

Standards of Value

Theory and Applications

Jay E. Fishman
Shannon P. Pratt
William J. Morrison



John Wiley & Sons, Inc.

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Jay Fishman:

To Marjan
You made it all possible—altijd

Shannon Pratt:

To my wonderful associates at Shannon Pratt Valuations

Bill Morrison:

To my wife, Margaret, the love of my life,
To my children, Christina and William, my pride and joy.

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Foreword

The first time I ever testified in court, I listened to the opposing expert, when cross examined, give the wrong standard of value as the basis for his opinion of value. This was a long time ago, but I never forgot it. That episode made me aware of how important the standard of value is within the context of any valuation—whether, estate and gift tax, dissenting rights, financial reporting, or marital dissolution.

The standard of value and the proper definition of the standard of value set the criteria upon which valuation analysts rely. Among many factors, it dictates whether you use a hypothetical buyer and seller, a market-participant buyer and seller, value to a single person, or a willing or unwilling buyer and seller. It also sets the stage for consideration of the various levels of value (five here) and whether discounts and/or premiums apply. My first experience with this in a courtroom made me realize how different the value can be if the analyst uses the wrong standard of value. It can also make your work indefensible, which is what happened to the other expert in that courtroom so long ago.

This book, with its well-known group of authors, helps clarify an area that many analysts think is simple and straightforward. It is anything but that. While I don't agree with every view expressed, I do agree with all the topics that make this book a very worthwhile read. This is a complex area with differing interpretations, particularly when dealing with multiple definitions within each state. Even the universally defined standard of value—"fair market value"—has some interpretation problems. Sure, it's a willing buyer and seller, a hypothetical buyer and seller, with no compulsion and both with reasonable knowledge of the relevant facts. However, who are the hypothetical buyer and seller? Is it the most likely buyer and seller? Some courts say no. Is it the average buyer and seller? If so, how do you average people? Is it a standalone value, a strategic buyer or a financial buyer? These are tough questions concerning a standard of value that many analysts choose to ignore. This book breaks down the walls of uncertainty and does much to help answer many of these difficult questions.

The authors connect the dots by introducing five standards of value: fair market value, investment value, intrinsic value, fair value (state actions) and fair value (financial reporting). They put these into service line applications for valuations in tax, marital dissolution, dissenting rights and shareholder oppression, and financial reporting. The various standards of value are then connected to the service line applications through the premise of value concepts of “value in exchange” and “value to the holder.” In Chapter four, “Standards of Value in Divorce,” the authors present clear, concise charts titled “Continuum of Value.” For example, one of these charts links the premise of value to the standard of value, segments it into enterprise and personal goodwill, with references to relevant case law and the important underlying assumptions. Discounts and premiums and the effect of buy sell agreements are also presented and explained.

One of the best parts of the book is the obvious attention to detail concerning the standards of value and their definition, by state, for marital dissolution and dissenters’ rights and shareholder oppression. There are charts showing each state and the important cases that set the criteria for valuation in these two areas. These charts will be extremely helpful to valuation analysts who practice in multiple states, as well as a good refresher for those whose practices are more local or regional.

In Chapter three, *Fair Value in Shareholder Dissent and Oppression*, the charts include the state, standard of value, definition of valuation term, precedent cases for allowing discounts, most recent case, relevant dates, and dissolution and buy-out election as a remedy for oppression. In Chapter four on divorce, the charts include the state, standard of value, definition of value, treatment of goodwill, effect of buy-sell agreements, discounts and relevant case law.

All of the chapters include the history and development of the standard of value and concise summaries of relevant case law and applicable regulations, statutes and standards. Again, readers may think this is a simple subject. However, as the authors have so eloquently presented here, it is quite complex. These authors have done their homework and compiled the state-by-state research to help valuation analysts better understand the many nuances within each state. Shannon, Jay and Bill, thank you for putting the time into this. It’s a welcome enhancement to our profession’s body of knowledge.

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Preface

We have all heard the expression “Value lies in the eyes of the beholder” (a play on words from the expression “Beauty lies in the eyes of the beholder”). We cannot imagine a sense in which this could be more true than in the value of a business or an interest in a business. *Value* has no meaning until it is defined. In the nomenclature of business valuation, these different definitions of value are called *standards of value*.

In some contexts, the standard of value is mandated by statute or regulations. For example, *fair market value* is the statutory standard of value for all federal gift, estate, and income taxes. *Fair value* is the mandated standard of value for financial reporting that is subject to regulation by the Securities and Exchange Commission. The expression *fair value* is also used as the standard of value in almost every state’s statutes for dissenting and oppressed stockholder actions, but the definitions are very different from the definition of fair value for federally regulated financial reporting purposes and differ somewhat from state to state.

Even when the standard of value is statutorily defined, it leaves much room for interpretation in case law. Very few state statutes dealing with property settlements for divorce address *any* definition of a standard of value. Therefore, in the context of valuations for divorce, virtually *all* the guidance as to the accepted standard of value is found in the case law, which varies greatly from state to state and even in different jurisdictions within some states.

It comes as a surprise to many people that the same identical shares of stock can have different values in different contexts. For example, one of the authors valued shares in a dissenting stockholder suit and was later retained to value the same shares for the estate when a stockholder died. For the estate tax valuation, the value was considerably less because of minority and marketability discounts, which were not mandated under the standard of value applicable in the dissenting stockholder action.

Standards of value that apply in certain circumstances may also be mandated in company articles of incorporation, articles of partnership, buy-sell agreements, arbitration agreements, and other documents. It is essential that attorneys and others drafting these documents have a clear understanding of the standards of value specified in the document and that they convey this understanding to their clients. How many times have we been confronted with language such as “the fair market value of the shares” and when the triggering event occurred found the shareholder shocked to find that the language did not mean a proportionate share of the total company value, but much less after discounts for minority interest and lack of marketability?

When embarking on a business or intangible asset appraisal assignment, the first thing one needs to know is the definition of value. Yet this is the first full book to comprehensively address this important issue.

We address standards of value in several contexts:

- Gift, estate, and income taxes
- Dissenting and oppressed stockholder actions
- Marital dissolution proceedings
- Fair value for financial reporting

We also present information on international standards of value.

The book lists each of the major federal statutes and regulations and relevant statutes of all states and territories so that the valuation report can cite the specific authority, and the attorney or valuation analyst can go to the full text of the relevant authority in case of a need to know more.

We have analyzed hundreds of court cases interpreting the various statutes and regulations. From these we have extracted the points that we believe to be most representative of the respective jurisdiction’s view on interpretation of various issues and included selected quotations from the case opinions. These range from a sentence to several paragraphs, and collectively include several hundred court case citations. They reveal the many different nuances of interpretation of the standards of value in different jurisdictions.

If there is a “case of first impression” on an issue (an issue that has not been tried before in that jurisdiction), courts sometimes look to precedent from other jurisdictions that have similar statutes. For this reason, and for general reference, we have selected certain issues (e.g., minority discounts in dissent cases, marketability discounts in dissent cases) and grouped the states or jurisdictions that seem to accord the issue common treatment.

We do not express opinions (except for our perception of consensus among the business appraisal community) on what the interpretations of the

appropriate standards of value *should be*. Instead, we merely report what the interpretations are as we understand them. We try hard to point out commonalities and differences of interpretation among jurisdictions and, sometimes, within the same jurisdiction.

Business valuations are extremely case-specific. Frequently, what may seem like a contradiction from one case to another can be explained by different facts and circumstances. Therefore, it is dangerous to draw broad generalizations from specific case opinions. A study of case precedents, however, is important to provide the attorney or the analyst some conception of the court's thinking on certain issues.

Use of the research compiled in this book as a starting point for understanding the relevant standard of value for a certain type of case in a certain jurisdiction will save attorneys and appraisers a great deal of time. We hope that it will also provide insight into the perspectives of the various courts on interpretation of various issues related to standards of value. Since the nature of the subject material contained in this book is evolving, the authors will attempt to monitor changes in theory, statute, and case law. The reader is invited to forward any questions, concerns, and comments to the authors as they arise.

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Introduction

PURPOSE

From a practical point of view, the appraisal process can be viewed as no more than answering a question: “What is the value?” Before this question can be answered, however, a definition of value is required. Defining the term *value* begins with identifying the standard of value, that is, the type of value being sought. Each standard of value contains numerous assumptions that represent the underpinnings of the type of value being utilized in a specific engagement. Even when a standard of value is specified, there is no guarantee that all would agree on the underlying assumptions of that standard. As James C. Bonbright wrote in his pioneering book, *Valuation of Property*:

When one reads the conventional value definitions critically, one finds, in the first place, that they themselves contain serious ambiguities, and in the second place, that they invoke concepts of value acceptable only for certain purposes and quite unacceptable for other purposes.¹

It has been our observation that Bonbright’s 1937 quote still applies today. This book is an attempt to address some of the ambiguities inherent in the application of common standards of value. It has been written by three valuation practitioners who deal with these issues on a daily basis. Since we are not attorneys, the book is not written to provide legal advice but rather to discuss the interaction between valuation theory and its judicial and regulatory application.

In this book, we address the standard of value as applied in four distinct contexts: estate and gift taxation, shareholder dissent and oppression, divorce, and financial reporting. We have written this book for judges, lawyers, and

1. James C. Bonbright, *Valuation of Property* (Charlottesville, VA: Michie Company, 1937), at 11.

appraisers, in the hopes of fostering a better understanding of the theory and application of the standard of value in the judicial and regulatory areas in which they are applied. We hope to provide a framework of appraisal theory as to the standards of value and the underlying premises of value generally applied in these four contexts.² With this analysis, we discuss the resulting methodologies and applications that flow from these standards.

This book is not designed to explain specific valuation techniques and methodologies. For instance, we address the applicability of shareholder-level discounts for lack of control and marketability, but we do not discuss how to calculate them. Our hope is that this book will help practitioners understand some of the intricacies of performing services in these venues so they will ask appropriate questions and seek relevant guidance. We also hope that the book will help appraisal users to understand why the practitioners are asking such questions. Last, we hope this book will contribute to a continuing dialogue on these issues.

Our chapter on fair value in financial reporting addresses the mechanical aspects of valuation and auditing under the pronouncements of the Financial Accounting Standards Board (FASB) and more recently, the Securities and Exchange Commission and the Public Company Accounting Oversight Board (PCAOB). Valuations for estate and gift tax, shareholder dissent and oppression, and divorce matters are presented within their respective judicial frameworks, whether the federal courts for estate and gift tax cases or the state courts for shareholder dissent and oppression cases and the family law probate courts for the valuation and distribution of property upon divorce.

The breadth of our research deals with standards of value as they relate to judicial and regulatory matters, and we have found that valuation literature, legal scholarship, economics, and case law are all evolving. We have attempted to look at the development of these concepts as they have emerged over time as well as how they differ among the states.

Generally, the judicial decisions appear to endorse certain valuation methodologies that are designed to address the specific fact pattern of a case. It is our observation that in many cases, the courts seem to look at valuation from the perspective of doing equity rather than adhering strictly to any one specific standard of value and properly following valuation theory, especially in the context of family law.

2. Premises of value represent the general concepts of property under which the standards of value fall. As we will explain, the premises of value can be as important as the standard of value.

In preparing this book, we have utilized a variety of resources in the fields of appraisal and law. In order to find state-specific language and case law applicable to our analysis, we have reviewed the annotated statutes of the 50 states and the District of Columbia in shareholder dissent and oppression and in property distribution in divorce. We have also reviewed law journals to seek legal perspective and identify the most important precedent-setting cases. In addition, we have reviewed articles in various publications to identify the major issues for the valuation professional. Finally, and most important, we have reviewed the cases themselves for perspective on the reasoning behind appraisal-related decisions.

As stated previously, we are not lawyers, and therefore in our review of case law, statutes, and varying legal analysis, we are approaching the issues from a valuation professional's perspective. We look to present the language used in the application of law and financial standards pertaining to business valuations and the specific assumptions that most practitioners make when that language is used.

We are not providing an opinion in any chapter as to the appropriate treatment of the standard of value. Our analysis represents a survey of how the standard of value is being treated across the United States in varying contexts. For instance, in divorce, we have attempted to discern how each state addresses (or does not address) the standard of value as it applies to businesses and business interests. We offer no opinion as to what is the correct standard. Instead, we survey and report the standards of value we see being applied in different states.

Every Appraisal Is Unique

In preparing an appraisal on a judicial matter, whether for a valuation for a federal jurisdiction in an estate or gift tax matter or for a state court matter pertaining to stockholders or divorcing spouses, the practitioner must be sensitive to the facts and circumstances of the case at hand. The practitioner must realize that the interpretation of the standard of value previously used in court cases may not apply across all cases. The specific fact pattern of a reported case might distinguish it from the case at hand.

The practitioner must also be aware that in prior case law, the terminology used and the ultimate outcome of the valuation may not be in sync. Additionally, jurisdictional differences may exist, and the way a certain standard of value is used in one jurisdiction may differ from its use in other state and federal jurisdictions.³

3. David Laro and Shannon P. Pratt, *Business Valuation and Taxes* (Hoboken, NJ: John Wiley & Sons, 2005), at 5.

Fair Value versus Fair Market Value

The two most widely used standards of value are fair market value and fair value. Before we discuss the definitions of these terms in valuation and law, we can look at their application on a purely linguistic level.

In plain language, fair value is a much broader concept than fair market value. Webster's thesaurus gives these synonyms for the word *fair*: just, forthright, impartial, plain, upright, candid, sincere, straightforward, honest, lawful, clean, legitimate, honorable, temperate, reasonable, civil, uncorrupted, equitable, fair-minded.⁴ Without the "market" modifier, fair value can be seen as a broad concept of a "value" that is "fair." Accordingly, the term *fair* gives a court wide latitude in reaching a judgment. The fair value of an asset could be its market value, its intrinsic value, or an investment value. Similarly, it could be a value in exchange, a value to the holder; it could represent a liquidation value or a going concern value.

The term *fair market value* is more limiting, by its use of the word *market*. Whether *market* applies to *fair* (as in fair market) or *value* (as in market value), we are limited to finding the value an asset would have in exchange, that is, on a market in the context of a real or hypothetical sale. Fair market value is the cornerstone for all other judicial concepts of value. Following a brief overview of common standards and premises of value in chapter one, we move first to a discussion of fair market value, as it sets the benchmark from which other standards of value are viewed.

Later, when we apply definitions set forth by the Internal Revenue Service, or the American Bar Association, or the FASB, or any other professional or regulatory body providing guidance, we arrive at a set of assumptions that limit the scope of the valuation. As we will see, fair value is indeed subject to wider interpretation from a judicial perspective than fair market value.

Fair market value is well defined and established in legal, tax, and accounting settings, and fair value is defined in terms of financial reporting. However, there is no universal definition of fair value in the context of dissent and oppression cases. Perhaps the most relevant definition was laid out in the landmark 1950 shareholder dissent case *Tri-Continental Corp. v. Battye*,⁵ where the court expressed the basic concept of fair value under the dissent

4. *Webster's New World Dictionary and Thesaurus* (New York: Simon & Schuster Macmillan, 1996), at 222.

5. 74 A.2d 71; 1950 Del. LEXIS 23; 31 Del. Ch. 523.

statute as being “. . . that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern.”⁶

Interestingly, the definition of fair value in *Black’s Law Dictionary* says “See fair market value.” Under the definition of fair market value, there is an example of a bankruptcy case.⁷ In that case, the term *fair value* is used, as opposed to *fair market value*, as if the terms were interchangeable. This circular referencing makes the concepts of fair value and fair market value difficult to separate in a broad legal context; however, as we show through a review of case law, statutes, and commentary, the two concepts are regularly viewed as different.

We will explain how fair value differs from fair market value in its application in shareholder dissent and oppression. In divorce matters, we will look at a continuum over which businesses are valued and see how, under certain circumstances in certain jurisdictions, fair value is closely related to fair market value and, under others, it is not.

Historical Perspective

Today, the term *fair market value* is used often in the statutory context. For example, New Jersey’s statutes use the term in 125 different sections of the code, from library material (§ 2A:43A-1) to farmland (§ 4:1C-31) to hazardous substances (§ 58:10-23.11b). The term *fair value* is much less pervasive. Today, it is used mainly for financial reporting, shareholder oppression and dissent, and sometimes divorce matters. The historical development of fair market value, fair value, and the standard of value in divorce are briefly summarized next.

1800 to 1850

In searching case law, we begin to see references to standards of value in the early nineteenth century; however, the standards of value are not necessarily defined as such. One of the earliest references to fair market value is in a tariff case from 1832.⁸ The term was set forth without further definition.

6. Id. at 3.

7. Bryan A. Garner, *Black’s Law Dictionary*, 8th ed. (St.Paul, MN: Thompson West, 2004), at 1587.

8. *United States v. Fourteen Packages of Pins*, 1832 U.S. Dist. LEXIS 5; 25 F. Cas. 1182; 1 Gilp 235.

1850 to 1900

In the late nineteenth century, the emergence of the railroads allowed an expansion of commerce to a national scale and aided the development of national, multishareholder corporations. As tax law developed and business organizations progressed, there came a need for judicial and legislative involvement in corporate law. Majority rule emerged in corporations when the courts recognized the operational necessity of abandoning unanimous consent for corporate decisions. The courts began to look for a manner by which to value property for taxation and to find equitable solutions to the disagreements of shareholders that naturally grew out of this evolution.

The earliest references to fair value were found in cases involving contractual agreements between individuals regarding the ownership of stock, property, or other assets.⁹ Like fair market value, the concept of fair value that emerged from these events remained undefined.

1900 to 1950

At the beginning of the twentieth century, the courts, the states, and other regulatory and advisory organizations began dealing more commonly with litigation involving business valuations. In the 1920s, the Commissioners for Uniform State Laws began developing a model code for businesses, but the Model Business Corporation Act of the American Bar Association (ABA) gained popularity and began to influence the state legislatures in the codification of dissenters' rights in their statutes. In 1933, the Illinois Business Corporation Act became the model statute for shareholder oppression, and in the early 1940s, California instituted a statutory buy-out provision where a corporation could elect to buy-out a shareholder who claimed to be oppressed, rather than going through dissolution litigation. Later that decade, the landmark case *Tri-Continental Corp. v. Battye*¹⁰ introduced the concept that fair value should compensate a shareholder for that which had been taken.

In the 1920s, the definition of fair market value began to emerge through various case decisions. The concepts of willing buyer, willing seller, known and knowable, and the effect of compulsion on fair market value were discussed and established as elements to consider in determining fair market value. The

9. *Montgomery v. Rose*, Court of Virginia, Special Court of Appeals 1855 Va. LEXIS 65; 1 Patton & H. 5, January, 1855. *The United States Rolling Stock Company v. The Atlantic and Great Western Railroad Company*—Court of Ohio, 34 Ohio St. 450; 1878 Ohio LEXIS 173, December 1878.

10. 74 A.2d 71, 72 (Del. 1950).