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Standards of Value

Theory and Applications

Second Edition

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

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Standards of Value

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JAY E. FISHMAN,
SHANNON P. PRATT,
WILLIAM J. MORRISON

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Jay E. Fishman

To Marjan: Altijd.

To our triple trouble: Micha, Justin, and Seth.

Bill Morrison

To my wife, Margaret, the love of my life.

To my children, Christina and William, my pride and joy.

Shannon Pratt

To my wife, Millie, and to our four children and ten grandchildren.

Contents

Foreword	xiii
Preface	xvii
Acknowledgments	xxi
About the Authors	xxv
Introduction	1
Purpose	1
Every Appraisal Is Unique	3
Fair Value versus Fair Market Value	4
Historical Perspective	5
Chapter Preview	8
Chapter 1: Common Standards and Premises of Value	8
Chapter 2: Fair Market Value in Estate and Gift Tax	8
Chapter 3: Fair Value in Shareholder Dissent and Oppression	9
Chapter 4: Standards of Value for Partnership and Limited Liability Company Buyouts	10
Chapter 5: Standards of Value in Divorce	12
Chapter 6: Fair Value in Financial Reporting	13
How Standard of Value Can Affect the Ultimate Conclusion of Value	13
CHAPTER 1	
Common Standards and Premises of Value	17
Common Standards and Premises	17
Price, Value, and Cost	17
Defining a Standard of Value	19
Premises of Value	20
Common Standards of Value	21
Fair Market Value	21
Fair Value	23
Investment Value	24

Intrinsic Value	25
Book Value	27
Common Operational Premises Underlying the Standard of Value	28
Going Concern	28
Liquidation Value	29
Fair Value in Alternative Contexts	30
Fair Market Value in Alternative Contexts	31
Standards of Value in the International Context	32
Summary	33

CHAPTER 2

Fair Market Value in Estate and Gift Tax 35

Introduction	35
Common Definitions of Fair Market Value	36
History of Fair Market Value	37
United States v. Fourteen Packages of Pins	38
Elements of Fair Market Value	41
Price at Which a Property Would Change Hands	42
Willing Buyer	44
Willing Seller	54
No Compulsion to Buy or Sell	59
Reasonable Knowledge of Relevant Facts	63
Common Discounts	80
Summary	87

CHAPTER 3

Fair Value in Shareholder Dissent and Oppression 89

<i>Gilbert E. Matthews and Michelle Patterson</i>	
Fair Value as the Standard of Value in Dissent, Oppression, and Entire Fairness Cases	89
The Appraisal Remedy for Dissenting Shareholders	94
History and Overview of the Appraisal Remedy	94
Appraisal Rights Today	97
Appraisal Rights in Publicly Traded Corporations: The Market Exception	99
Fair Value Can Be Less Than Arms'-Length Price	102
The Oppression Remedy	106
Development of the Oppression Remedy	106
Context of Oppression Remedy	107
Dissolution as a Remedy for Oppression	110

Shareholder Buyouts as an Alternative Remedy	110
Examples of Oppression	116
Fair Value Is the Standard of Value in Appraisal and	
Oppression in Almost All States	121
Fair Value as Defined by Various Authorities and Statutes	121
The Valuation Date—Before the Effectuation of the	
Corporate Action to Which the Shareholder Objects	125
Valuation Date in Appraisal Cases	125
Valuation Date in Oppression Cases	126
Customary and Current Valuation Techniques	130
Fair Value in Delaware	139
Delaware Fair Value Standards	139
Entire Fairness in Delaware	140
Components of Fair Value in Delaware	144
Ohio's Unique and Unfavorable Standard of	
Value in Appraisals	155
Fair Value Normally Excludes Discounts	
and Premiums	157
Most States Now Reject Minority and	
Marketability Discounts	157
Levels of Value	159
Discounts at the Shareholder Level	160
The "Implicit Minority Discount"	163
No Premiums Are Applicable to DCF Values	167
Discounts at the Corporate Level	168
Control Premiums at the Corporate Level	169
Some States Permit Considering Extraordinary	
Circumstances in Determining Whether to	
Apply Discounts	171
Court Decisions Have Moved toward Rejecting Discounts	172
Equitable Adjustments to Fair Value	188
Consideration of Wrongdoing in Calculating Fair Value	188
Damage Claims	193
Summary	194

CHAPTER 4

Standards of Value for Partnership and Limited Liability Company Buyouts

197

Noah J. Gordon

Introduction	197
Buyout upon Dissociation	198

Buyout in Lieu of Dissolution	199
Dissenters' Rights	200
Partnerships and Limited Liability	
Partnerships (LLPs)	200
Limited Liability Partnerships	201
General Partnership Standard of Value Cases	212
Limited Partnerships	216
Limited Liability Companies, Generally	222
Uniform Acts	223
Buyout in Lieu of Dissolution	224
Withdrawal and Buyout	228
Dissenters' Rights	231
Professional LLCs	232
LLC Decisions	232
Summary	235

CHAPTER 5

Standards of Value in Divorce 237

Introduction	237
Marital Property: General Background and History	240
Identification of Marital Property and Separate Property	242
Relationship between Valuation and Identification of Intangible Assets	244
Appreciation on Separate Property	246
Premises and Standards of Value in Divorce	249
Premises of Value	249
Standards of Value	250
Premises of Value Revealed through the Valuation of Insurance Agencies	255
Concepts of Value under the Two Premises	257
Standards of Value in Divorce among the 50 States	258
Lack of Statutory Insight	258
Revealing Standard of Value through Case Law	260
Toward a Standard of Value Classification System	265
Value in Exchange	274
Goodwill	274
Lack of Control and Marketability Discounts under Value in Exchange	290
Fair Value	293
Buy-Sell Agreements under Value in Exchange	299
Value to the Holder	304

Goodwill	304
Double Dipping	315
Shareholder-Level Discounts under the Value to the Holder Premise	317
Fair Value	317
Buy–Sell Agreements under Value to the Holder	318
Summary	320

CHAPTER 6

Fair Value in Financial Reporting 323

Neil J. Beaton

Introduction	323
Fair Value in Financial Reporting: What Is It?	324
Application of Fair Value	325
History of Fair Value in U.S. Accounting Literature	328
Application of the Fair Value Standard to Business Combinations	333
Application of the Fair Value Standard to Asset Impairment Tests	336
Interpretation of Fair Value Compared to Other Standards of Value	339
Fair Value in Financial Reporting versus Fair Value in Dissenters' Rights Cases	339
Fair Value in Financial Reporting versus Investment Value	339
Fair Value in Financial Reporting versus Fair Market Value	340
Audit Issues	342
Summary	343
Appendix: Sources of Information	344

APPENDIX A

International Business Valuation Standards 347

Introduction	347
International Valuation Standards Council	347
Valuation Organization	348
Broad Definitions	350
Approaches to Valuation	351
Types of Property	352
Toronto Valuation Accord	353
Mission and Objectives	354
Definitions	355
Fair Value Measurement	356

Conclusion	357
Royal Institute of Chartered Surveyors	358
International Financial Reporting Standards	358
Appendix B	
Chart— Fair Value in Dissent and Oppression	359
Appendix C	
Standards of Value in Divorce Classifications by State and Standard of Value	377
Index	443

Foreword

The authors of this very useful book have again asked me to write the Foreword. I'll start this with the ending in the Foreword I wrote in the first edition. "Shannon, Jay, and Bill, thank you for putting the time into this. It's a welcome enhancement to our profession's body of knowledge."

Since the first edition was published in 2006, I can't tell you how many times I have referred to it. It is a very valuable and easy-to-navigate resource. It's incredible that these three authors have put so much time into keeping us all up to date in the practice areas of tax, divorce, dissenting rights and shareholder oppression, and fair value for financial reporting. These four areas make up four of the six chapters.

Right up front, it is important to note that this book is not just about the definitions of the various standards of value. The real value of this important resource is that the authors have taken an enormous amount of time to explain the history, evolution, and application of standards of value in different venues. Also, for state-specific valuations, such as marital dissolution and shareholder dissent and oppression, they have looked at all the states and provide definitions, nuances, applications, supporting regulations, statutes, and case law.

They have also added a new chapter, "Standards of Value for Partnership and Limited Liability Company Buyouts." This chapter discusses general partnerships, limited partnerships, limited liability partnerships, and limited liability companies. These types of business entities are often misunderstood by valuation analysts, often to the detriment of their clients and their advisors. Nowhere else have I ever seen these types of entities discussed in such detail. Furthermore, they present individual states' definitions of value under partnership statutes and relevant court cases.

The proper definition of the standard of value sets 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 and whether discounts and/or premiums apply. My experience with standards of value in various dispute settings makes me realize how different the value can be if

the analyst uses the wrong standard of value. It can also make your work indefensible, regardless of whatever good valuation work you perform.

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. 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."

Again, 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 5, "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 and 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.

Gil Matthews and Michelle Patterson have substantially rewritten Chapter 3, "Fair Value in Shareholder Dissent and Oppression," which now also includes a section that discusses shareholder dissent in Delaware. The exhibits include, on a state-by-state basis, the applicability of the market exception for appraisals, the availability of the buyout remedy in oppression,

statutory language regarding valuation techniques, and summaries of significant court decisions regarding discounts.

The chapter on “Fair Value for Financial Reporting,” Chapter 6, has benefited immeasurably by the changes that have occurred since 2007 as well as the rewriting by Neil Beaton.

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. I’ll end as I began. 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
- Buyout of owners of partnerships, limited partnerships, and limited liability companies
- Marital dissolution proceedings
- Fair value for financial reporting

This 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.

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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Acknowledgments

This book has been written by three active business valuation practitioners who each have at least 25 years of experience in the business valuation profession. However, this book would not have been possible were it not for the unstinting efforts of many others. First and foremost are Noah J. Gordon, of Shannon Pratt Valuations, and Christina Giorgio and Ernest Stalzer, CPA/ABV/CFF, MBA, CDFA, both of WithumSmith+Brown, who performed a significant amount of work on this book. Ottaviana De Ruvo and Holden Warriner, also both of WithumSmith+Brown, provided research services.

This book has benefited immensely from review by many individuals with a high level of knowledge and experience in business valuation. The following people reviewed most or all of the entire manuscript, and the book reflects their tremendous efforts and legion of constructive suggestions:

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In addition, this book covers a number of specific topics and covers areas where business valuation and law intersect. The following people reviewed certain chapters and provided significant constructive suggestions:

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We also would like to thank our colleagues and families for the support they gave us over the time this book was written.

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He holds bachelor's and master's degrees from Temple University as well as an MBA from LaSalle University. Mr. Fishman is a fellow and life member of the American Society of Appraisers, a former chairman of its Business Valuation Committee, former editor of the *Business Valuation Review*, chair of ASA's Government Relations Committee, a fellow of the Royal Institution of Chartered Surveyors, an accredited senior member of the Institute of Business Appraisers, Inc., a former member of the Appraisal Standards Board of the Appraisal Foundation, and chair of its Appraisal Practice Board. He was also a member of the Internal Revenue Service's Advisory Council.

Shannon P. Pratt, CFA, ARM, ABAR, FASA, MCBA, CM&AA, has a reputation for knowledge and experience in the field of business valuation that is unparalleled. He is the best-known authority in the field of business valuation and has written numerous books that articulate many of the concepts used in modern business valuation around the world.

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Dr. Pratt's professional recognitions include being designated a life member of the Business Valuation Committee of the American Society of Appraisers, a life member of the American Society of Appraisers, past chairman and a life member of the ESOP Association Advisory Committee on Valuation, a life member of the Institute of Business Appraisers, the Magna Cum Laude in Business Appraisal award from the National Association of Certified Valuation Analysts, and the distinguished service award of the Portland Society of Financial Analysts. He recently completed two three-year terms as trustee-at-large of the Appraisal Foundation. Dr. Pratt is the author of *The Market Approach to Valuing Businesses*, 2nd edition; *Business Valuation Body of Knowledge: Exam Review and Professional Reference*, 2nd edition; and *Business Valuation Discounts and Premiums*, 2nd edition; coauthor with Roger Grabowski of *Cost of Capital: Estimation and Application*, 4th edition; *Cost of Capital: Workbook and Technical Supplement*, 4th edition; and *Cost of Capital in Litigation*; coauthor with the Honorable David Laro of *Business Valuation and Federal Taxes: Procedure, Law and Perspective*, 2nd edition, all published by John Wiley & Sons; and *The Lawyer's Business Valuation Handbook*, 2nd edition, published by the American Bar Association. He is author of *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th edition, and coauthor of *Valuing Small Businesses and Professional Practices*, 3rd edition, both published by McGraw-Hill. He is also coauthor of *Guide to Business Valuations*, 22nd edition, published by Practitioners Publishing Company.

He is publisher emeritus of a monthly newsletter, *Shannon Pratt's Business Valuation Update* (primarily for the professional appraisal community). Dr. Pratt develops and teaches business valuation courses for the American Society of Appraisers, the AICPA, and the National Association of Valuators

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William J. Morrison, CPA/ABV, is a partner in the Paramus, New Jersey, office of WithumSmith+Brown, PC, and has over 25 years experience as a valuation analyst. He is a CPA in New Jersey and is accredited in business valuation and forensics by the AICPA. He is the partner in charge of the firm's Litigation, Valuation and Insolvency Group.

He founded and was president of the forensic accounting firm, Morrison & Company (merged with WithumSmith+Brown in December 2010). He is a CPA licensed in New Jersey with over 30 years experience as an investigator, forensic accountant, and business valuator. He has also served as a special agent for the Federal Bureau of Investigation (FBI), an internal auditor, and a CPA. Mr. Morrison has been qualified as an expert for the Supreme Court, Superior Court, and Federal Court of New Jersey, and has been appointed as an expert for the federal and state courts in New Jersey in over a thousand matters as a forensic accountant, valuation expert, and mediator. He has provided expert witness services in complex civil and criminal matters involving stockholder oppression, high-net-worth divorces, economic damage claims, and federal, criminal, and tax matters, among others.

He has lectured to organizations such as the New Jersey Institute of Continuing Legal Education, American Society of Appraisers, NACVA, and New Jersey Society of Certified Public Accountants (NJSCPA).

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Gilbert E. Matthews, CFA, co-author of Chapter 3, "Fair Value in Shareholder Dissent and Oppression," is chairman and a senior managing director of Sutter Securities, an investment banking firm headquartered in San Francisco. He has more than 50 years of experience in investment banking, having worked with a wide variety of clients in mergers, acquisitions, and divestitures, friendly and unfriendly tender offers, public and private offerings of securities, recapitalizations, bankruptcy and other financial restructurings, and international transactions. Mr. Matthews has provided expert testimony in more than 20 states with respect to valuation, investment banking practice, and other matters.

Prior to joining Sutter in 1995, Mr. Matthews was with Bear Stearns in New York, where he had been a senior managing director and a general

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Mr. Matthews received an AB from Harvard and an MBA from Columbia. He has spoken on fairness opinions, valuations, and related matters before numerous professional groups. In addition, he has written several book chapters and articles on fairness opinions, corporate valuations, and litigation relating to valuations and appraisals. He is on the editorial boards of *Business Valuation Review*, published by the American Society of Appraisers, and *Business Valuation Update*, published by Business Valuation Resources, and is a member of the Fairness Opinions Working Group of the International Valuation Standards Council.

Michelle Patterson, JD, PhD, co-author of Chapter 3, "Fair Value in Shareholder Dissent and Oppression," is a lawyer and retired professor. She received her JD from UCLA in 1982, her PhD from Yale in 1975, and her AB from the University of Chicago in 1965. Having been a professor for many years at Brandeis University and the University of California, Santa Barbara, she attended law school at UCLA and practiced litigation with a national corporate law firm. Dr. Patterson subsequently moved to San Francisco, taught law and other courses at San Francisco State, was the director of Pre-Law Advising, and did professional jury analysis with a litigation support company. Since 2001, she has been a consultant to Sutter Securities, where she has assisted in litigation matters and financial advisory services. Dr. Patterson has served on various editorial boards and published numerous articles, some with Gil Matthews in the areas of business finance and corporate law.

Noah J. Gordon, Esq., author of Chapter 4, "Standards of Value for Partnership and Limited Liability Company Buyouts," is legal counsel for Shannon Pratt Valuations, Inc., where he is regularly involved with business valuations. He regularly contributes to business valuation publications and has served as a contributing author and editor of several legal treatises and publications. He has recently contributed to *Guide to Business Valuations* (2013), *The Lawyer's Business Valuation Handbook, 2nd edition* (2010), *Business Valuation Discounts and Premiums, 2nd edition* (2009), *Valuing a Business: The Analysis and Appraisal of Closely Held Companies, 5th edition* (2008), *Cost of Capital: Applications and Examples, 4th edition* (2010), and *The Market Approach to Valuing a Business, 2nd edition* (2005). He served as associate editor of *Shannon Pratt's Business Valuation Update, Economic*