BLOCKAGE DISCOUNT

James P. Catty

The term "Blockage Discount" is defined by the Canada Valuation Service (the "Valuation Service"), published by Carswell Thomson Professional Publishing, as:

The decrease in market price resulting from the imbalance of supply and demand that results when market supply is increased pursuant to unusual market activity. In the context of the public markets, the decrease in stock market trading price created by the forces of supply and demand when a block of shares larger than normal trading lots is exposed for sale at one time.

While Revenue Canada does not appear to have formally articulated its views on value with respect to notional sales, it has set out its position with respect to V-Day values. For publicly traded securities Revenue Canada will normally apply the following rules:

a) The "closing price" on the day on which the transaction takes place, or is deemed to have taken place, will be used to determine value.
b) If the security in question is listed on more than on a stock exchange in Canada, the value will be determined by reference to the exchange on which the particular stock was most active.

Revenue Canada has reserved the right to assess on a different basis, whenever in their opinion these rules produce an artificial result. On the other hand, a taxpayer has the right to persuade Revenue Canada or the courts that some other method is more appropriate in a particular case. For the Shares, in view of all the circumstances, CVS believes that the "closing price" does not represent Value. For large holdings, the courts and taxation authorities have accepted a Blockage Discount as appropriate method in a number of cases; some key ones in Canada, Australia and the United States are discussed below.

Untermyer Estate

The classic Canadian decision with respect to value compared with stock market trading prices is Untermyer Estate v the Attorney General of British Columbia (1929) SCR 84. Mr. Untermyer owned 318,800 (6.4%) of the 5,000,000 issued shares of Premier Gold Mining Company Limited. On the date of his death, Premier closed at $2.20 per share. The Estate contended that the fair market value (the term then used in the BC Succession Act) of the shares was $1.90 each; the fair market value was determined by the Commissioner to be $2.00 per share.

In a subsequent hearing, Mignault, J., commented in part:

> "The parties before the Commissioner seem to have considered that the best test of 'fair market value' was the price for which Untermyer's holdings could have been sold, but they differed widely in their views of the means whereby such a sale could have been best effected. All the witnesses recognised that it would have been impracticable to attempt to sell at once this large block of shares. Such a course would have broken the market where, of course, to a large extent, price is regulated by the economic law of supply and demand, and it fluctuates according as one or the other of these elements predominates..."
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> "The learned Commissioner considered that the possibility of a sale of the shares by private negotiation had not been sufficiently looked into......."
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> "I would not deduct anything from the market value of these shares on the assumption that the whole of them would be placed on the market at one and the same time, for I do not think that any prudent stockholder would pursue a like course. To make such a deduction in a case like the one at bar, would be to render the 'sacrifice value', or 'dumping value' of the shares the measure of valuation".

It was held that the price allowed by the Commissioner did not exceed the fair market value of the shares; this price implied a Blockage Discount of approximately 9%.

Corkings v Collins

The Supreme Court of Canada case of Corkings v Collins, (1936) SCR 37, deals with a similar situation. In allowing a Blockage Discount, Duff, CJ., said that Mr. Justice Mignault's decision in Untermyer could not be treated as establishing a general principle of law applicable to all cases. His Lordship notes that although the price at which the shares in question were selling on the stock market might be regarded as prima facie evidence of value, the lower courts were "quite right in declining to accept that as conclusive...."

Mr. Justice Duff's statement is authority for the view that at any given time, the stock market price is not necessarily indicative of the real value of a particular block of securities and should not be accepted as indicative of value for the courts.

Henderson Estate

In Henderson Estate v MNR, Bank of New York v MNR, (1973), 73 DTC 5471, the same Blockage Discount issue was scrutinised. At the time of his death, directly and as controlling member of an "investors syndication", Mr. Henderson had control over approximately 50% of the outstanding shares of Campbell Chibougamau Mines Limited, which had closed at $10.87 a share the day before.

Evidence was introduced that the Executors had attempted unsuccessfully to sell the shares to other mining companies at $8 per share. Further, that assets of a 50% owned corporation were purchased approximately six months after death in an arm's length transactions for shares of Campbell, Chibougamau with an indicated value of $9.00 per share.

The executors had filed at $2.75 to $3.25 per share, supported by expert testimony with regard to ore reserves, the price of copper, mill capacity and interest rates. In disallowing these amounts, Cattanach, J., pointed out that although such factors might lead to intrinsic value, in his view, "intrinsic" did not necessarily mean fair market value, and in this case, he said that it did not.

The Minister had arrived at a value of $8.00 per share by discounting the most recent closing price by approximately 25% to allow for the delay, uncertainty and inconvenience likely to occur if the shares were sold in an orderly manner over a reasonable period.

The executors advanced the following argument (all of which are also applicable to the Ntex Shares) against the use of the stock market price as a basis for determining fair market value.

a) Mr. Henderson's death occurred during a period of transient book in the stock market which normally occurs in the case of a mining stock when the company is in its first year of product;
b) The stock market did not possess accurate and reliable information about one reserves, which were estimated at substantially reduced levels shortly after Mr. Henderson's death;
c) The stock market price was artificial given Mr. Henderson's practice of buying and selling company shares in the market, and his influence through his own shareholdings and those of the syndicate.

In dealing with these arguments and finding for the Minister, Cattanach, J, stated:

a) Rules that the term "transient boom" referred to an unexpected, non-recurring event which was not the case in the present circumstances; the Executors had asserted that the book was a normal occurrence for mining companies in their first year of production. This predictably was held contrary to the intended meaning given to the words "transient boom" by Mignault, J in the Utermyer case, supra;
b) Rejected the effect of imperfect information on market price on the grounds that it was difficult to estimate:
c) Ruled that the Executors had failed to produce sufficient evidence to show that Henderson manipulated the market price.

While the Estate did not disagree with the discount from the stock market price, it did not agree with the figure from which the discount had been taken, arguing that stock market price did not reflect fair market value, and therefore appealed the decision.

On Appeal (1975) 75 DTC 5332 (FCT), Ryan, J., in dismissing the appeal, held that under the circumstances the stock market appeared to be the best indicator of the fair market value of the shares:

> "The learned trial judge expressed the opinion that the appellants had not discharged the onus cast on them to rebut the presumption that the (stock) market price, in a case of this kind, is the best guide to fair market value, and, with respect, I agree. In so far as consistency is concerned, the market seems to have been a consistent one, at least in the sense I have indicated above."

Bruce-Smith Estate

Australian jurisprudence would appear to run parallel to that of Canada. The three major decisions on blockage are the unreported decision in 1945 of Kent and Martin v FC of T (Federal Commissioner of Taxes), Gregory v FC of FC of T,71ATC4034 and Bruce-Smith Estate v FC of T,73ATC4137. It may be instructive to note that these cases were all heard pursuant to the Estate Duty Assessment Act.

In the unreported decision of Kent and Martin v FC of T, Williams, J, rejected a submission by the appellant that a discount should be made for "blockage" based upon the assumption that a hypothetical sale would occur not at the date of death of the deceased, but rather over a considerable period after that date.

In the Gregory case, Gibbs, J, having set out the relevant passage from the judgment of Williams J in Kent's case, respectfully disagreed with the latter's remarks concerning discounts or blockage.

In this case, S. Pty Ltd owned 1.45% of the shares of MI Pty Ltd which in turn owned 99% of the Shares of B Pty Ltd which in turn owned 44% of a public company, Myer Emporium. One of the issues in the case was whether, in arriving at the value of the shareholding of MI in Myer Emporium, it was proper to allow a discount from the ordinary market price because of the size of the parcel of shares held, in answering in the affirmative, Gibbs, J stated:

> "If, however, in fact the size of a parcel depreciates its real value, there is no principle of law that requires a fictitious and excessive value to be attributed to it for purposes of estate duty....in the present case, the evidence supports the view in valuing the assets of Myer Investment, a reduction should be made to allow for the size of the holdings in Myer Emporium."

Bruce-Smith Estate FC of T, 73 ATC 4137, provides a number of comments on the valuation of large blocks of shares in publicly traded companies.

The deceased owned approximately 2% of the issued shares of Howard Smith Limited, a public company. The shares of Howard Smith Limited were held in such a manner that the company was relatively immune from takeover; its 20 largest shareholders held over 40% of the issued shares. On the date of death, shares in the company traded on the Sydney and Melbourne Stock Exchanges at prices within a range of $3.20 to $3.30 a share. The estate argued that the value per share was $2.75, whereas the Commissioner adopted the $3.20 price for the purpose of his valuation of the deceased's very large parcel of shares.

The Valuation Service summarises the decision as follows:

1. A large block of shares conferring control upon the shareholder may, for that reason alone, have special value, outweighing in some cases a lack of ready marketability;
2. Stock exchange transactions in marketable parcels (normal trading lots) will not necessarily provide an accurate measure of the value of an unusually large block of the securities;
3. Where the block of securities in question is significantly larger than normally dealt with in stock exchange trans-actions, an alternative market may exist. This market deals with large parcels of listed securities. In such a market, no question of blockage would arise, since a large block of shares will not be unusual in such circumstances. By postulating a hypothetical sale on that particular market, a proper value of a large block of shares may be ascertained.

In his concluding remarks, Stephen, J., stated:

> "I accordingly conclude that there did exist at the date of death of the deceased, a ready market for a large parcel of shares such as those here in question, and that, if sold on that market at that date, the shares would have realised about $3.00 a share. In the circumstances, no complete precision is possible, but on the evidence, I think it proper to adopt as the likely sale price the sum of $3.00, yielding a discount of $0.20 (6.25%) for 'blockage' factor.
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> "In doing so, I proceed upon the view that, consistently with what was said by Gibbs, J., in Gregory's case and in accordance with my own views expressed above, the disabilities affecting the holder of a very large parcel of shares should be reflected in the value for duty....."

Stephen J.'s conclusion in Bruce - Smith Estate was largely based on expert evidence with respect to how such a block might best be marketed. A brokerage firm indicated that any orderly attempts to sell the block of shares in question on the stock exchange without grossly depressing the price might have taken "years literally; years in the plural", while in the alternative "block" market, it could have been sold in a matter of days. The type of purchasers frequenting this market would include banks, insurance companies and other institutional investors.

The Block Market

In "Fluctuations in the Stock Market and Price Versus Value", Journal of Business Valuation, November, 1974, H. H. Crann commented:

Institutional trading tends to be done in large blocks of shares. Frequently the trade between buyer and seller is negotiated privately, with the transaction then being completed on the exchange so as to comply with stock exchange regulations and this so called third market has grown enormously in recent years. In Canada, there is no well-developed third market, but most of the leading firms now have block trading departments which specialise in bringing institutional buyers and sellers together....

Volatility and the 'breadth of the market' do of course affect prices, often significantly. In confident times, an order to buy a block of stock which has a narrow market can result in a trade taking place several dollars above the apparent market level. Conversely, in a downtrend, a seller of a block may have to offer a substantial concession. The quotations that you see in the paper are useful price indicators, but they may have rather limited application.

US Experience

In the US, the essential statement as to the valuation of shares for tax purposes is Revenue Ruling 59-60; Section 4(g) acknowledges "the size of the block of stock itself is a relevant factor to be considered". In this, it is following the US Courts that have, on the whole, consistently held that the size of a particular shareholding is one of the factors to be taken into consideration in determining the fair market value of such a block.

The Valuation Service, in discussing the points of view of the US Treasury Department and the US Courts, states:

> "There is no automatic assumption that a large number of shares necessarily is of a different value per share than a smaller number. Indeed, the assumption appears to be that the market price of the stock reflects fair market value, unless the petitioner can prove otherwise.
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> "In rebutting this assumption, the following factors appear to have been discussed in case after case:
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> 1. The number of shares outstanding;
> 2. The number of shares listed;
> 3. The distribution of outstanding shares (i.e. is the entire outstanding stock likely to be traded, or are large blocks held by interests close to the company and unlikely to be traded);

4. Daily and weekly trading in terms of number of shares for a reasonable time preceding and after the date of valuation;
5. Trading volume related to amount listed and number of shares being valued;
6. Price movements".

Acceptance by Courts

The case of Gerrard Trust Company et all Executors v The Commissioner highlights the significance of factors (3) and (4) above. (Estate of Mr. Edward W Bok, see Ralph E Badger. "Blockage as a Valuation Problem" Vol 20, NY Inst of Tax, p587). In this case Mr. Edward W Bok died on January 9, 1930 owning among other assets 134,968 common shares of the Curtis Publishing Company, which was listed and traded both on the New York and Philadelphia Stock Exchanges.

During the week beginning December 28, 1929, in which there were no sales of Curtis common shares on the New York Stock Exchange, the high asking price was $116 and the low bid price was $112.125. For the week beginning January 4, 1930 the only sale of Curtis Publishing Company common stock was 100 shares at $114. In the week beginning January 11, 1930, 500 shares were sold at prices varying from $113.50 to $115. The Commission claimed a value for the common stock of $114 per share, the price which 100 shares were sold at on the New York Stock Exchange in the week of the decedent's death. The petitioners, however, claimed the value of Curtis common stock was $65 per share and that quoted market prices were not truly reflective of fair market value.

Although Curtis Publishing Company had 1,800,000 outstanding common shares the evidence showed that only 159,160 (8.8%) shares were in the hands of the public and available for trading; thus the block under consideration (7.5%) of the outstanding shares was equal to 84.8% of those available for trading.

Determination of US Discounts

In blockage cases where the court uses a figure different from the ones assigned by either the taxpayer of the Commissioner, such figures generally arise from one of four processes.

1. The use of a set reduction factor;
2. Employment of a formula;
3. Reliance upon expert testimony; and
4. Avail of some technique without a yardstick that could benefit a future taxpayer (Robert S. Holzman, "The Blockage Rule", Taxes, Vol 46, No 5293 at 296 (1968).

Use of a set reduction factor

In Groff v Munford, 45-2 USTC 10,223; 150 F 2d 825, a gift had been made of 14,000 shares of Electrolux Corporation which had a mean average between high and low selling prices on the Montreal Stock Exchange of $23.37 per share.

Because of the thin amount of trading during the month, the court adopted as its criterion the mean price of the actual sales on the exchange during a three-month period following the date of the gift which turned out to be $23.50 per share. The court then reduced this value by $2.00 (an 8.5% discount) which was equivalent to the fee that an experienced securities broker would have received from selling a block of 20,000 shares of the same stock two years later under a "best efforts" arrangement.

Employment of a formula.

The case of Du Pont v Deputy. 39-1 USTC 280; 26 F Supp 773, involved gifts totalling 8,600 shares of Christiana Securities Corporation, the Du Pont family holding company. The donor set the value at $1,080.00 per share and the Commissioner at $1,812.22 per share (which represented the New York Stock Exchange sales prices for that day of the underlying securities, plus cash owned by Christinana less the value of the preferred stock.

The court refused to accept the value of either the petitioner or the Commissioner, preferring to set the value of each share at 12 times the average earnings of the underlying companies, or $1,100.00. In doing so the court stated:

The adoption of the rule of 12 times average earnings of the underlying companies for a series of years, or a capitalization rate of 8 1/3% furnishes the fairest method of determining the value of Christiana Securities Company common stock. The Supreme Court of the United States in determining the value of shares of stock, adopted and approved the capitalization of average earnings over a period of years at the rate of 6%. (p 289)

Reliance on expert testimony

In Lamar Fleming Jr., CCH December 18, 489(m); 10 TCM (1951), the petitioner gave 15,000 shares of Anderson, Clayton & Company common stock to his son and 10,000 shares of the same stock to each of his two daughters. In his Gift Tax return he valued the stock at $50 per share or a total of $1,750,000. The Commissioner valued the stock at $5/8th per share which was the mean between the high and low for which 800 shares were sold on the New York Stock Exchange on October 4, 1946. The court compromised on a value of $54.50, relying on expert testimony, the past history of the company, its prospects, dividend record, balance sheet, book value, and in general the condition of the securities market.

We are convinced from the evidence that the 35,000 shares of the stock did not have a high fair market value on the date of the gift. The inactivity of the stock, the fact that there were only slightly more than 1,600 stockholders and the fact that 80% of the stocks were closely held resulted in a thin market. From the evidence which has been presented to us we have concluded that the 35,000 shares in question could not have been marked on October 4, 1946 or during any reasonable period of time thereafter at $50 5/8th per share. It seems clear to us that figure must be considerably discounted to arrive at the stocks' fair market value on the basic date. (p 767)

Avail of some technique without a yardstick

An illustration of a case within this category is Henry F Du Pont, CCH December 13, 303; 2 TC 246 (1943), where the court, noting that experts had testified that it would take 90 days to liquidate a block of 52,900 Du Pont shares, observed that the market had continued to decline during that period and placed a valuation some 18 points below the New York Stock Exchange mean for the critical date on the shares in question.

Impact on Control

The ownership of large block of shares may sometimes be a double-edged sword insofar as value per share is concerned, since the value of a shareholding is also a function of the degree of control which attaches to it. As a result, it is possible that a large block of shares may be worth more on a unit basis than a smaller block. In the case of Estate of Marjorie Gilbert Brush, CCH December 26, 214(m); 22 TCM 900 (1963), the decedent owned 62,982 of the 1,412,891 shares in Sea Train Lines Incorporated. Moreover, more than two-thirds of the stock was owned directly or beneficially by investors of three principal groups, one of which was the active directors, who were attempting prior to the valuation date to acquired additional shares to obtain majority control of the corporation. As a result, the court concluded that:

> “The substantial number of shares held by the decedent's estate may for such reason have had greater value as a single block because of their potential for affording "'leverage' to a potential buyer or buyers in acquiring a controlling stock interest." (p 910)

CVS draws the following important conclusions from the various listed cases in Canada, Australia and the United States:

1. The "value" term used in an applicable statute can have a significant bearing on the outcome of any particular case, viz the distinction made by the courts between "real value" and "fair market value";
2. Each case must stand on and be decided on the facts peculiar to it;
3. To date, the courts seem to have given important weight to stock market transactions;
4. The courts will accept blockage discounts where the value of unusually large blocks of securities is in question;

5. A semi-organized market exists for large blocks of securities. This market may have a particular significance in valuing unusually large blocks of securities.

DISCOUNTS FOR LACK OF MARKETABILITY

The Blockage Discounts discussed above, which relate to the size of the Block, consideration must also be given to the discounts for lack of marketability such as those related to restricted or unregistered securities, although both may apply to the same block of shares. In the United States, if there is no agreement that requires the issuer to register them in accordance with the Securities Act, unregistered shares, often called "letter stock", may only be sold in negotiated transactions to sophisticated investors.

Restricted Securities

Under SEC Rules l44 and l44A, the amount of stock that can be sold by any person during any three month period cannot exceed the lesser of 1% of the outstanding class of securities or the average weekly reported trading volume over the appropriate four week period; this is known as the "dribble" rule, which rule only applies when the securities have been held for at least two years. Rule 144 sales, in any quarter are limited to the greater of 1% of the issued shares or the average weekly trading volume. As a result of these limitations, securities subject to Rule 144 are often "privately placed" with sophisticated investors, who buy them at a discount because of the restrictions on their resale.

According to Mercer, the tax courts have typically allowed discounts in the order of 20% to 40% to reflect the illiquidity of unregistered shares in public companies. Revenue Ruling 77-287 provides official guidelines for valuing stock in publicly traded companies which are restricted from resale due to Federal securities laws.

The Revenue Ruling refers to the SEC 1971 Institutional Investors study, which reached the following conclusions:

a) Earnings of a company consistently had significant influence on the size of the discounts for its restricted securities; apparently earnings patterns determined the degree of risk in the investments.
b) Sales also had a major influence on the amount of discount at which restricted securities sold; companies with the lowest dollar sales account for most of the transactions involving the highest discount rates.
c) Trading Market and resulting liquidity influenced the discounts as well; discounts were greatest for restricted stocks of companies whose unrestricted shares traded on the Over-

the-Counter market (now NASAQ), while the discounts for shares of companies listed on the New York Stock Exchange were the smallest.

d) Resale Provisions often affected the size of the discount; in particular piggyback rights or an option to require registration, at the issuer's expense tended to reduce the discount.

US Empirical Data

The following table sets out the results of ten studies of discounts relating to restricted shares. The data has been obtained from the Guide, page 8-27 and other sources.

Summary of Restricted Stock Studies

Study	Source	Years Covered In Study	Mean Discount %	Median Discount %
SEC Overall Average	A	1966-1969	25.8	
SEC Nonreporting OTC Companies	A	1966-1969	32.6	
Gelman	B	1968-1970	33.0	
Trout	C	1968-1972		33.5
Moroney	D	1962-1972	35.6	
Maher	E	1969-1973	35.4	
Standard Research Consultants	F	1978-1982		45.0
Willamette Management	G	1981-1984		31.2
Silber Study	H	1981-1989	34.0	
FMV Study	I	1979-1992	23.0	
Management Planning, Inc.	J	1980-1995	27.7	28.2

A "Discounts involved in Purchases of Common Stock (1966-1969)", Institutional Investor Study Report of the Securities and Exchange Commission. H.R. Doc. No. 64, Part 5, 92d Cong., lst Sess. 1971, pp. 2444-2456.

B Milton Gelman, "An Economist-Financial Analyst's Approach to Valuing Stock of a Closely Held Company," Journal of Taxation, June 1972, pp. 353-354.

C Robert R. Trout, "Estimation of the Discount Associated with the Transfer of Restricted Securities," Taxes, June 1997, pp. 381-385.

D Robert E. Moroney, "Most Courts Overvalue Closely Held Stocks," Taxes magazine, March 1973, pp. 144-154. Although the period covered is likely 1969-1972, no specific years are given in the published account.

E J. Michael Mahor, "Discounts for Lack of Marketability of Closely-Held Business Interests," Taxes, September 1976, pp. 562-571.

F "Revenue Ruling 77-287 Revisited, "SRC Quarterly Reports, Spring 1983, pp. 1-3.

G Williamette Management Associates study (unpublished) quoted in "Valuing a Business", Shannon Pratt.

H William L. Silber, "discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices," Financial Analysts Journal, July-August 1991, pp. 60-64.

I Lance S. Hall and Timothy C. Polack, "Strategies for Obtaining the Largest Discount", Estate Planning magazine, January /February 1994, pp. 38-44. In spite of the long period covered, this study had only about 100 transactions involving companies that were not "small capitalization". It supported the SEC Institutional Investor Study in finding that the discount for lack of marketability was higher for small capitalization companies.

J Management Planning, Inc. "Analysis of Restricted Stocks of Public Companies: 1980-1995". Published in "Quantifying Marketability Discounts-Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests", by Z. Christopher Mercer, Peabody Publishing, Memphis, TN, 1997, pp. 345-370.

Pre-IPO Transactions

The October 1997 issue of "Shannon Pratt's Business Valuation Update", a respected US valuation industry Newsletter, contains references to two sets of studies since 1985 on "Discounts for Lack of Marketability". They were done by Willamette Management founded by Dr. Pratt and John Emory of Robert W. Baird & Co.

	Williamette Median		Emory Median	
	Transactions	**Discount**	**Transactions**	**Discount**
	Sales only		*Sales & Options*	
1985	25	43.2%		
1986	74	47.5%		
1985-86			21	43%
1987	40	43.8%		
1988	19	51.8%		
1989	19	50.4%		
1987-89			27	45%
1990	23	48.5%		
1989-90			23	40%
1991	34	31.8%		
1992	75	52.4%		
1990-92	42	40.0%		
1993	110	53.3%		
1992-93			54	44%
1994-95			46	45%
1995-97			91	42%

In his commentary, Dr. Pratt states:

> "I believe that the typical adjudicated court decision, whether in Tax Court or some other venue, underestimates the full impact of lack of liquidity."

All of the published studies cover stocks of companies that either have an established public market or, at least, prospects for a public market. As John Emory asked, "how much greater should discounts be for the more typical company's stock that has no marketability, little if any chance of ever becoming marketable, and is in a neutral to unpromising situation?"