USE AND APPLICATION OF MINORITY AND MARKETABILITY DISCOUNTS

Minority and marketability discounts are adjustments to the fair market value of stock because the minority interest owner(s) cannot direct or control the business operations and because the minority interest lacks marketability.

KEY POINTS

1. *A minority discount is a reduction in the price of stock from its fair market value because the minority interest owner(s) cannot direct or control the business operations, and because of lack of marketability of the shares.*
2. *There is no obligation to provide a minority discount; it is primarily the decision of the seller of the stock in a closely held business and should be considered in the context of any financing terms extended, and collateral received.*
3. *The most commonly applied discount is approximately 25%, and applied only to sales of stock in tranche one of most succession plans.*

In order to build a business of enduring and transferable value, the founding owner(s) usually construct a model that includes multiple next generation advisors who simultaneously become active investors. This practice model not only greatly increases the options open to founding owners in planning for the succession of their business, but it also raises issues related to selling minority interests to employees, a partner, or family members.

The majority of independent financial service or advisory businesses at this level are structured as either an S-corporation or an LLC. As an entity, the majority owner or owners can set up an ownership track that permits employees, sons and daughters to buy into the Company incrementally, in small pieces, over time, as minority owners. But this buy-in process, regardless of the size of the firm, is always punctuated by questions of value and payment terms, which together, raise the issue of the applicability of a minority discount and lack of marketability discount on the shares or ownership interest being purchased.

A minority discount is only relevant when valuing shares in a closely held or privately owned company. Publicly traded shares are already priced as minority holdings, requiring no discount from the quoted value of the stock. That is not so for minority shares in a private company, such as a financial services or advisory practice.

A minority interest is non-controlling ownership, usually defined as less than 50% of a company's voting shares. A minority discount, at least in the case of an amicable buy-in situation, is a reduction in the price of stock from its fair market value because the minority interest owner(s) cannot direct or control the business operations, and because of lack of marketability of the shares.

A **minority discount** applied to a non-controlling ownership interest in a small business reflects the notion that a partial ownership interest may be worth less than its pro-rata (proportional) share of the total business. For example, ownership of a 25% share in the business may be worth less than 25% of the entire Company value. This is so because this 25% ownership may be limited as to the scope of control over critical aspects of the business, including:

- *Electing the Company directors and appointing its officers*
- *Declaring and distributing profits (dividends or profit distributions)*
- *Entering into contractual relationships with customers and suppliers*
- *Raising debt or equity capital for the Company*
- *Hiring and dismissing employees or officers of the Company*
- *Selling the Company or acquiring other operations*

The key to whether a minority interest discount applies to an employee's purchase of shares in the business where they work is the degree of control that they may exercise or lack as a minority owner. Control in these situations can be measured in three ways. The first is the percentage of ownership. Second, is the ability to influence management or the majority ownership structure (which is often just one or two other owners). Third, control also may be measured by the influence a minority owner has over the clients they personally serve.

A **lack of marketability** discount is available in situations where a company's shares cannot easily be sold on the open market to a wide range of buyers because the Company is closely held or imposes restrictions on the transfer of its shares. For many closely held companies, including independent financial services and advisory practices, there is little or no market for transferring or selling less than all of the Company's outstanding shares. To make matters worse, the liquidity of some shares is further restricted by a company's Buy-Sell or Shareholders' Agreement, may be contingent on employment, and may be set up as non-voting (even in an S-corporation) for the sake of administrative expediency by the majority owner(s).

In practical terms, the applicable range of discounts is generally between 10% and 40% percent – though it is imperative that every owner and investor confer with their CPA/accountant as to what is reasonable and appropriate in each situation. The amount of the minority discount is not set or specifically established by law. It depends on a number of factors and is adjusted for a given situation, rather than being applied as a universal standard. Note that it is appropriate to calculate separate discounts for lack of control and lack of marketability, but the cumulative total should be within the range of 10% to 40%. A discount, if offered, should be applied fairly and evenly. For example, if a 10% interest in the Company is being sold to two investors at or at about the same time, the same valuation method and the same level of discounting (if any) should apply to each sale.

Consider that in most internal sales of independent financial services and advisory businesses, the owner or seller of the stock almost always provides very generous financing terms enabling the purchase of the minority shares, perhaps even providing the funding through profit distributions or a salary increase or bonus. Also consider that, in the majority of cases we work with, the minority owners have a direct path to majority ownership upon the founding owner's death, disability or retirement, usually through a written continuity or succession plan (i.e., a Buy-Sell or Shareholders' agreement), which also, again, is usually accompanied by very generous, long-term financing terms from the founding owner or the Company.

The FP Transitions Comprehensive Valuation Report ("CVR"), which serves as the first step in the Succession Management Program, provides a valuation of the entire financial services practice. The CVR focuses on the open market value of 100% of the assets of a going concern. Owners and their new minority interest shareholders are then left to determine if the value of the Company should be adjusted for an internal stock sale given the circumstances of the overall plan and the individual transactions necessary to support that plan, and then whether to apply a minority discount to the particular shares of each Advisor/Investor.

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