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Expert Analysis

Seeking Lack-of-Marketability Discount With Minority Discount Poses Risks

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The lack-of-marketability discount is separate and distinct from the minority discount. Each addresses a fundamentally distinct aspect of owning an equity interest in a closely held corporation. The minority discount is designed to reflect a minority owner's inability to control the corporation's affairs. The marketability discount, on the other hand, takes into account the illiquidity of any interest in a closely held corporation resulting from the absence of a ready market over which that interest can be sold and converted to cash. The marketability discount "bears no relation to the fact that the… shares in the corporation represent a minority interest."[1] While New York courts commonly permit the application of a marketability discount, there appears to be a bright-line rule against applying a minority discount.

Recently, in *Cole v. Macklowe*, 604784/99, NYLJ 1202472812444, at 1 (NY Sup Ct, Sept. 25, 2010), the Supreme Court, New York County, refused to allow the defendant to present expert evidence regarding either a minority or lack-of-marketability discount when valuing the plaintiff's 10 percent equity interest in several real-estate holding companies. This decision misconstrues the fundamental differences between the two types of discounts and is inconsistent with existing lack-of-marketability jurisprudence from the Court of Appeals and Appellate Division. Moreover, the decision serves as a warning of the danger associated with introducing the minority discount into the valuation analysis.

'Cole v. Macklowe'

Harry Macklowe is the chairman of Macklowe Properties, a privately owned investor and developer of residential and commercial real estate. Warren Cole was hired by Macklowe Properties as vice president of financing and acquisitions. Over the course of several years, Mr. Cole excelled as an employee, and he became Mr. Macklowe's "right hand man." In 1994, Mr. Macklowe awarded Mr. Cole a 10 percent equity interest in all investment projects going forward as a bonus for his years of exceptional service. That agreement was subsequently memorialized in two separate documents that identified the various projects covered by Mr. Macklowe's offer and specified that Mr. Cole's interests were to be in the form of limited partnership interests or LLC membership interests.

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As the saying goes, all good things must come to an end, and the once close relationship between Mr. Macklowe and Mr. Cole was no exception. In April 1999, Mr. Cole resigned from Macklowe Properties under less than amicable conditions. That same month, Mr. Macklowe informed Mr. Cole that he did not view either written agreement to be binding upon him. Almost immediately, Mr. Cole commenced an action in the New York County Supreme Court seeking money damages requiring Mr. Macklowe to pay him the fair market value of his equity interests in each of the entities that owned the real estate identified in the two agreements.

Mr. Cole's case has bounced from the Supreme Court to the First Department and back numerous times over the last 11 years. In the process, there have been seven published decisions on varying issues ranging from trial bifurcation to the application of discounts. This article focuses exclusively on those portions of the decisions that are relevant to the Supreme Court's exclusion of testimony regarding the lack-of-marketability discount.

Midway through the action, both parties submitted partial motions for summary judgment regarding the method for calculating Mr. Cole's damages. Mr. Cole argued that the written agreements continue to exist into the future and requested 10 percent of all distributions previously made, as well as a declaratory judgment requiring Mr. Macklowe to pay him 10 percent of any future distributions.

In essence, Mr. Cole wanted the court to recognize that he had an ongoing 10 percent interest in the projects. Mr. Macklowe, on the other hand, denied both that the agreements were still in effect, and that Mr. Cole continued to have an interest in the properties. Mr. Macklowe therefore argued that Mr. Cole's only remedy was money damages measured by the market conditions that existed at the time of the alleged breach plus distributions that were withheld from Mr. Cole prior to the breach.

The court agreed with Mr. Macklowe and held that damages should be based upon the total distributions withheld from Mr. Cole prior to Mr. Macklowe's repudiation of the agreements and the value of Mr. Cole's equity interests in the real-estate owning entities based on market conditions that existed at the time of the breach. On appeal, the First Department affirmed the Supreme Court's decision, essentially transforming the balance of Mr. Cole's case to a valuation proceeding such as

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those conducted under Business Corporation Law §623 or BCL §1118.

Mr. Macklowe interpreted both the Supreme Court's and First Department's decisions as entitling him to present expert evidence regarding both lack-of-marketability and minority discounts. Mr. Cole disagreed.

The Supreme Court denied Mr. Macklowe's request to present expert testimony on either discount. In the court's view, Mr. Cole is entitled to the "fair value" of his interests, which it defined as the price "'a willing purchaser in an arms' length transaction would offer for [the party's] interest in the company as an operating business,'" and according to the court, a ban on both discounts is necessary to award Mr. Cole his equity share of the entities as going concerns.

The Supreme Court further noted four additional considerations that it concluded weighed in favor of precluding the use of any discount. First, the court analogized Mr. Cole's claim to recover the value of his interest under a breach-of-contract theory to a dissolution proceeding brought by a minority owner in response to oppressive conduct by the majority. The court believed that discounts are not applied in such cases since doing so would deprive the minority owner of a fair appraisal remedy.

Second, the court interpreted the Court of Appeals' decision in *In re Friedman Realty Corp. v. Beway Realty Corp.*, 87 NY2d 161 (1995), as precluding all discounts—minority and marketability alike—where doing so would reduce the value of the minority owner's interests. Third, the court held that because the LLCs in which Mr. Cole had an interest owned real estate, applying a discount would deprive Mr. Cole of the value that he would have obtained if the real estate were sold on the open market. Finally, the court concluded that since Mr. Cole was in essence selling his interest to Mr. Macklowe, an "insider" to the LLCs, applying discounts would unfairly result in a windfall to Mr. Macklowe.

Discussion

The Supreme Court's decision to preclude Mr. Macklowe from presenting evidence regarding the proper lack-of-marketability discount to be applied is inconsistent with the Court of Appeals' decision in *Friedman*, the progeny of cases that have followed it, and the fundamental nature of the lack-of-marketability discount. Because the measure of Mr. Cole's damages seeks to ascertain the value of a 10 percent interest in various closely held LLCs—an interest that cannot be easily sold—the court should have permitted Mr. Macklowe to present expert testimony regarding the appropriate marketability discount to be applied.

Perhaps the most glaring error in the court's decision was its conclusion that the marketability discount sought by Mr. Macklowe was based upon Mr. Cole's lack of control over the entities. Here, the court confused the lack-of-marketability discount with the minority discount. While the minority discount has been consistently excluded from valuation proceedings, the Court of Appeals has held that "whatever the method of valuing an interest in such an enterprise, it should include consideration of any risk associated with illiquidity of the shares"—a clear blessing of the lack-of-marketability discount.[2] By refusing to allow expert evidence, the court disregarded this directive from the Court of Appeals.

Furthermore, none of the policy reasons advanced by the court warrant preclusion of expert testimony regarding the lack-of-marketability discount. In fact, numerous cases have applied the discount in the presence of the exact same facts identified by the court in *Cole*. For example, the Court of Appeals' decision *In re Seagroatt Floral Co., Inc.*, 78 NY2d 439 (1991), followed the petitioner's commencement of a dissolution proceeding under BCL §104-a, the minority oppression statute, and the corporation's BCL §1118 election to purchase the minority's interest. Under those circumstances, the Court held that it was appropriate to apply the lack-of-marketability discount—even though an "insider" was acquiring the interests. The Second Department in *Blake v. Blake Agency, Inc.*, 107 AD2d 139 (2d Dept. 1985), applied a marketability discount in nearly identical circumstances. Thus, there was no basis for the Supreme Court to conclude that Mr. Cole's efforts to vindicate his minority ownership interests, or the fact that an "insider" would be purchasing those interests, warrant preclusion of the lack-of-marketability discount.

> 'Cole' stands as a sharp warning against requesting a minority discount. It remains clear that such a discount will not be applied, and requesting one just might defeat a request for other discounts.

Nor was the court's emphasis on the nature of the assets owned by the entities (real estate) correctly placed. In *Friedman*, the Court of Appeals permitted the application of a lack-of-marketability discount to reduce the value of a minority shareholders' interest in companies whose sole assets were real estate. The Supreme Court cited *Friedman* in its preclusion order, but misapplied its holding. Other cases, such as *United States Dredging and Jamaica Acquisitions Inc. v. Shea*, 25 Misc.3d 1212(A) (Nassau Co. Sup. Ct. 2009),[3] have also applied the discount where the corporation's sole assets were real estate.

As a 10 percent owner of a LLC, Mr. Cole had no ownership rights to the real estate itself. By concluding that discounts would deprive Mr. Cole of his equitable share if the properties were sold on the open market, the Supreme Court failed to recognize the disconnect between ownership of a corporation or an LLC, such as Mr. Cole had, and ownership of the real estate, which lies in the entities.

Conclusion

It appears that Mr. Macklowe's primary mistake may have been requesting both a lack-of-marketability and minority discount to be applied against Mr. Cole's interests. New York courts have consistently rejected a discount based upon lack of control. There seems to be little upside to requesting one because, in all likelihood, the discount will not be applied. And, following *Cole*, there appears to be only a downside from such a request. A large part of the *Cole* court's decision to reject the lack-of-marketability discount was based upon its erroneous blending of that discount with the minority discount—leading the court to conclude incorrectly that the lack-of-marketability discount is based upon lack of control. Had Mr. Macklowe stayed away from the minority discount altogether, the court would have had no reason to focus any of its analysis upon lack of control, substantially reducing the risk that the court would view it as the basis of the lack-of-marketability discount—and incorrectly reject the lack-of-marketability discount.

Thus, *Cole* stands as a sharp warning against requesting a minority discount. It remains clear that such a discount will not be applied, and requesting one just might defeat a request for other discounts.

1. *Blake v. Blake Agency, Inc.*, 107 AD2d 139, 149 (2d Dept. 1985).

2. *In re Dissolution of Seagroatt Floral Co., Inc.*, 78 NY2d 439, 445 (1991).

3. The authors' firm served as counsel to the petitioners in this case.

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