Chapter 10: Fractional Interests (Business Interests)

Nothing causes more consternation and disagreement among valuation people, business brokers, the Internal Revenue Service and clients, than minority (fractional) interest discounts. This chapter will look at the control versus minority interest issues, with a focus on the presence or absence of control, the control studies available, the marketability of a minority or control position, as well as other discounts.

Introduction

The value of a fractional interest in a business is ordinarily lowered by a discount to account for certain disadvantages of holding this minority position. Discount adjustments to a base business value are usually made by buyers of minority interests, while premiums are sometimes paid for control interests. These adjustments are made to the base values through the cost, market and income approaches to valuing a company. The magnitude of such adjustments depends on whether one is valuing a minority or control interest.

Obviously a buyer who would gain a control interest would pay a premium for this position in order to exercise control. On the other hand, a potential buyer of a minority interest would discount his or her purchase price from the par value in order to account for lack of control. The rationale is that the buyer of a minority interest would want a higher or enhanced yield on his money in order to compensate him for the additional risk and lack of liquidity of the investment.

Although most individuals take discounts or premiums in aggregate for a control or lack of control position, quantifying these adjustments should be made in two steps:

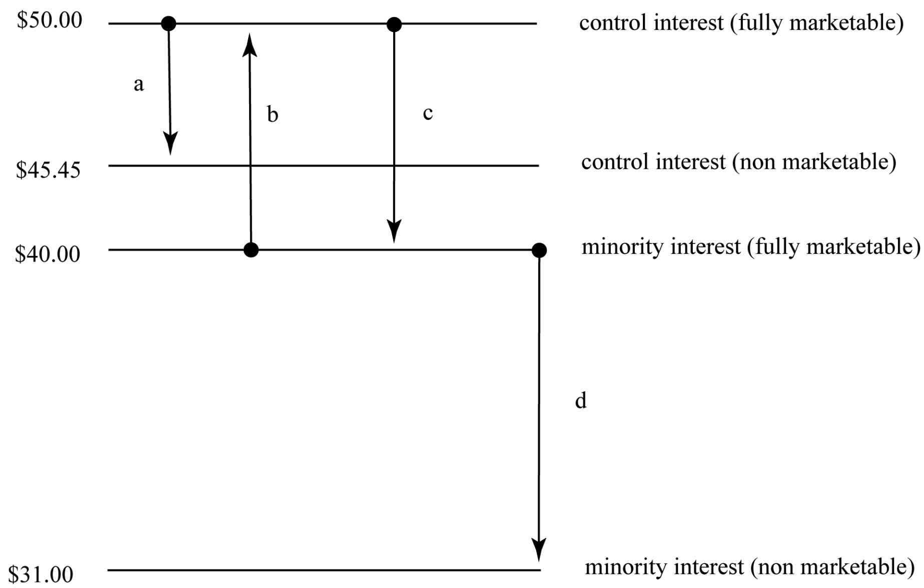
(1) adding a premium to a minority interest for a control position or subtracting a discount from a control interest for a minority position; and

(2) subtracting a discount for a lack of marketability (greater discount is for selling a minority position, with a lower discount for selling a control position).

At first, the firm must be valued to determine whether the subject interest is a minority or control position. Once the first step has been made there may or may not be adjustments made for the marketability of this position. Obviously, it is easier to sell a control position than a minority position.

A graphical presentation of the minority and control interest discussion can be seen in Figure 10-1.

Figure 10-1: Possessory Interests versus Discounts



In Figure 10-1, **Range a** is a discount for a lack of marketability for a controlling interest (9.1%). **Range b** represents a premium over and above a minority interest which is fully marketable (e.g., a publicly traded share). This assumes that a base price of $40.00 per share is the minority share price. The control premium in this case is a 25% premium (difference between $40/share and $50/share). **Range c** represents the difference between the value of a controlling and minority interest, assuming that both interests are fully marketable. In this instance, $50 per share represents control (fully marketable), while $40.00 represents a minority interest (fully marketable). The minority interest is the algebraic equivalent of the control premium. In this case it is calculated to be (0.25/1.25)= 20% (see Equation 10-2 on page 238). Finally, **Range d** shows the difference in value of a minority interest (fully marketable) at $40.00/share and a minority interest which lacks marketability ($31.00/share). This equates to approximately a 22.5% discount for lack of marketability for the minority interest. Notice the difference between the lack of marketability for the control position (9.1%) and that of a minority interest (22.5%).

The rest of this chapter will look at the control versus minority interest issues, with a focus on the presence or absence of control, the control studies available, the marketability of a minority or control position, as well as other discounts.

Legal Entity

The type of legal business entity and the percentage of overall ownership in that entity determines the magnitude of the discount adjustment (if a minority interest is considered), or the premium adjustment (if a majority interest is considered). The types of legal entities to consider are: general or limited partnerships, C or S Corps, or limited liability corporations. Business legal entities have idiosyncrasies which need to be noted before any application of discounts can be made. Sole proprietorships are typically not considered, since they do not involve fractional business interests. These minority interest nuances are summarized in Table 10-1 on page 232. Please see Table 2-17 on page 53 for an overview of the nuances of different business entities.

As will be shown below, the magnitude or lack of a discount is a function of many different variables, and therefore there is no set formula approach.

Classification of Capital Stock

Before applying a control premium or minority interest discount adjustment, it is also important to understand the different classifications of capital stock. Stock shares have different preferences. Sometimes these preferences have elements of a control or minority interest, or lack thereof. There are two basic types of capital stock: common and preferred.

Common Stock

The common stock is the basic ownership equity of a company, having no preference but reaping all residual rewards as well as being subject to all losses. Occasionally, there is more than one class of common stock. In such cases, distinctions between one class and the other are based on the dividend, voting, or other rights. Common stockholders generally control the management of the corporation and profit the most if the company is successful. Common shareholders are guaranteed neither dividends nor assets upon liquidation.

Preferred Stock

Sometimes certain shareholder rights are sacrificed in return for other special rights or privileges. This special class is most typically called preferred stock and is usually preferred in liquidation and preferred as to dividends. It may be entitled to a par value in liquidation or it may be entitled to a premium. However, its rights to dividends are generally fixed, although they may be cumulative, which means that preferred shareholders are entitled to arrearages (accumulation) of dividends before the common stockholders may receive any dividends. In addition, preferred stockholders may sacrifice their rights to control management.

Table 10-1: Entity Discount Overview

Legal Entity*	Most frequently valued position	Comments
General partnership	50% interest for two partners, or a 33% interest for three partners	While a 50% interest (assuming two partners) has elements of a minority interest, the discount is not as great as a smaller interest (e.g., a 45% interest of one partner vs. a 55% interest by the other). Typically, the larger the number of partners, the greater the discount; three partners with two having 49% and one with 2%, the 2% would represent a swing vote and would have a limited discount on its pro-rata share of the company value.
Limited partnership	Usually range from between 1-10% interest for a general partner and between 10-99% for a limited partnership interest	Limited partner has no or limited control and therefore typically has a substantial discount; general partner has control and therefore limited discount for overall marketability; some states allow a 1% interest to force liquidation, therefore check each state's rules; review the Commercial Code in state where operating.
Family limited partnership	Same as limited partnership	Same as above
Real estate limited partnership	Same as limited partnership	Same as above; typically also involves fractional interests in real estate.
C Corporation	Usually a range from between 1-49% for a minority interest or 51% for a control position	Degrees of control or lack thereof need to be weighed; review types of stock and ability to vote or not, and whether fiduciary duty is important in the state of incorporation; similar to comments for general partnership; review the Commercial Code in state where operating.
S Corporation	Same as C Corporation	Similar to C corporation; maximum of 75 shareholders.
Limited liability corporation (LLC)	Similar to limited partnership and S corporation	Has elements of both corporation and limited partnership interests; can have 75 different member classes; commercial code applies in state where operating; member vs. non-member managed LLCs can alter magnitude of discount. Member managed minority interests have more elements of control than non-member managed minority interests.

*Review Commercial Code of each state where business entity is operating.

The characteristics of preferred stock are dividend participation rights, voting rights, and rights of conversion into common stock. Within the preferred stock classes there may be a variety of orders of priority and preference relating to dividends and liquidation rights. In summary, preferred stock gives up *some* degree of control for a guaranteed return on investment.

Sometimes companies can accomplish the same results of a preferred and common class of stock by issuing Class A and B stock. When this has been done, one of the issues is the common stock and the other issue has some preference or restriction of basic rights.

Rationale for a Control Premium or Lack Thereof

Why should one apply a control premium adjustment for a majority position, or a discount adjustment for a minority interest? With corporate stock, a controlling block of shares allows the possessor to elect a majority of the board of directors. The board of directors controls the identity and wages of the company's management, and, therefore, the direction of the business. In addition, the possession of control implies the power to force or stop certain fundamental changes in the structure of the company, such as a merger, sale of assets, liquidation, and so on. These considerations favor controlling interests over noncontrolling interests in all kinds of property. The ability to control current operations, and/or to block dispositions or other major changes, are an additional element of value, the presence of which commands the premium, and its absence warrants a discount.

Other cited reasons for an application of a premium are: the opportunity to improve performance, the safety of investment, the psychic and other nonfinancial values, self dealing opportunities, or superior access to information. *Self dealing opportunities are perhaps the best rationale for providing control adjustments.* This last reason is most applicable to privately held firms.

Determining the Presence or Absence of Control

Attributes of Control

The first issue to resolve is the degree of control that one is valuing. From this point, all discounts or premiums are generated. Control is generally measured by the ability to hire or fire management, set dividend frequency and amounts, cause fundamental changes in the structure or operations of the business, and the ability to liquidate the business. A more elaborate list has been put forward by Shannon P. Pratt, as seen in Table 10-2 on page 234.

Furthermore, the degree of control is reflected by a number of additional factors:

- cumulative versus noncumulative voting
- contractual restrictions
- the effect of regulation
- the financial condition of the business
- the effect of state statutes
- the effect of distribution of ownership

If the company has noncumulative voting with respect to the election of directors, then the company belongs to the majority. If the company has cumulative voting, then some of the value attributable to the ability to elect directors will shift from the majority holder to the minority interests.

The difference between cumulative and noncumulative voting is that cumulative voting allows minority shareholders to accumulate all of their votes and cast these votes among a few director or management candidates, or just one. The ability to accumulate these votes increases the chances of obtaining