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Tales From the Trenches:
The Case of the 70% Equity Interest Valued as a Minority

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Editor's note: This is an article in a series of valuable lessons to be learned based on the experiences of seasoned valuation experts. While you may be able to find some of this advice in books, only real-life experiences can highlight the nuances that can only be found in the minds of the experts who have lived through many engagements. Do you have a lesson to share? Contact the editor at andyd@bvresources.com.

Several years ago, I got involved with a unique valuation for an estate. The estate owned 70% of the common equity of a corporation. During my valuation, I determined that the 70% common interest did *not* have control of the corporation and, in fact, was a minority interest. The IRS audited the estate tax return, and we prevailed on the issue that the 70% ownership interest was, in fact, subject to both a minority and a large marketability discount.

Backstory. Before we get into the nuts and bolts of why we prevailed on that matter, let me provide you with some of the details surrounding the valuation.

- The corporation was in existence since the late 1950s and was now being managed by the third-generation owner (Owner3G).
- The corporation has a semiproprietary product with certain process patents. There are only three or four competitors in the market. Only about 30 customers across the U.S. use the product. Almost all the customers used more than one of the suppliers for the product.
- Although the company had a long history of solid earnings and stable growth, Owner3G bought out the remaining shareholders using cash reserves and incurring some long-term debt. At the time of the final buyout, Owner3G owned 100% of the equity of the company.
- Owner3G had some marital problems, culminating in a divorce, and Owner3G used corporate funds to buy out any marital interest in the company, incurring more long-term debt in the process.
- Owner3G neglected the company, until it was solvent on a balance sheet basis but insolvent on a cash-flow basis. Unbilled sales and accounts receivable had grown to over 250 days outstanding, and inventory turns decreased from approximately 14 per year to two per year. Accounts payable were about 150 days, and the long-term debt was in arrears more than six months.
- The lender finally demanded that Owner3G bring in a turnaround management group (TMG), or it was going to foreclose on the long-term debt.

The bank finally approved a TMG, with the understanding that the TMG would have full day-to-day operating control of the company. The

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TMG provided full-time executive management and used existing personnel of the company for production management. As part of the agreement with the bank, Owner3G transferred all the intellectual property that was held outside the company to the company itself, and the bank relieved Owner3G of his personal guarantee for the debt. The new TMG agreement imposed other conditions including:

- TMG would purchase 30% of the equity of the business for cash. The cash was used to bring payables current, with the balance of the cash being applied to the bank credit lines.
- TMG had a "buy-sell" and "put" agreement in place as it related to its ownership interest. This was a formula agreement and did not reflect any fair market value criteria. No "buy-sell" agreement was in place for Owner3G's shares. TMG also held a "right of first refusal" as it related to the 70% equity interest Owner3G owned.
- Owner3G could appoint one member to the board of directors, while the TMG appointed four members to the five-member board.
- TMG was given absolute veto powers over any action the shareholders took.
- TMG was given a management contract that provided significant management fees be paid each year. However, the payment of those management fees was subject to certain cash-flow requirements, and, to the extent those payments were not paid annually, the unpaid balance carried forward as a preferred "payment" in the future. For the first two years, 100% of the management fees were deferred.
- The company entered into an agreement with the bank that gave the bank veto powers over any capital expenditures in

excess of $25,000 per year, as well as TMG management fees and officers' salaries.

- The bank agreement further stipulated that the company would make quarterly interest payments, guaranteed by the TMG, and that the bank would receive 70% of the annual net after-tax cash flows the business generated as principal repayments.

- Owner3G was given a modest salary and remained as the president of the company, although he had no input into day-to-day management.

Over the next three years or so, the company returned to profitability and financial stability. By the third year, sales and profit margins were increasing, and net after-tax cash flows exceeded $1 million per year, with the bank debt being significantly reduced each year. Projections for Year 4 for net after-tax cash flows was more than $1.5 million.

Estate matter. Unfortunately, Owner3G had what he thought was a minor health issue but, upon going to the doctor, was told he had less than six months to live and eventually died within 90 days of the diagnosis. Since Owner3G had a taxable estate (without his ownership interest in the company), we were asked to become involved with the valuation of his 70% ownership interest in the company.

When we were doing our analysis of the company, we noted that the only way the estate would ever get any value from the shares was when (and if) the TMG eventually decided to sell the company as a whole. There was no provision for dividends, and TMG held effective control of all the financial and operational activities of the company as well as collecting a significant management fee annually. The estate was truly a passive investor, without any way to monetize its investment without TMG's assistance.

Our valuation report contained a significant discount for minority and marketability. Upon initial examination, the IRS ruled against the minority discount, stating that, by definition, a 70% equity interest could not be a minority. It also proposed to reduce the marketability discount because the estate held a controlling issue. When the issue was taken to appellate, we were able to convince the IRS that the draconian restrictions between the TMG and Owner3G's estate did, in fact, create a minority position for the 70% interest, and appellate accepted our positions as to both the minority and marketability discounts.

Lesson learned. Although, on the surface, the 70% equity interest certainly appears to be a controlling block, it is important for the valuator to understand *all* the agreements that impact the ownership interest. In the case at hand, the effective controlling interest was the 30% interest the TMG owned. It had complete control of all operations and cash flows, as well as the ability to monetize the holdings in the future.

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