RE-THINKING DISCOUNTED VALUE FOR LACK OF MARKETABILITY IN SALE OF CLOSELY HELD BUSINESS INTEREST

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Courts are frequently called upon to set valuation formulas in closely-held-business disputes. Determining the appropriate formula is a fact-sensitive inquiry. Should buyers pay a premium for businesses formed as S-corporations? Should a seller take a discount because she's a key employee?

In *Zelouf International v. Zelouf*, the New York State Supreme Court Appellate Division recently rejected a purchasing shareholder's request that a "Discount for Lack of Marketability," or DLOM be applied in determining the target company's fair value, and ultimately questioned whether DLOMs are ever appropriate in appraisal actions.

A DLOM is an adjustment that reflects the liquidity risk in owning closely held businesses and can affect valuations by up to 30 percent. Under a DLOM, in a transaction between company shareholders, the selling shareholder's interest may be discounted because the purchasing shareholder will have difficulty selling the entire company to third parties at a later date.

In *Zelouf International*, Nahal Zelouf, a 25% shareholder of her family's textile company, asked the court to determine the fair value of her interest when her nephew and brother-in-law (who collectively owned the remaining shares) forced the sale of her shares. The purchasers argued that courts *must* apply DLOMs when determining a closely held company's fair value since any potential purchaser would encounter difficulties if, in the future, they ever sold the business. In short, they asked the court to pass downside risk through to the sellers.

The court found no evidence that the purchasers in *Zelouf International* would ever sell the company, and therefore held that applying a DLOM was unwarranted. The court also suggested that DLOMs are rarely, if ever, appropriate in appraisal actions, reasoning that sellers shouldn't absorb speculative risk associated with uncertain contingencies. Citing authorities that included prominent New Jersey and Delaware cases, Justice Kornreich noted that judicial fondness of DLOMs is waning. The decision also cautions that courts should not use DLOMs as proxies for minority discounts, which New York law proscribes.

Practitioners should be vigilant regarding further developments.