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BEST PRACTICES REGARDING CONTROL PREMIUMS: COMMENTS REGARDING THE APPRAISAL FOUNDATION'S PROPOSED WHITE PAPER ON CONTROL PREMIUMS[1]

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After everything that has been written over the past 20 years on the topic of control premiums,[3] it is surprising that so many business valuers[4] still cannot understand why public company shares do not trade as minority interests, and why it is bad practice to add a control premium when valuing a private company using public company data. This paper will further the arguments against control premiums with some new observations that will extend and clarify these concepts. The conclusion of this paper will discuss the dangers of a *Daubert* challenge if one is applying control premiums, both in an accounting and financial reporting context as well as in more general cases.

The Problem of Language

Business valuation as a profession is fairly young. Although people have been valuing businesses for hundreds of years, and the CICBV and ASA have been accrediting business (intangible asset) valuers and appraisers since the 1970s, prior to the 1980s it was essentially a cottage industry. Professionals worked with pencil and paper, slide rules and pocket calculators. With the introduction of the personal computer thirty years ago, valuators gained the ability to work with numbers on automated electronic spreadsheets and produce reports using word-processing software. These advancements greatly reduced the time and cost for both professionals and clients. The advent of the Internet in 1995 further leveled the playing field and reduced costs for valuation professionals, setting the stage for rapid expansion of both supply and demand for business valuation services.

1 The following article is a distillation of the comments of Eric Nath in a panel discussion on the Appraisal Foundation's proposed White Paper on control premiums presented to the ASA/CICBV Advanced Business Valuation Conference in Miami, Florida on October 6, 2010.

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3 Many articles have been written on the topic of control premiums. See, for example:
Gilbert E. Matthews, "Misuse of Control Premiums in Delaware Appraisals", Business Valuation Review, Summer 2008, pp 107-118, Lawrence A. Hamermesh and Michael L. Wachter, ''The Short and Puzzling Life of the 'Implicit Minority Discount' in Delaware Appraisal Law,'' 156 U. Pa. L. Rev. 1 (2007), pp. 3–4, Richard A. Booth, ''Minority Discounts and Control Premiums in Appraisal Proceedings,'' 57 Business Lawyer 127 (2001), Eric Nath, "How Public Guideline Companies Represent 'Control' Value for a Private Company", Business Valuation Review, December, 1997, pp 167-171, Eric Nath, "A Tale of Two Markets", Business Valuation Review, September, 1994, pp 107-112, Eric Nath, "Control Premiums and Minority Interest Discounts in Private Companies", Business Valuation Review, June, 1990, pp 39-46.

4 This paper, written for an international audience, will use the terms "valuers" and "appraisers" interchangeably to mean professionals involved in business valuation.

Although the technological capabilities of business valuers have evolved dramatically over the last three decades, some of the language and labels used to describe the concepts and the techniques employed in the profession have not kept up. Unfortunately, this slower evolution of the language has allowed many myths to take root and become embedded in the profession. One myth is that public shares trade as minority interests, and therefore convey no control to their owner. A related myth is that premiums paid for public companies in takeovers are indicative of the differential between minority value and control value. If one believes these myths then the obvious corollary is that the reciprocal of a control premium is a minority interest discount.

Language affects the way a culture thinks about and understands the world. In the business valuation profession, the language of "control premiums" has created misunderstandings that have continued to confuse many. Therefore, closer look at the language of control premiums is key to unlocking the logic and conclusions that public shares do not trade as minority interests, and that control premiums should not be used in business valuation (at least not in the traditional way[5]).

In the eyes of most business appraisers, a "control premium" denotes a premium paid in the takeover of a public company. This term entered the lexicon in the 1980s, and was so named based on the superficial observations that public company shares trade as non-controlling blocks, and premiums are generally offered by buyers interested in taking over a public company. On the surface, this differential in price appeared to quantify the value of control. Gigabytes of data have been generated and untold time devoted to analyzing so-called "control premium data" from public company acquisitions.

At the same time, the term "marketable minority interest" was invented as a way to describe what was understood to be the essential nature of shares in the public market. The reason that a public market price was thought to represent "minority" value is that public shareholders have none of the prerogatives of control such as the ability to hire and fire management, borrow money, make acquisitions, sell the company, etc. As a non-controlling block of stock that is nevertheless marketable, the term "marketable minority interest" seemed an obvious representation of what it was like to own shares of a public company.

It was only a short step from there to supposing that when valuing a private company, based on some form of public company analysis, the result was a "minority value." Furthermore, this was said to be true whether the public market data was applied as a multiple under the market approach or as a cost of capital input in the income approach. And, of course, if minority value from the public market is the base from which value is initially derived, then to develop a controlling interest value for a private company, or to determine potential impairment to value of a public company's operating unit on a control basis for financial reporting purposes would require the application of a "control premium" — which could conveniently be based on the so-called "control premium data" from public company takeovers.

5 Traditionally, one adds a "control premium" based on public company takeover premiums to a "marketable minority" level of value in order to obtain a "control-marketable" level of value. Some practitioners are now evaluating the differential in control versus minority at the cash flow level rather than through explicit premiums or discounts. This is an entirely different methodology which may be appropriate in some instances, but it will not be covered in this paper.

The Myth of the "Marketable Minority Interest"

One of the principles being proposed in early drafts of the Appraisal Foundation's White Paper on control premiums is that "control" is an "investment attribute." This concept is important, and true. It deserves deeper exploration in order to properly evaluate any final pronouncements in the Appraisal Foundation's White Paper.

For many business appraisers, it is difficult to understand how a small block of public stock doesn't represent a minority level of value. The answer begins, and really concludes, with the fact that public shareholders have total control over their investment. Goldman-Sachs buys and sells the same stock within the space of less than half a second: they surely have total control over their investment. Nor is this a special case — most investors in the public market have the ability to buy and sell within minutes, if not seconds. If "control" is an "investment attribute," then virtually every public shareholder has total control over their investment. This fundamental investment attribute of owning public stock has been ignored in almost every discussion about "control premiums" and "marketable minority value." Instead, the only issue discussed concerning "control" in a public market context is whether or not a public shareholder can exercise *management* control (i.e. hiring, firing, selling, etc.). But that completely misses the point. Except for large activist investors, no public shareholder has the least interest in anything to do with management control; it would defeat the whole purpose of having a public stock market in the first place! Public markets exist to allow investors the opportunity to easily invest (or disinvest) in companies without requiring any management skill or management responsibility whatsoever on the part of the investor. Management is intentionally outsourced. So, if public stockholders have total control over their investment and that is the only control they want or need, then how can a premium paid in the takeover of a public company possibly have anything to do with the differential in value between minority and control?

In addition to the fact that ownership of public shares conveys to the investor complete control over the investment itself, discussion in the literature concerning public company acquisitions has almost never acknowledged or even considered the fact that every sale of a public company has involved a control-level seller. Those who claim that premiums paid to acquire public companies somehow quantifies the differential in value between lack of control on the selling side and full control on the buying side are forgetting that every public company is actually controlled by a board of directors. The board, in turn, controls management, which exercises tactical control. Finally, it is not necessarily a foregone conclusion that the board of directors cannot be restructured by the shareholders, who represent a third level of control. So, in reality, there are three layers of control in a public company. Once one understands that a sale of a public company is nothing more or less than a transaction between a control seller and a control buyer, it becomes obvious that an acquisition premium for a public company cannot possibly have anything to do with the value of minority versus control.

To help avoid these misconceptions it would help to abandon the terms "marketable minority interest" and "marketable minority level of value" in favor of more to-the-point terms such as "public market value," "public market equivalent value" or perhaps "as-if publicly-traded value." These are better descriptors of what we are really talking about that will help us avoid controversies which seem to be over valuation theory but which are actually linguistic misunderstandings.

The Myth of the Control Premium

If premiums paid in takeovers of public companies have nothing to do with issues of minority value versus control value, why then are premiums usually paid in such acquisitions?

The answer is very simple. Besides the fact that everyone who owns an asset always wants to get the highest price in a sale, a more technical reason is that every seller has an opportunity cost which a buyer must overcome. Public shareholders face the same choice as any other control seller when asked to sell their shares in a tender offer: could I realize a higher return if I don't sell, and if so, how long might it take me to realize a better return — and what are the risks in the meantime? For example, if the stock of a given company is expected to appreciate in value at 10% or 15% over the next year or two, then today's bird-in-the-hand of a 30% or 40% premium might make sense, particularly if this premium is validated by a reasonably rigorous auction.

On a more mechanistic level, acquisition premiums are simply a manifestation of the laws of supply and demand in a liquid market. When buying pressure is put into the system (e.g. an M&A buyer makes a tender offer), the supply and demand curves shift and the price naturally goes up. This is simply Economics 101. The very same market reaction occurs when there is unexpected good news for a company; the stock price charts of public companies under both types of buying pressure tend to look remarkably similar, with higher relative volume and a jump in stock price. It doesn't take a tender offer for a stock to jump 30% in a day, and in fact most high volatility stock market action on the upside occurs in the absence of any proposed takeover. (The reverse phenomenon might be seen in the context of a blockage discount which represents, in effect, excess selling pressure.)

Also not to be forgotten is that tender offers usually only require approval of 90% of the current holders.[6] Exerting enough buying pressure to tip 90% of existing owners into the "sell" column will usually require a higher price (a premium over the previously unaffected value) in the relatively frictionless system of the public market, but usually not nearly as high as it might have to be if the requirement were 100%. It is a fact that sometimes a very high premium is required to tip 90% of the existing holders into the "sell" column, sometimes a low premium, and sometimes market dynamics are such that a company may be acquired at a discount. Again, nothing about these mundane market forces and dynamics speak to, or are driven by, a differential in value between "minority" and "control."

Summary and Conclusion

What can appraisers or valuers take away from the foregoing? First, public shareholders have total control over their investment. This is all the control any public investor needs, so the data being published on "control premiums" is in reality no such thing. It would be much more accurate and less misleading to name this data for what it really is: "acquisition premiums" or "transaction premiums." Although some of the premiums may include some sort of strategic element, there are many more things that enter into the premium data than simply strategic aspects. One thing these

6 "90%" is included here because this is usually the point at which a short-form ("squeeze-out") merger can be accomplished. Of course, not all buyers must meet the 90% hurdle if they already own a substantial position in the company, or if the board issues "top-up options". In addition, this author understands that in some states only an 80% acceptance rate is required to complete a squeeze out. These types of conditions might create less need to pay a high premium.

premiums most emphatically have *nothing* to do with is the value of control versus the value of no control.

Much has also been written in the last two decades about the fact that it is impossible to know which companies in the public market might sell for a premium.[7] Logically, if a public company was truly worth more than its trading price it would almost certainly be snapped up. Every single company in the public market is looked at every single day by strategic buyers, competitors, hedge funds, buy-out funds — there is probably no company that is not being continuously evaluated as a possible acquisition. Only in hindsight can we ever really know which public companies commanded an acquisition premium of some kind. But if we cannot know until our hindsight is 20/20 which companies command a premium, then clearly the only reasonable and logical assumption when using public stocks as a valuation proxy (under either the market approach or the income approach) is to assume that there is no acquisition premium which can be reliably linked with the data.

In ***Daubert v. Merrell Dow Pharmaceuticals (92-102), 509 U.S. 579 (1993)*** the U.S. Federal Court confirmed that the Federal Rules of Evidence — especially Rule 702 — govern the admissibility of expert testimony into evidence. Although *Daubert* did not involve an appraisal issue, these Rules of Evidence have recently become much more important in business valuation litigation. The nub of the *Daubert* case is contained in the following paragraph:

> Faced with a proffer of expert scientific testimony under Rule 702, the trial judge, pursuant to Rule 104(a), must make a preliminary assessment of whether the testimony's underlying reasoning or methodology is scientifically valid and properly can be applied to the facts at issue. Many considerations will bear on the inquiry, including whether the theory or technique in question can be (and has been) tested, whether it has been subjected to peer review and publication, its known or potential error rate, and the existence and maintenance of standards controlling its operation, and whether it has attracted widespread acceptance within a relevant scientific community.

With so much literature demonstrating the invalidity of "control premiums" and "control premium data," it should be a straightforward matter to have the report and testimony of any appraiser who wishes to assert a control premium excluded from the courtroom. In particular, the theory and application of control premiums have by now been shown to have been tested and found faulty, they have largely been rejected by most reputable appraisers, it can be shown that the error rate is close to 100%, and, finally, no rebuttal whatsoever has ever been written to support a claim that "control premiums" based on public company acquisition premiums have any scientific validity.

With respect to the Foundation's White Paper it must be acknowledged that accountants need some latitude in which to make the rules practiced in their industry. In particular, accountants should have the ability to make a rule that under particular conditions (whatever those may be) a premium for control may be permitted for financial reporting and impairment testing purposes. But if such a rule is adopted let there be no mistake that it would be only for purposes of expediency rather than accuracy. If, for accounting purposes, an appraiser or valuer applies a control premium to a marketable minority interest based on the control premium data, he or she may wish to think about whether the issue might ever be subject to dispute or litigation; if it is, a *Daubert* challenge will likely ensue.

7 *Ibid.*

Finally, and of utmost importance, it is imperative that if the White Paper comes out in support of control premiums for purposes of financial reporting and impairment testing, such support can only be narrowly relevant to the accounting world and not to any other area of appraisal or valuation.

Stay tuned, watch carefully, and in the meantime don't forget to think for yourself.