse.

Given this fact, such a buyer might attempt to sell off the assets of the companies in Lorco that were unwanted. In disposing of such assets, the buyer would: (i) assume the risk of not realizing the pro-rata value in Lorco on the sale of one or more of Luxco, Landco or Lesco; (ii) incur legal, accounting and other costs in the disposal process; (iii) lose the time value of money between the time he/she paid for the shares of Lorco and the time a disposition of one or more of its subsidiaries took place; (iv) be

compelled to devote management time in the disposition process and thus be unable to allocate it to other productive activities.

Alternatively, a buyer prepared to keep Lorco as he/she found it, would, in the real world, pay less than the sum of the values of Luxco, Landco and Lesco, because not all of these companies were equally desired and because most investors prefer single line companies to conglomerates.

Discount

Given the disabilities described above, it is appropriate to discount the freely traded minority interest value of Lorco due to its status. Over the better part of the past 20 years, most diversified companies have sold at discounts to single-line companies.

With some conspicuous exceptions such as General Electric, the financial world has abandoned the 1960's mergers and acquisitions premise that diversification creates increased value, a theory that works well when one buys a portfolio of securities for investment but which has generally not worked well in instances where control of entire companies is involved.

That the whole of a diversified company is often worth less than the sum of its parts was borne out in the LBO movement of the 1980's when KKR's of the world could sell off acquired assets, pay down deal debt and still have significant corporate assets left at the end.

A means by which to quantify the discount for diversified company status is to compare the price/earnings, price/cash flow and market/book value ratios of the Value Line Diversified Companies, a proxy for diversified companies versus the S&P 500, a proxy for single line companies at the valuation date. While results will vary at different valuation dates, discounts of 10 percent-30 percent would not be untypical. From the figure thus derived, an appropriate premium or discount should be taken.

Conclusion

Valuing equity interests in closely held companies for matrimonial purposes or indeed for any purpose is complex. The valuator may find that when valuating a diversified company, an appropriate discount may be applicable. Thus, the non-titled spouse will see the sum of the marital assets worth less than its individual pieces. While this will surely raise eyebrows (some ire, too) it is the practical result of a proper valuation.

(1) This will usually depend upon whether any fluctuation in value is due to the efforts of either spouse. See, for example, *Greenwald v. Greenwald*, 164 AD2d 706, 565 NYS2d 494 (1st Dep't 1991); *Heine v. Heine*, 176 AD2d 77, 580 NYS2d 231 (1st Dep't 1992).