Bankruptcy:

The Reasonably Equivalent Value Of A Business Interest

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Introduction

This article is a financial analyst’s view of what *reasonably equivalent value* is. I will first establish some definitional groundwork on the subject. This will be followed by a general overview of business valuation. Finally, there will be two examples of the determination of *reasonably equivalent value* as the term is used in bankruptcy litigation.

In order to protect creditors, the Bankruptcy Code (§ 548) contains a provision forbidding certain transfers of assets from the debtor entity to others within one year of the filing for bankruptcy. Among the restrictions on such transfers, the debtor is restricted from transferring any assets for less than *reasonably equivalent value*.[[1]](#footnote-1) It must also be shown that either the debt was insolvent at the date of the transfer or that this transaction rendered the debt insolvent. The objective of this article is to discuss, in financial terms, the meaning of *reasonably equivalent value*.

The burden of establishing that a transfer was for less than reasonably equivalent value is on the bankruptcy trustee and the date upon which the value is to be determined is the date of the transfer.[[2]](#footnote-2) In determining the amount of reasonably equivalent value, it is necessary to recognize not only cash and other tangible assets received for the transferred asset(s), but also indirect benefits. Such indirect benefits, for example, can be received in the form of funds flowing from a parent to debtor or intangible benefits in the form of the maintenance of parent’s financial strength.[[3]](#footnote-3) Even the goodwill generated by a charitable contribution can be considered to be reasonable equivalent value.[[4]](#footnote-4)

What is reasonably equivalent value when business interests are transferred? Is reasonably equivalent value always fair market value? If the business interest is an interest in the debtor, when would reasonably equivalent value be the going concern value? If the business asset that is transferred is less than a controlling interest in a business entity, would a minority discount be applied to the value? Could there be a discount for lack of marketability? These are the questions that will be covered in this article.

What Is The Definition of Reasonably Equivalent Value?

In one situation, the court determined that the reasonably equivalent value of a business asset that is a going concern is the *realizable commercial value*. The question before the court with regard to a potential fraudulent conveyance was whether the transaction conferred realizable commercial value on the debtor that was reasonably equivalent to the realizable commercial value of the assets that were transferred. When the debtor is a going concern and its **realizable going concern value** is equal to or exceeds its going concern value before the transaction, reasonably equivalent value has been received.[[5]](#footnote-5)

In this discussion of value, the determination of the fair market value of a business asset for federal income, gift or estate tax purposes will be compared to the determination of reasonably equivalent value for § 548 purposes. The Internal Revenue Service Revenue Ruling 59-60[[6]](#footnote-6) sets forth that “…A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases.” Likewise, case law under § 548 tells us that there is no precise formula and that the court must make its determination based upon all facts and circumstances.[[7]](#footnote-7)

Factors to be considered in the determination of reasonably equivalent value include the fair market value of the property, the manner in which the sale of the property took place, and the marketability of the property.[[8]](#footnote-8) From a business valuation standpoint, the court has given very little guidance in the particulars of the valuation of a business interest for purposes of determining reasonably equivalent value. By comparison, the tax court has boldly opined on some of the finest points of business valuation with lengthy, detailed, written opinions. Consequently, it has been my experience with the bankruptcy court, as well as general case law, that reasonably equivalent value, realizable commercial value and realizable going concern value are all roughly equal to the general standard of value that is used for federal income, estate and gift tax purposes — fair market value.

Fair market value is defined as follows:

[t]he price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.[[9]](#footnote-9)

The concept of the market conditions that face a willing buyer and a willing seller has also been expressed in bankruptcy case law.[[10]](#footnote-10) This is an important principal of the definition of fair market value. “A willing buyer or seller” sets forth the general principal that the two parties should be generally representative of a typical hypothetical buyer or seller. These general representatives of buyers and sellers are to be distinguished from a specific buyer and/or a specific seller. The fact that the seller/debtor is in a poor position with regard to the negotiation of the sale of the interest in question should not be considered in the valuation process. After all, the definitions quoted above clearly state that neither party should be under any compulsion to conclude the transaction.

We must also consider that the definition of fair market value defines the relationship between the willing buyer and willing seller as arm’s length. If, therefore, the value of an interest in a closely-held business entity is either wholly or partially based upon one or several transactions of interests in this entity or similar entities, then the appraiser should make certain that these transactions were conducted at arm’s length.[[11]](#footnote-11) Before I discuss some specific cases regarding reasonably equivalent value, I will briefly cover some key points of business valuation in general.

Business Valuation in General

Valuation Approaches

There are several business associations that deal in the area of business valuation. The only one of those organizations that has set forth standards for business valuation is the Business Valuation Section of the American Society of Appraisers (“ASA”). In general, the ASA Standards list three valuation approaches: the asset based approach, the income approach, and the market approach. The ASA Standards describe each approach as follows:

**Asset Based Approach**: A general way of determining a value indication of a business’s assets and/or equity interest using one or more methods based directly on the value of the assets of the business less liabilities.

**Income Approach**: A general way of determining a value indication of a business, business ownership interest or security using one or more methods wherein a value is determined by converting anticipated benefits.

**Market Approach**: A general way of determining a value indication of a business, business ownership interest or security using one or more methods that compare the subject to similar businesses, business ownership interests or securities that have been sold.

Although any of these approaches might be applied to the valuation of most business entities, one or more of them will be more applicable to some businesses than to others. An asset approach, for example, is typically more applicable when a business enterprise has a large amount of assets. A real estate holding company would be a good example of such an enterprise. Such an approach may have very little relevance to a low-capital personal services business, such as an engineering firm. The application of the asset approach to valuation typically yields the *net asset value* of the enterprise. All of the assets, including tangible and intangible, are appraised at their fair market value; the liabilities are then subtracted to yield the net asset value.

The income approach, of course, would only be relevant in the valuation of a business enterprise that either currently generates income (or cash flow) or is likely to generate income in the foreseeable future. An enterprise, therefore, that owns only undeveloped land would not generally be a good candidate for the application of the income approach to valuation.

The market approach to valuation requires that the appraiser secure some information on arm’s length transactions in the co-ownership interests of the enterprise being valued and/or arm’s length transactions of business interests that are similar to those that are being valued. This typically involves seeking publicly-traded guideline companies that are similar to the enterprise being valued or seeking transactions of privately-held companies that have recently changed hands. If no such transactions can be found, this method cannot be utilized.

Adjustments to Value

When valuing closely-held business interests, there are sometimes adjustments to the values as derived from the various approaches discussed above. Typically, this is to account for whether the interest being valued is controlling or non-controlling, and whether or not the interest is freely traded on a public market. Below, in Illustration 1, we graphically show what type of value we must deal with, depending upon the control and marketability issues. These adjustments are discussed in the next section of this report.

ILLUSTRATION 1[ADJUSTMENTS]

ADJUSTMENTS TO VALUE

The diagram above sets forth two general principals with regard to adjustments to value. First, there is the question of whether the interest is a controlling interest of an enterprise or a non-controlling interest. Clearly, an interest that controls the underlying enterprise should have more value per share or partnership interest than one which does not.

The second principal set forth is one of marketability. Stocks that are traded on the New York Stock Exchange, for example, are typically very marketable. An investor could usually sell a small minority interest in a publicly-traded company at or near the last trading price and have his or her proceeds within several business days. This is rarely the case with a closely-held business interest. Marketability is a factor, therefore, that must be considered in the valuation process and this has been recognized by the bankruptcy courts.[[12]](#footnote-12)

The type of adjustment that an appraiser applies to the value yielded by one of the valuation approaches depends upon the type of value that the approach yields. The net asset value, which is yielded by the asset approach to valuation, is a controlling interest value and a value that assumes that the interest is not freely traded unless its stock is publicly traded. If, therefore, the transaction in question with regard to § 548 involves a controlling interest in a business enterprise, no further adjustment for control would be necessary. If, on the other hand, the transaction in question involves a minority or otherwise non-controlling interest in the enterprise, then there might be a need to adjust the value with a *minority discount*.

As mentioned above, the application of the asset approach yields a non-freely traded value. If the transaction in question were of a controlling interest in a business enterprise, then there should be very little adjustment necessary for marketability unless the interest is publicly-traded. If, however, the interest is a non-controlling interest, then some *marketability discount* would probably be appropriate because it is typically much more difficult to sell a minority interest in an enterprise than a controlling interest in the enterprise.

If the application of an income approach involves the use of a multiple, discount rate or capitalization rate, which is based upon trades of stocks of publicly-traded companies, then the value yielded by this approach would be a minority, freely-traded value. If the closely-held business interest being valued is controlling interest, therefore, it might be necessary to make an adjustment to the value by the application of a *control premium* and perhaps some small discount for lack of marketability. If the closely-held business interest being valued is a non-controlling interest, there should be little or no adjustment in the form of a control premium or minority discount, but there should be a significant adjustment to account for the lack of marketability of the interest being valued relative to the publicly-traded stocks upon which the value was based.

When the market approach to valuation is being used, the value yielded, in terms of control versus non-control as well as freely traded versus non-freely traded, depends upon the market transactions upon which the value is based. If, for example, the value yielded is based upon use of publicly-traded guideline companies, then the resulting value is typically considered to be a minority-interest value that is a freely traded value. If the transaction in question involves a minority interest in a business enterprise, therefore, then very little, if any, adjustment for control would be necessary. There would, however, be an adjustment for lack of marketability. If the transaction in question involves a controlling interest, then a control premium might need to be applied.

On the other hand, if the appraiser uses transactions of closely-held businesses as a basis for applying the market approach, then the resulting value will be a controlling interest value which is non-freely-traded. If the transaction in question involves a minority interest in a business enterprise, therefore, a minority discount might be necessary. There might also need to be some adjustment for lack of marketability. If the transaction in question involves a controlling interest then very little, if any, adjustment would be necessary for either control or marketability.

This should give the reader a very brief sketch of business valuation theory. I will now discuss several examples in which I was involved.

Specific Applications of Valuation Theory

Minority Interest in a Real Estate Partnership

The first example involves the bankruptcy of an automobile dealer. In addition to owning several automobile dealerships, the dealer also owned general partnership interests in several general partnerships that owned real estate upon which his dealerships were located; dealerships belonging to other members of the same family were also located upon this real estate.

The dealer was heavily in debt to a number of creditors, including members of his family. The transaction in question involved the dealer’s exchange of certain of the general partnership interests described above in return for the full and/or partial cancellation of certain debts to family members (who were also partners of these partnerships).

The question put to the bankruptcy court was whether these transferred partnership interests were transferred for more than reasonably equivalent value for purposes of determining whether this transaction involved a fraudulent conveyance.

The key valuation issues were the application of a minority discount and a discount for lack of marketability. Again, the interests transferred were general partnership interests that were mostly less than 25% interests in these partnerships. The only significant assets of these partnerships were real property upon which there were automobile dealerships. These dealerships leased the land and/or facilities from the partnerships.

The partnership agreements were very cursory. The rights inherent in the partnership interests, therefore, were largely found in the Uniform Partnership Act as adopted by the state in which the partnerships were located.

Based upon this information, I will take one partnership as an example of what actually transpired in this case. The numbers are changed to protect the privacy of the parties involved. Let us say that one partnership, “Chevrolet Partnership” (“the Partnership”), owns land and dealership improvements that have been appraised by a real estate appraiser at $15 million. There was a third-party mortgage on this property in the amount of $10 million. The net asset value of the Partnership, therefore, was $5 million. The debtor/dealer owned a 15% general partnership interest and several other family members owned general partnership interests that ranged between 5% and 20%. The debtor/dealer’s *pro rata* share of the net asset value of this Partnership, therefore, was $750,000.

The debtor/dealer exchanged this Partnership interest to family members in return for the cancellation of $600,000 of debt with the understanding that the fair market value of this partnership interest was significantly below the *pro rata* net asset value of $750,000 because it was a non-controlling interest that was not marketable. The bankruptcy trustee argued that the value of the partnership interest was equal to or very near the $750,000 *pro rata* share of net asset value and that, therefore, the Partnership interest was transferred to family members for less than reasonably equivalent value.

The trustees retained several experts to show why the value of the Partnership interest should be at or near the *pro rata* net asset value of $750,000. I was retained to estimate the fair market value of the Partnership interest (as well as other Partnership interests that will not be discussed in this article). The most important factors that would determine the value of the interest in question include the following:

1. The net asset value of the Partnership.

2. The rights of the partner owning a 15% general partnership interest as defined in the Partnership agreement and the Uniform Partnership Act as adopted by the state in which the Partnership is situated. In this case, the state was Virginia.

3. The financial condition and financial results of the lessee dealership as it would affect the level of cash flow available to be distributed to the partners of the Partnership.

4. The marketability of the Partnership interest.

The net asset value of the Partnership was already discussed. It is important to mention that state law of Virginia, where this Partnership resides, sets forth that the property of the Partnership is not vested in the partners.[[13]](#footnote-13) Now, attention will be turned to the rights of the debtor/dealer as a 15% partner in the Partnership. The Partnership agreement and state law must be considered in light of several important factors that we must consider:

Purpose of the Partnership

Distributions of income/cash flow

Distributions of sales/refinancing proceeds

Additional capital contributions

Assumption of recourse debt

Management of the Partnership’s business

Potential for self-dealing of management

Dilution

Income tax consequences

Restrictions on transfer of interest

To take one extreme position, the purpose of the Partnership might be to keep specific investments forever in the hands of the family that owns the Partnership and to allow the income and gains, if any, to be accumulated and reinvested in other non-liquid assets. This would clearly restrict the cash distributions from income as well as liquidation and refinancing proceeds. This purpose might be stated in a separate section, in the entity’s business section, or in a separate letter from the managers of the entity. In this case the purpose, as assumed by the partners, was to retain the underlying property indefinitely to be used by the dealership which was owned by family members. Since there were no plans to sell the dealership or the underlying real property, there was no reason to believe that any of the partners would have access to the underlying net asset value for the foreseeable future.

Cash flow distributions were not being made. The dealership had entered into a long-term lease with the Partnership at a rental rate that was significantly below the market rent. The cash collected was barely enough to meet the mortgage payments. The economy was in a recession at the time of the valuation and the dealership was having financial difficulties. Although this dealership had been making its rental payments on a timely basis as of the valuation date, there was no assurance that these payments would continue. In fact, it was clear that there would be no significant cash flow being generated by the Partnership for some time to come. Each partner, however, would be entitled to his or her *pro rata* share of the Partnership income.[[14]](#footnote-14) Again, since the partners were not about to liquidate the underlying property, there was no reason for any of the partners to expect that any portion of the net asset value would be available to them for the foreseeable future.

The possibility that partners may be called upon to make additional capital contributions or that they would be liable for additional debt are both negatives in the valuation process. All partners are jointly and severely liable for all Partnership liabilities.[[15]](#footnote-15) This is particularly difficult on a partner, since he or she does not have vested title in the underlying property. These liabilities for debt and potential capital contributions are clearly negative factors to be considered in the valuation process.

The management of the Partnership’s operations is in the hands of all of the partners[[16]](#footnote-16) unless there is a partnership agreement that states otherwise, since each partner has an equal right in the management and the conduct of Partnership business.[[17]](#footnote-17) For decisions on matters that fall outside the “ordinary course of business of a partnership”, a unanimous agreement among the partners is necessary. For ordinary business decisions, however, only a majority of the partners in interest is required for the decision to be implemented.[[18]](#footnote-18) In any case, it is clear that a 15% partner has considerably less authority over the underlying property than a fee-simple owner.

With regard to transferability, the Partnership agreement was silent. Virginia law provides that general partnership interests cannot be transferred, but only the right to profits, losses and distributions can be transferred. Any assignee interest, therefore, would have absolutely no management authority with regard to the operations of the Partnership. This would certainly argue for a significant marketability discount even in this situation in which the Partnership agreement did not restrict transfers. It must also be considered that there is no public market for the Partnership interests.

Considering the net asset value, the inability of a partner to have access to that value, the lack of significant cash flow and the restrictions on transfer, we concluded that a discount of just over 50% from the *pro rata* net asset value was appropriate in the valuation of this interest leaving the fair market value well below the amount of debt that was cancelled in the transaction between the debtor/dealer and certain family members who received the Partnership interest. The judge rendered an oral opinion in this case, recognizing both the minority discount and the discount for lack of marketability.

Leveraged Buyout of Debt Stock

In this case, the company that ultimately became the debtor was a retail auto parts dealer with over thirty locations. We will call this enterprise “Smith Auto Parts.” Smith Auto Parts was owned by four members of one family and had been operated successfully for over twenty years. A dispute arose between two family members and the other two family members over who should manage the operations of Smith Auto Parts. Several very acrimonious lawsuits followed that ultimately resulted in a settlement agreement between the parties.

According to the settlement agreement, an Employee Stock Ownership Plan (“ESOP”) was to be created by Smith Auto Parts which would borrow $2 million from a third party lender. These proceeds would be used to buy out the two dissenting shareholders and to serve as consideration for a non-complete agreement between the dissenting shareholders (“Dissenting Shareholders”) and Smith Auto Parts. Smith Auto Parts was to guarantee the $2 million loan made to the ESOP. The shareholders who were staying with Smith Auto Parts (“Remaining Shareholders”) retained a valuation expert to determine whether the dissenters’ stock was worth at least $2 million. I was retained by the Dissenting Shareholders to advise them on valuation issues. It was decided between myself, the Remaining Shareholders, the Dissenting Shareholders and the related counsels that a third appraiser should be retained to render an independent value of Smith Auto Parts for purposes of the ESOP transaction.

In 1992, the transaction between the Dissenting Shareholders and the ESOP was completed leaving the ESOP with approximately one-half of the stock of Smith Auto Parts and the Dissenting Shareholders with $2 million in cash. Despite the fact that the general economy was recovering from a recession, competitive and other factors led to filing of a petition under Chapter 11 toward the middle of 1993. The bankruptcy trustees sued the Dissenting Shareholders, the third party lender of the ESOP loan, the Board of Directors of Smith Auto Parts and the Remaining Shareholders charging that the ESOP transaction that was completed pursuant to the settlement agreement amounted to fraudulent conveyance under federal and local state bankruptcy laws. The trustees alleged that the stock of Smith Auto Parts that was sold to the ESOP was sold for more than reasonably equivalent value, and that the transaction left Smith Auto Parts with unreasonably small capital, and that the transaction rendered Smith Auto Parts insolvent.

It is interesting to note that in this case it was an indirect **purchase** of an asset by the debtor rather than a sale of an asset that was to be tested for the reasonably equivalent value standard. This is in contrast to the last example, which is more typical, where the debtor sold assets pursuant to the bankruptcy.

I was retained as both a fact witness and a valuation consultant to the counsel for the Dissenting Shareholders. In this case, the due diligence of the ESOP appraisers lent credibility to the fact that the ESOP paid no more than reasonably equivalent value for the stock of the Dissenting Shareholders. The action by the trustees was terminated when the bankruptcy court ruled against them in summary judgment.

Summary

The standard for reasonably equivalent value, with regards to the valuation of a closely-held business interest, under § 548 appears to be fair market value as defined above. Considering this fact and bankruptcy case law, the debtor(s), creditors, and all other parties associated with a bankruptcy or potential bankruptcy would be well-advised to seek the help of a qualified business appraiser before concluding any transaction between the debtor (or potential debtor) and other parties when such transaction may potentially be labeled as a fraudulent conveyance.

1. § 548(a)(2)(A). [↑](#footnote-ref-1)
2. *Morris Communications NC, Inc. (1990, CA4 NC)* and *Thames* (1981, BC DC SC). [↑](#footnote-ref-2)
3. *Lawrence Paperboard Corp*. (1987, BC DC Mass). [↑](#footnote-ref-3)
4. *Missionary Baptist Foundation, Inc*. (1982, BC ND Tex) 24 BR 973. [↑](#footnote-ref-4)
5. *Mellon Bank, N.A. v Metro Communications, Inc.* (1991, CA3 Pa). [↑](#footnote-ref-5)
6. Revenue Ruling 59-60, 1959-1 C.B. 237. [↑](#footnote-ref-6)
7. *Join-In International* (U.S.A.), Ltd. (1986, BC SD NY) 56 BR 555. [↑](#footnote-ref-7)
8. *Pruitt* (1987, BC ED NY) 72 BR 436. [↑](#footnote-ref-8)
9. Regulations § 1.170-1, § 1.170A-1, § 1.412(c)(2)-1, § 20.2031-1(b) and § 25.2512-1. The American Society of Appraisers, through its Business Valuation Standards, defines fair market value as: The amount at which property would change hands between a willing seller and a willing buyer when neither is under compulsion to buy and when both have reasonable knowledge of the relevant facts. As can be seen, this is the same as the IRS definition. [↑](#footnote-ref-9)
10. *Ozark Restaurant Equipment The Company* (1988, CA8 Ark) 850 F2d 342. [↑](#footnote-ref-10)
11. See *Morris Communications NC, Inc. (1990, CA4 NC)* and *Thames* (1981, BC DC SC). [↑](#footnote-ref-11)
12. *Pruitt* (1987, BC ED NY) 72 BR 436 [↑](#footnote-ref-12)
13. Virginia Code Section 50-73.89. [↑](#footnote-ref-13)
14. Distribution of cash flow was not addressed in the partnership agreement, but Virginia Code Section 50-73.99(B) sets forth that such distributions should be made. [↑](#footnote-ref-14)
15. Virginia Code Section 50-73.96(A). [↑](#footnote-ref-15)
16. Virginia Code Section 50-73.91. [↑](#footnote-ref-16)
17. Virginia Code Section 50-73.99(F). [↑](#footnote-ref-17)
18. Virginia Code Section 50-73.99(J). [↑](#footnote-ref-18)