

# CHAPTER TEN

## A CLOSE LOOK AT THE MANDELBAUM DECISION AND ITS EFFECT ON MARKETABILITY

### Chapter Objectives

1. Identify the reason why the *Mandelbaum* decision is important in the determination of discounts for lack of marketability.
2. Identify the primary issues addressed in the *Mandelbaum* case.

## I. INTRODUCTION

*Mandelbaum v. Commissioner*, T.C. Memo 1995-255, Affd. 91F3d 124 (3<sup>rd</sup> Cir. 1996) is an important case in business valuation, in that it isolates size of a discount for lack of marketability as its only substantial issue. Rarely have the courts been so specific in their analysis of an issue, nor has a court's decision been open to so much commentary and review by practitioners.

Setting up a list of factors to consider in developing a discount for a lack of marketability could have, and should have, provided the business valuation community with a useful tool. However, given the listing provided by Judge Laro in the decision, practitioners, once again, find themselves addressing tough issues with added cloudiness and complexity.

## II. MANDELBAUM DECISION

### A. MANDELBAUM IS AN IMPORTANT DECISION FOR TWO REASONS

1. Issue of a lack of marketability discount was the only issue before the court
2. Court's ultimate and unusual resolution of the case sheds light on possible matters to consider in assessing the size of discounts for lack of marketability in the future

**B. FACTS IN MANDELBAUM**

1. Three brothers owned 100% of stock in a New Jersey based corporation, “Big M,” which operated a chain of women’s apparel stores
2. Ultimately, the brothers entered “gifting” programs as part of their estate planning
3. Values on gift tax returns were disputed by the IRS
4. By trial, both parties stipulated as to the “freely traded value” of each share of the stock that was previously gifted
5. Court records indicate that stipulated values consider any applicable minority discount
6. Only open issue—discount for the subject stock’s lack of marketability
7. IRS expert determined 30% for all six dates of gift
8. Taxpayers’ expert determined 75% for 1986-1989 and 70% for 1990

**C. EXPERT’S CASE—RESPONDENT (IRS BDO SEIDMAN—PAUL R. MALLARKEY)**

1. Utilized three studies on sale of “restricted” stock
  - a) SEC Institutional Investor Study
  - b) Moroney, “Most Courts Overvalue Closely-Held Stocks”
    - (1) Median Discounts 30.1% to 40%
    - (2) Average cash-purchase discounts of 36% over unrestricted shares
  - c) Maher, “Discounts for Lack of Marketability for Closely-Held Business Interests”
    - (1) Mean discount is 34.73%
2. Summary of three studies—30% to 35%
3. Additionally, the expert testified that the company’s stock risk was neutralized by its size and stable gross profits, allowing Big M to remain profitable
4. Expert conclusion—30% for all three years

**D. EXPERT’S CASE—PETITIONER (MANDELBAUM—PRICE WATERHOUSE, ROGER J. GRABOWSKI)**

1. Utilized three studies on sale of “restricted” stock (same as IRS)
2. Utilized four additional restricted stock studies
  - a) Gelman, “An Economist—Financial Analysts Approach”
  - b) Trout, “Estimation of the Discount Associated with the Transfer of Restricted Securities”
  - c) Pittock and Stryker, “Revenue Ruling 77-287 Revisited”
  - d) Willamette Management Associates Study
    - (1) Study of 33 arms-length private placements of restricted stock compared to freely-traded counterparts from January 1, 1981 to May 31, 1984
3. In combination, all seven restricted stock studies found an average discount of 35% for marketability
4. Also utilized three IPO studies

- a) Emory, “The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock—January 1980 through June 1981”
- b) Emory, “The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock—January 1985 through June 1986”
- c) Willamette Management Associates Study

(1) 14 studies of private stock transactions to subsequent public offerings of stock in the same companies

5. In combination, all three IPO studies found an average discount of 45%

**E. EXPERT’S CASE—PETITIONER (MANDELBAUM—PRICE WATERHOUSE, ROGER J. GRABOWSKI)**

1. Additional expert testimony:

- a) Big M is illiquid and, as such, requires a higher discount
- b) Research of investment firms resulted in the expert’s judgment that Big M investors would require a 35% to 40% yield, requiring a 10 to 20 year holding period

2. Expert Conclusion:

- a) 75% for first five years
- b) 70% for final year

**F. COURT’S DECISION—JUDGE LARO**

Disregarded both experts

1. IRS expert:

- a) Did not give adequate focus to outside investors buying into Big M, as intent was to hold it in the family
- b) Did not give adequate focus to transferability restrictions in shareholders’ agreements
- c) Focused too sharply on “restricted stock” studies (holding period of stock studied was approximately 2 years), and expert did not support such a short period for Big M
- d) Also failed to reconcile fact that restricted stock studies encompass publicly traded corporations, and Big M is not a publicly traded corporation

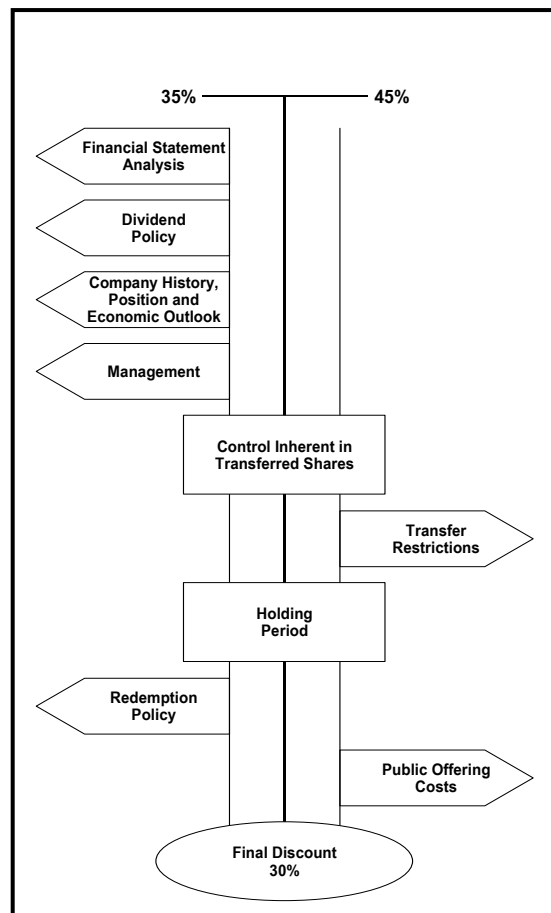
2. Taxpayers’ expert:

- a) Focused only on willing buyer and not willing seller
- b) Too focused on shareholder’s agreements—the expert’s perception that the right of first refusal significantly impairs value is not supported, especially as no fixed price is set (right of first refusal is only a buyer ordering mechanism, it does not limit the buyers to whom the seller can sell)

- c) Only interviewed venture capital investors and did not consider a more representative group of willing buyers
- d) Reliance on interviews of venture capital investors for rates of return and holding period misplaced

## G. COURT SOLUTION

1. “Find the Appropriate Discount for Lack of Marketability Based on Evidence before the Court”
2. Starting Point:
  - a) Taxpayer’s analysis of 10 studies used as a benchmark
  - b) IPO studies—45%
  - c) Restricted stock studies—35%
3. Factors considered by the court to increase or decrease benchmark discount:
  - a) Financial statement analysis
  - b) Dividend policy
  - c) Nature of the company, its history, its position in the industry, and its economic outlook
  - d) Management
  - e) Amount of control in the transferred shares
  - f) Restrictions on transferability of the stock
  - g) Holding period for the stock
  - h) Company’s redemption policy
  - i) Costs associated with a public offering
4. Final assessment of nine factors:
  - a) 5 Below Average
  - b) 2 Neutral
  - c) 2 Above Average
5. Conclusion: below average discount warranted
  - a) Court determined 30%



The *Mandelbaum* case was affirmed in the Third Circuit in 1996. A more recent case, *Estate of Kaufman v. Commissioner*, embraced the nine factors under *Mandelbaum*. Judge Laro also decided this case.

### III. CHAPTER SUMMARY

*Mandelbaum* is the most critical case addressing discounts for lack of marketability in the last decade. While Judge Laro's method of determining the final discount causes as much confusion as it does clarity, the case at least allows the practitioner to frame his/her discount for lack of marketability in view of the noted factors.

#### A. THERE ARE SEVERAL IMPORTANT POINTS TO REMEMBER REGARDING *MANDELBAUM*:

1. Scorecard of deviations related to nine factors in reference to an average discount is not typical of prior cases
2. Some factors may have been duplicated given that the stipulated values were "freely traded" values
3. The Court's determination of discount, if taken to its farthest degree, could swallow up the entire valuation process
4. The Court's 30% discount, in addition to any applicable minority discount, is not substantially lower than what other recent court cases have allowed (generally, around 35%)
5. The case clearly reflects a need to produce credible evidence to support the discount for lack of marketability and a critical need to tie the final reasoning for the size of the discount to the specific attributes of the ownership interest being valued

This page intentionally left blank.