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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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Second Edition

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.

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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For permission to reprint material from his works, we thank Michael Mard of the Financial Valuation Group for the information on subsequent events. We greatly appreciate the enthusiastic cooperation of the professionals at John Wiley & Sons: John DeRemigis, executive editor, and Judy Howarth, associate editor. We would also like to thank Gil Matthews and Michelle Patterson for substantially rewriting Chapter 3, Noah J. Gordon for coauthoring our new Chapter 4, and Neil Beaton for significantly rewriting Chapter 6.

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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Jay E. Fishman, FASA, is a managing director of Financial Research Associates, a regional business valuation and forensic accounting firm with offices in Bala Cynwyd, Pennsylvania, New York City, and Edison, New Jersey. He has been actively engaged in the appraisal profession since 1974 and specializes in the valuations of business enterprises and their intangible assets. Mr. Fishman has coauthored several books, including the highly acclaimed *Guide to Business Valuations* (with Shannon Pratt and Jim Hitchner), and written numerous articles on business valuations as well as qualifying as an expert witness and providing testimony in 12 states and federal courts. He has taught courses on business valuation to the Internal Revenue Service, the National Judicial College, and the American Institute of Certified Public Accountants (AICPA) in the United States and internationally, in the People's Republic of China, on behalf of the World Bank in St. Petersburg, Russia, and in Moscow, Russia.

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.

Dr. Pratt is chairman and chief executive officer of Shannon Pratt Valuations, Inc., a business valuation firm headquartered in Portland, Oregon; publisher emeritus for Business Valuation Resources, LLC; and a member of the board of directors of Paulson Capital Corporation, an investment banking firm specializing in small-firm IPOs and secondary offerings.

Over the past 40 years, Dr. Pratt has performed valuation engagements for mergers and acquisitions, employee stock ownership plans, fairness opinions, gift and estate taxes, incentive stock options, buy-sell agreements, corporate and partnership dissolutions, dissenting stockholder actions, damages, marital dissolutions, and many other business valuation purposes. He has testified in a wide variety of federal and state courts across the country and frequently participates in arbitration and mediation proceedings.

Dr. Pratt holds an undergraduate degree in business administration from the University of Washington and a doctorate in business administration, majoring in finance, from Indiana University. He is a fellow of the American Society of Appraisers, a master certified business appraiser, a chartered financial analyst, a master certified business counselor, and is certified in mergers and acquisitions.

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 and Analysts (NACVA), and frequently speaks on business valuation at national legal, professional, and trade association meetings. He also developed and often teaches a full-day seminar on business valuation for judges and

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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).

A graduate of Boston College with a bachelor of arts degree in history, he also earned his master's degree in business administration from Fairleigh Dickinson University. He is a member of the AICPA, NJSCPA, and the Society of the Former Agents of the Federal Bureau of Investigation.

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 partner of its predecessor partnership. He was in the Corporate Finance Department from 1967 through 1995 and a security analyst from 1960 through 1967. From 1970 through 1995, he was chairman of Bear Stearns' Valuation Committee, which was responsible for all opinions and valuations issued by the firm.

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.

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