Standards of Value

Theory and Applications

Jay E. Fishman
Shannon P. Pratt
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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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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.

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Dr. Pratt is the author of *The Market Approach to Valuing Businesses, 2nd edition; Business Valuation Body of Knowledge, Cost of Capital: Estimation and Application*, *2nd edition;* and *Business Valuation Discounts and Premiums*; and coauthor with the Honorable David Laro of *Business Valuation and Taxes: Procedure, Law and Perspective*, all published by John Wiley & Sons; and *The Lawyer's Business Valuation Handbook*, published by the American Bar Association. He is coauthor of *Valuing a Business: The Analysis and Appraisal of Closely Held Companies, 4th edition*, and *Valuing Small Businesses and Professional Practices, 3rd edition*, both published by McGraw-Hill. He is also coauthor of *Guide to Business Valuations, 16th edition*, published by Practitioners Publishing Company.

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Mr. Morrison has lectured frequently to organizations such as the New Jersey Institute of Continuing Legal Education and the New Jersey State Society of Certified Public Accountants. He has published numerous articles on business valuation and forensic accounting in publications such as *Valuing Professional Practices and Licenses* published by Aspen.

Prior to founding Morrison & Company, he served as a Special Agent for the Federal Bureau of Investigation as an internal auditor and as a Certified Public Accountant. He holds a bachelor's degree in history from Boston College and an MBA in accounting from Farleigh Dickinson University.

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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.

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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).

first discount was applied for lack of control of a corporation at the behest of the IRS in *Cravens v. Welch*,[11] a California Tax Court case. A shareholder was looking to deduct taxable losses on the minority shares of a corporation, and while the shareholder desired to set a higher initial value of his shares, the IRS looked to lessen that value by applying a discount. Later the application of the minority discount (though benefiting the IRS in this case) would be applied commonly in estate and gift tax matters to the benefit of the shareholder.

1950 to 1975

Businesses began to change in the latter half of the twentieth century. The most valuable assets of a business were often no longer tangible assets, such as real property and equipment, but were intangible assets, such as patents, trademarks, trade names, and goodwill. Because of this, valuation theory itself had to evolve to cope with new sorts of assets, which required complex valuations. The need for judicial valuations grew because of the disputes that arose over the value of intangible assets.

In family law, equitable distribution and the concept of community property emerged in the 1970s and, along with the emergence of intangible value, created a new need for business valuations in the judicial context of divorce. In estate and gift tax matters, the definition of fair market value was codified and explained in Treasury Regulations as well as by IRS Revenue Rulings.

In stockholder matters, the states more broadly adopted dissent and oppression statutes. By the 1970s, the states widely implemented the fair value buy-out provision in dissolution statutes. Previously, the resolution to shareholder oppression was generally achieved by dissolving the existing corporation. Because of the availability of the fair value buy-out, oppressed shareholders were now better able to recover their investment upon filing suit as oppressed shareholders.

1975 to the Present

Despite codification, from 1975 to the present, the Tax Court continues to deal with fair market value issues including shareholder-level discounts, trapped in capital gains, and subsequent events. The family courts have struggled with the treatment of goodwill, the application of shareholder-level discounts and the weight accorded buy-sell agreements.

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11. 10 F. Supp. 94 (D.C. Cal. 1935)

Some of the most significant developments have occurred in shareholder oppression and dissent in the past 30 years. The courts had previously been hesitant to dissolve a company unless extremely harsh conduct was recognized, but with the institution of the fair value buy-out in many states, the courts in those states became more inclined to allow the minority shareholder to be compensated with a payment for the value of his or her stock. In the late 1970s, tests for oppression emerged in the form of cases establishing that a shareholder may be awarded his or her fair value if there is a breach of fiduciary duty, unfair or unreasonably burdensome conduct by the majority, or a breach of the minority shareholder's reasonable expectations. In the early 1980s, the Delaware decision *Weinberger v. UOP, Inc.*[12] established the notion that customary and current valuation techniques may be used in determining fair value in shareholder dissent cases instead of the rigid guidelines previously applied. Several iterations of the Revised Model Business Corporation Act published by the ABA and the Principles of Corporate Governance set forth by the American Law Institute (ALI) set suggested guidelines for determining fair value in these situations, and the states increasingly adopted these guidelines over this time period.

CHAPTER PREVIEW

Chapter 1: Common Standards and Premises of Value

Chapter 1 gives a general overview of the concepts of value, cost, and price. We introduce the standards of value generally, their application, and their basic underlying assumptions. In addition, we introduce the premises of value that underlie the assumptions of the standards of value.

Chapter 2: Fair Market Value in Estate and Gift Tax

Chapter 2 deals with fair market value in estate and gift tax valuations. In this chapter, we discuss the history and development of fair market value as well as its definition. We deconstruct the definition of fair market value in detail and discuss the implications of the definition on valuation in federal estate and gift tax matters.

In the federal tax arena, fair market value is an established standard with a generally uniform interpretation. The most common definition of fair mar-

12. 457 A.2d 701, 713 (Del. 1983)

ket value comes from the estate and gift tax definition in Treasury Regulation 20.2031-1:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. [13]

By this definition, assets are valued under a premise of value in exchange under the fair market value standard. While there are many issues that must be decided in each case under the fair market value standard, practitioners can generally rely on the assumption that the property to be valued is that which the shareholder or the shareholder's estate, holds, whether it is a minority or a majority share of a given asset. We surveyed court cases dealing with fair market value, focusing on those concerned with what constitutes a marketplace, shareholder-level discounts, and the effect of events subsequent to the valuation date.

Through case law, IRS rulings, and valuation literature, there is an established body of law and theory that frames the issues dealt with on an ongoing basis by the federal Tax Court. We review a sample of the major federal tax court cases to provide clarity on the legal framework applicable to business appraisal. We also explain the elements of fair market value so that later we can show the characteristics that distinguish other valuation standards, such as fair value, from this well-known benchmark.

Chapter 3: Fair Value in Shareholder Dissent and Oppression

Chapter 3 discusses fair value in dissenting and oppressed shareholder matters. Because modern corporations function under a system of majority rule, minority shareholders are vulnerable to exclusion or abuse by those with a controlling interest. As a special protection, minority shareholders are granted limited rights in dissent and oppression statutes as a check against majority rule. However, there remains ambiguity in the statutory language, which lends itself to varying interpretations of exactly what the shareholder will receive as compensation in those cases.

Shareholders are generally entitled to the fair value of their shares when they dissent from particular actions defined by statute or petition for the dissolution of a corporation because of the alleged abuse at the hands of majority

13. Gift Tax Regulation 25.2512-1 defines the term similarly.

shareholders. In this chapter, we review the history and development of both shareholder dissent and oppression as well as the development of fair value as a standard of value in these matters. We look at the guidance provided by law associations and landmark cases in each state in an attempt to classify them in terms of their interpretation of various elements of fair value.

Although dissent and oppression are addressed under separate statutes, cases in both areas reference each other in their common use of the term *fair value*. Most states define the term only in their dissent statutes. The model corporate business statutes set forth by the ABA's Revised Model Business Corporation Act (RMBCA) and the ALI's *Principles of Corporate Governance* also provide guidance as to procedural requirements of both oppression and dissent, as well as in setting guidelines for the determination of fair value.

One major issue addressed in the determination of fair value in these matters is the application of shareholder-level discounts. The trend over the past 25 years, as guided by the ABA and the ALI and precedential case law, has been, in the absence of special circumstances, generally to not apply these discounts. Many courts (and much of the modern commentary and scholarship) direct the minority shareholder's value to be determined as a pro rata share of the equity value of a corporation, without the application of shareholder-level discounts for lack of control and lack of marketability.

Some have argued that the term *fair value* is used in statutes to distinguish it from fair market value and the assumptions one would make when determining fair market value. In its application, fair value is a broader standard. It may represent very different values depending on the facts and circumstances of a case, and discounts may or may not be applied, based on whether the shareholder was mistreated or excluded in a manner that dissent or oppression remedy is the appropriate recourse.

The ABA and the ALI definitions of fair value have suggested clarification with regard to the application of shareholder-level discounts. The 1984 fair value definition from the RMBCA reads:

> The value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.

In 1992, the ALI's *Principles of Corporate Governance* issued the following definition, including guidance on the application of discounts:

> . . . . the value of the eligible holder's proportionate interest in the corporation, without any discount for minority status or, absent extraordinary cir-

> cumstances, lack of marketability. Fair Value should be determined using the customary valuation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rise to appraisal.

In 1999, the ABA followed the ALI in recommending that discounts not be applied. The RMBCA was revised so that the definition of fair value states:

> The value of the shares immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation pursuant to section 13.02(a)(5).

The state legislatures have the opportunity to establish their own definitions, with or without reference to these suggested guidelines. We have seen statutes and case law moving toward the 1992 ALI and 1999 ABA definitions described above.

We have performed an extensive review of statutes, case law, and commentary on appraisals performed pursuant to dissent and oppression cases to achieve a better understanding of the rights of minority shareholders and the valuation process that leads to the ultimate determination of what that shareholder will receive. We have created a chart on the dissent and oppression standards of value in the 50 states and the District of Columbia, which is in Appendix B. In this chart, each state's statutory standard of value is listed, any definition of that term, the valuation date, the availability of oppression as a trigger for dissolution, whether an election to buy out in lieu of dissolution is permitted by statute, and recent precedential case law governing the application of discounts. Using this chart, we have grouped the states through an evaluation of case law in order to establish common themes among states that treat fair value similarly.

Chapter 4: Standards of Value in Divorce

Chapter 4 addresses the premises and standards of value used when valuing a business in divorce. In this chapter, we review the history and development of the concepts of marital and separate property as well as the manner in which the concepts of equitable distribution and community property have developed. We then clarify the standards of value that the states apply consciously or by implication through the decisions of their courts.

In matrimonial valuations, there is no one consistent business valuation trend across the nation. States, and even different jurisdictions within the states, treat various issues such as goodwill, shareholder-level discounts, and buy-sell agreements very differently. In reviewing these issues, we have found that there is a continuum over which the standards of value fall, ranging from the most stringent interpretation of the value in exchange to the broadest view of the value of property to its owner (holder). Based on their treatment of goodwill, shareholder level discounts, and the weight accorded buy-sell agreements, we have attempted to classify states as to where they fall on that continuum.

Other than as a matter of public policy and legislative intent, we find no consistent pattern as to why the states diverge in their application of standard of value. The bodies of law in the 50 states and the District of Columbia have developed independently, and these laws are continually evolving. Recently some states have had cases of first impression dealing with the standards by which businesses are valued, and in these cases the courts have performed an analysis of nationwide case law to guide their decisions. There does not, however, appear to be an overwhelming demand in divorce to centralize the standards of value across the states as the ABA and the ALI have done in dissent and oppression matters.

Through our survey of precedential case law, annotated statutes, as well as legal and valuation publications, we have attempted to group states based on their treatment of goodwill, shareholder-level discounts, and the weight accorded buy-sell agreements in order to understand the standard of value generally applied in each state. We have grouped states according to the premise of value and the standards of value either stated in their statutes or stated or implied in their case law. With this analysis, we hope to provide appraisers and appraisal users with some insight as to the standard of value used in a particular jurisdiction.

The basic elements of this continuum involve two general premises of value:[14] value in exchange and value to the holder; and three standards of value: fair market value, fair value, and investment value. We use these two premises and three standards of value to create a chart which groups the precedential cases of each state as follows:

Value in Exchange		Value to the Holder
Fair Market Value	Fair Value	Investment Value

14. General premises, to be distinguished from operational premises like liquidation value and value as a going concern. This will be discussed in further detail in Chapter 1.

Basically, we analyze each state's position on this continuum through their treatment of goodwill, shareholder-level discounts, and the weight afforded buy-sell agreements.

Chapter 5: Fair Value in Financial Reporting

Chapter 5 addresses fair value in financial accounting. In this chapter, we discuss the current and proposed standards for the reporting of assets and liabilities for corporations as established by the Financial Accounting Standards Board (FASB). Further, we discuss the history and development of the concept of fair value in financial reporting and how changes in the nature of businesses led to the publication of FASB's Statement of Financial Accounting Standards (SFAS) 141 and 142.

As we looked at the ALI and ABA guidelines for fair value in oppression and dissent, we look at the guidelines laid out by the pronouncements of the FASB and regulations from the Securities and Exchange Commission to better define and understand fair value in the financial reporting context.

Within this analysis, we address the hierarchy of fair value techniques discussed by the recent Working Draft of the FASB and the preference for using established market prices over present value measurements in determining fair value. We discuss the mechanisms in the SFAS guidelines governing the treatment of intangible assets, including goodwill. We also compare fair value in financial reporting to fair value in shareholder dissent and oppression, investment value, and fair market value. We arrive at the emerging trends in financial accounting, including expansion of fair value measurement guidelines, consistency in the application of valuation techniques, and new practices in the auditing of fair value measurements.

HOW STANDARD OF VALUE CAN AFFECT THE ULTIMATE CONCLUSION OF VALUE

The standard of value underlies the theoretical and practical applications of valuation and defines for the appraiser the type of value being sought.[15] In some circumstances, the applicable standard of value is fairly clear. In tax cases, fair market value is applied in accordance with the definition set forth in the

15. Shannon P. Pratt, Robert Reilly, and Robert Schweihs, *Valuing a Business*, 4th ed. (New York: McGraw-Hill, 2000), at 28.

treasury regulations and the guidance of IRS Revenue Rulings and Tax Court cases. There may still be controversies, such as the size of discounts allowed or the inclusion of events subsequent to the valuation date, but essentially the definition stands and provides relatively unambiguous guidance in a valuation assignment.

In other applications, however, the standard of value is not necessarily as clear. While the statutory application of fair value is nearly ubiquitous among the 50 states and the District of Columbia in dissenters' rights and oppression cases, the term is rarely meaningfully defined by those statutes. Over the past century, the courts, law associations, and state legislatures have weighed in on the appropriate definition of fair value to clarify its application.

Even less clear, in divorce, the standard of value is rarely explicitly established by case law and even less frequently by statute. For most states, we have to sort through various elements of a business's value and valuation issues such as the application of discounts in order to determine how a given state's courts determine the applicable standard.

The value of a business is the present worth of the future benefits of ownership, at a given point in time.[16] However, values can change for the same asset as premises and standards of value change. As will be discussed in this book, the application of a particular standard of value has a substantial effect on the valuation conclusion.

To better illustrate this concept, we will demonstrate through a hypothetical example how value could be viewed using different standards as applied to different purposes. We will use, as an example, an accounting practice owned in equal share by three accountants.

For the estate tax valuation upon the death of one of the owners, the business interest in this closely held entity would be valued using fair market value. Accordingly, the one-third interest would be valued in exchange. Since the one-third interest lacks control, shareholder-level discounts would be considered.

Alternatively, should two of the shareholders oppress the third; the wronged party could allege oppression and the remaining shareholders could choose to exercise their buy-out option, rather than risk an expensive and drawn out court proceeding that could result in a judicially mandated dissolution and possibly even the awarding of damages to the wronged shareholder. Under the fair value buy-out remedy in his or her state's dissolution statute, the shareholder could be paid the fair value of his or her interest. In this case, the major-

16. Id. at 40.

ity of states (as prescribed by the guidelines set by the ABA and the ALI) would value the company as a whole—the enterprise—and take a pro rata share of that value based on percentage ownership. Generally, no shareholder-level discounts would be applied, as the courts attempt to compensate the shareholder for that which had been taken from him.

Upon divorce, a whole range of values could arise based on the differing premises and standards of value. Depending on the statutes and case law in a given state, the value might be determined at fair market value, fair value, or investment value. Accordingly, for divorce purposes, shareholder-level discounts might be considered, considerable weight may be accorded buy-sell agreements, or none of these considerations may apply.

As can be seen, each of these situations could result in significantly different dollar amounts for the same ownership interest. This example illustrates the importance of understanding the premises and standards of value in a particular venue and for a particular purpose, and it is our hope that this book will contribute to continuing professional dialogue surrounding these issues.

1

Common Standards and Premises of Value

COMMON STANDARDS AND PREMISES

In this chapter, we provide a brief introduction to the standards of value that we discuss and analyze throughout this book. The premises and standards discussed in this chapter will be discussed in more detail in the upcoming chapters.

We begin by analyzing the meaning of value itself and why it is necessary to understand the implications of each standard of value. We also introduce two overarching premises of value: value in exchange and value to the holder. Then we briefly address how these premises of value impact the standard of value and the assumptions that underlie any given standard of value.

Oscar Wilde wrote:

> What is a cynic? A man who knows the price of everything and the value of nothing.[1]

Although Wilde commented on the metaphysical relationship between price and value as social concepts, this quote illustrates quite plainly that the words are not interchangeable.

1. Oscar Wilde, *Lady Windermere's Fan*, Act 3 (1893).

Price, Value, and Cost

In various reference works price, value, and cost are all defined with reference to one another.

Price, for example, is defined by *Webster's New World Dictionary* as "the amount of money, etc. asked or paid for something; cost. 2. Value or worth. 3. The cost, as in life, labor, etc. of obtaining some benefit."[2] *Black's Law Dictionary* defines *price* as "the amount of money or other consideration asked for or given in exchange for something else. The cost at which something is bought or sold."[3]

Webster's defines *cost* as "the amount of money, etc. asked or paid for a thing; price"[4]; *Black's* defines it as "expense; price. The sum or equivalent expended, paid, or charged for something."[5]

While price and cost are transactional outcomes, value is a less concrete concept, not necessarily requiring the arrival at a set price between parties in a transaction. Value exists in a sale, in an ongoing business, and in liquidation. The main question (and the primary focus of this book) is: By what standard should value be judged? Price certainly can sometimes represent value—one arrived at in a transaction. Cost sometimes can as well, insofar as it is the amount of money or compensation required to produce or purchase a product or service. Value, however, can represent a more general concept of worth that may not be easily represented by a transactional price or cost.

In his classic work, *Valuation of Property*, James C. Bonbright writes:

> The contrast between "value" and "cost" as fundamental concepts is that the former term refers to the advantage that is expected to result from the ownership of a given object of wealth (or to the market price that this advantage will command), whereas the latter term refers to the sacrifice involved in acquiring this object. This distinction is clear in our minds when we ask whether anything or any desirable human achievement "is worth what it costs" . . . Cost, then, is the price that must be paid for value.[6]

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2. *Webster's New World Dictionary of the American Language* (New York: Macmillan, 1996), at 487.
3. Bryan A. Garner, *Black's Law Dictionary*, 8th ed. (St. Paul, MN: Thompson West, 2004) at 1266.
4. *Webster's New World Dictionary*, at 136.
5. Garner, *Black's Law Dictionary*, at 371.
6. James C. Bonbright, *Valuation of Property* (Charlottesville, VA: Michil Company, 1937).

Cost can take the form of an outlay of resources or forgoing other opportunities, the so-called opportunity cost. While cost may be incurred in acquiring value, value does not necessarily equate to cost.

Webster's has 13 definitions for *value*, ranging from "a fair or proper equivalent in money commodities, etc. for something sold or exchanged; fair price" to "that which is desirable or worthy of a scheme for its own sake; a thing or quality having intrinsic worth."[7] *Black's* contains two pages of definitions for term *value*, beginning with its primary general definition: "(1) the significance, desirability, or utility of something." The second definition is "(2) the monetary worth or price of something; the amount of goods, services, or money that something will command in an exchange."[8]

The interrelationship between the terms *price*, *cost*, and *value* and the ambiguities associated with them mandates clear, internally consistent, definitions of these terms.

Defining a Standard of Value

In 1989, the College of Fellows of the American Society of Appraisers published an opinion on defining standards of value. In that opinion, the College recognized the importance of defining the standard of value:

> . . . . the necessity to identify and define the applicable standard of value as a critical part of any appraisal report or appraisal engagement. It also recognizes that there legitimately can be different definitions of the same appraisal term and different contexts based either on widely accepted usage or legal definitions through statutes, regulations, case law and/or legally binding documents.[9]

With regard to business valuation, the College of Fellows asserts that: "every appraisal report or engagement should identify the applicable standard of value."[10] In addition, the Uniform Standards of Professional Appraisal Practice mandate identification of the standard of value in every appraisal.[11]

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7. *Webster's New World Dictionary*, at 1609.
8. Interestingly, these two ideas represent the two premises of value that will be discussed later in this chapter, the first representing a value to the holder premise, the second representing a value in exchange premise.
9. *Valuation*, Vol. 34, No. 2 (June 1989) "Defining Standards of Value". Opinion of the college of Fellows.
10. Id. at 4.
11. Uniform Standards of Professional Appraisal Practice, 2006, Standards Rule 2-2 a(v) "state the type and definition of value and cite the source of the definition."

While stating a standard of value in an appraisal engagement seems like a straightforward concept, different standards may have different meanings in different contexts. Therefore, defining *value* and adhering to the assumptions inherent in a particular standard of value, especially in connection with a valuation for tax, judicial, or regulatory purposes, often is no easy task.

Bonbright perhaps sets the issue up best when he writes:

> At first thought one might suppose the problem with the finding value is a fairly simple one—or at all events, that it might be settled once and for all by consensus of those experts who were called upon to pass judgment on property values.[12]

He continues:

> 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.[13]

Bonbright further suggests:

> [T]he problem of defining value, for the many practical purposes for which the term is used, is an exceedingly difficult one, deserving quite as much attention as does the technique in proof.[14]

The standard of value is a definition of the type of value being sought. The premise of value is an assumption as to the actual or hypothetical set of circumstances applicable to the subject valuation. Later in this chapter, we introduce the standards and premises of value that are critical to understanding valuation in the judicial and regulatory context.

Premises of Value

Throughout this book, we discuss two overarching premises of value: value in exchange and value to the holder. These premises affect the applicable standard of value. The premise chosen establishes the "value to whom?"

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12. Bonbright, *Valuation of Property*, at 11.

13. Id. at 11.

14. Id. at 11–12.

- *Value in exchange.* Value in exchange is the value of the business or business interest changing hands, in a real or a hypothetical sale. Accordingly, discounts, including those for lack of control and lack of marketability, are considered in order to estimate the value of the property in exchange. The fair market value standard and, to some extent, the fair value standard fall under the value in exchange premise.
- *Value to the holder.* The value to the holder premise represents the value of a property that is not being sold but instead is being maintained in its present form by its present owner. The property does not necessarily have to be marketable in order to be valuable. We discuss later, however, that the value to the holder may be more or less than the value in exchange. The standard of investment value falls under the premise of value to the holder, as does, in certain cases, fair value.

These two premises represent the theoretical underpinnings of each standard of value. In other words, they represent the framework under which all other assumptions follow.

COMMON STANDARDS OF VALUE

In many situations, the choice of the appropriate standard of value is often dictated by circumstance, objective, contract, operation of law or other factors. In many instances, the choice of the standard of value may be clear, but the meaning of that standard of value is less clear. To the valuation professional, the application of a specific standard of value has significant implications regarding the assumptions, methodologies, and techniques that should be used in a valuation. For instance, What is being valued? Does the property change hands? Who are the buyer and seller?

In a judicial context, the standard of value is generally set by regulations (as in estate or gift tax), by statute (as in dissent and oppression), by case law (as either stated or implied by divorce cases in most states), or some combination of the above. In financial reporting, the standard is set by the Statements of Financial Accounting Standards. Next we introduce some common standards of value.

Fair Market Value

Fair market value is perhaps the most well known standard of value and is commonly applied in judicial and regulatory matters. Fair market value applies to virtually all federal and state tax matters, including estate, gift, inheritance, income, and ad valorem taxes, as well as many other valuation situations.[15]

The Treasury Regulations give the most common valuation definition of fair market value:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[16]

Black's Law Dictionary defines fair market value as "the price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm's length transaction; the point at which supply and demand intersect."[17]

The willing buyer and willing seller are presumed to deal at arm's length; they are independent third parties, not specific individuals, and therefore the price arrived at will not be influenced by any special motivations or synergies of a specific buyer. Fair market value implies a market on which the buyer and seller transact and assumes current economic conditions as of the date of the valuation.[18]

Under fair market value, discounts may be applied to shares of a closely held company if they lack control over the corporation or lack marketability. Additionally, the property is being valued assuming a sale, regardless of whether the property actually will actually be sold.

Estate and gift tax cases applying fair market value provide the most frequent interpretation of the definition and application of its principles. Using these principles, fair market value has been applied in other areas. In this book, when used in other contexts, the terms of fair market value are discussed only when they depart from the interpretation in estate and gift tax matters.

Fair market value is the espoused standard of value used in a number of states for valuations in connection with divorce. Generally, only assets that can be sold are considered under a fair market value standard. In these cases, only the elements of a company's assets, including certain types of goodwill that are salable, will be included in the valuation. In addition, discounts for lack of control or lack of marketability are usually considered.

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15. Shannon P. Pratt, Robert Reilly, and Robert Schweihs, *Valuing a Business*, 4th ed. (New York: McGraw-Hill, 2000), at 28.
16. Treasury Regulation § 20.2031-1.
17. Garner, *Black's Law Dictionary*, at 1587.
18. Pratt, Reilly, and Schweihs, *Valuing a Business*, at 29.

Fair market value also acts as a default standard in shareholder dissent and oppression matters in states that follow the Revised Model Business Corporation Act. If one dissents or oppression is proven, absent special circumstances, fair value without discounts is generally applied.

Fair Value

Fair value may be the applicable standard of value in a number of different situations, including financial reporting, valuation of a company going private, shareholder dissent and oppression matters, corporate dissolution, and divorce.

The definition of fair value depends on its context. For financial reporting, fair value is defined in relevant accounting literature and is closely akin but not the same as fair market value. The definition of fair value from the Financial Accounting Standards Board for financial reporting purposes is:

> The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.[19]

This definition is similar to the one used in estate and gift tax regulations, but it does not require that buyers and sellers be as well informed as in fair market value for estate and gift tax. While the parties are required to be uncompelled under the Treasury Regulations, fair value for financial reporting purposes prohibits only a forced or liquidation sale.[20]

In judicial appraisals, fair value is a legally mandated standard that applies to specific transactions and is commonly used in matters involving dissenter's rights and shareholder oppression. Until recently, there was no clear consensus on the definition of fair value in judicial valuations, but prevailing precedents have suggested that use of the term fair value distinguishes it from fair market value and the assumptions that underlie its application. While not clearly defined until the last 20 years or so, the most recent applications of fair value have established it, absent special circumstances, as the value of the shares on a pro rata enterprise basis.

19. SFAS No. 141, Business Combinations, Glossary, and FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurement, Glossary of Terms.

20. David Laro and Shannon P. Pratt, *Business Valuation and Taxes* (Hoboken, NJ: John Wiley & Sons, 2005), at 285.

Investment Value

Investment value, in the nomenclature of business valuation, means the value of an asset or business to a specific or prospective owner. Accordingly, this type of value considers the owner's (or prospective owner's) knowledge, abilities, expectation of risks and earning potential, and other factors.[21] Investment value often considers synergies available to a specific purchaser.

For example, for some companies, investment value may reflect the added value to that company of vertical or horizontal integration. For a manufacturer, it may reflect the added value of a distributor in order to control the channel of distribution of the manufacturer's particular products. For other companies, it may reflect the added value to acquire a competitor in order to achieve the cost savings of combined operations and possibly eliminate some price competition.

For an individual, investment value considers value to the owner and typically includes a person's reputation, unique skills, and other attributes.

For these reasons, reflecting the *added* value of the combination of the company's or individual's unique attributes with the subject property, investment value may result in a higher value than fair market value, which reflects the value to a *hypothetical* investor and may not reflect the added value to an owner or unique purchaser.

Investment value crops up primarily in the context of marital dissolutions, whether the court calls it by that name or not. It is not uncommon to have a family law court's opinion refer to a standard of value by name, but upon reading the text of the opinion, one may find that the court considered some aspects of what the business appraisal community would view as a different standard of value, often investment value. In this context, investment value usually considers the value of property not to a hypothetical buyer or seller, but to its current owner. From a business valuation perspective, when a divorce court uses investment value in this manner, the particular buyer is the current owner, and the application of value to that particular buyer translates to an investment value. Hence, *investment value* is often used synonymously with *value to the holder*.

Fair market value is impersonal, but investment value reflects the unique situation of a particular person or company. For example, whereas Revenue Ruling 93-12 did away with family attribution in fair market value, a minority holder who is part of a family control group may not be accorded a minority discount under the standard of investment value.

21. Id. at 201–209.

Investment value can be measured, for example, as the discounted net cash flow that a particular investor would expect a company to earn, in the way that particular investor would operate it. For a potential corporate acquirer, for example, investment value could be measured as the stand-alone value of the subject company plus any revenue increases or cost savings that the buyer would expect to achieve as a result of the synergies between the companies.

Investment value considers value from these perspectives of the potential sellers and buyers:[22]

- Respective economic needs and abilities of the parties to the transaction
- Risk aversion or tolerance
- Motivation of the parties
- Business strategies and business plans
- Synergies and relationships
- Strengths and weaknesses of the target business
- Form of organization of target business

Intrinsic Value

Intrinsic value is the value considered to be inherent in the property itself. Intrinsic value is defined by *Webster's Dictionary* as "being desirable or desired for its own sake without regard to anything else";[23] and by *Black's Law Dictionary* as "the inherent value of a thing, without any special features that might alter its market value. The intrinsic value of a silver coin, for instance, is the value of the silver within it."[24]

Intrinsic value is not the legal standard of value in any federal or state statute. Nevertheless, the phrase *intrinsic value* is found in many judicial opinions regarding business valuation, particularly in family law cases and dissenting stockholder or oppressed stockholder cases. Because it connotes the inherent value of a thing, the term *intrinsic value* has often been used synonymously with the term *investment value*.

The concept of intrinsic value arises out of the literature and practice of security analysis. In fact, the most widely sold book ever on security analysis,

22. Laro and Pratt, *Business Valuation and Taxes*, at 285.

23. *Webster's Third New International Dictionary* (Springfield, MA: G & C Merriam Company, 1966).

24. Garner, *Black's Law Dictionary*, at 1587.

Graham and Dodd's Security Analysis, has an entire chapter on intrinsic value.[25] Graham and Dodd define intrinsic value as "*the value which is justified by assets, earnings, dividends, definite prospects, and the factor of management*" (emphasis original).[26]

According to Graham and Dodd, these four factors are the major components of intrinsic value of a going concern:

1. Level of normal earning power and profitability in the employment of assets as distinguished from the reported earnings, which may be, and frequently are, distorted by transient influences
2. Dividends actually paid or the capacity to pay such dividends currently and in the future
3. A realistic expectation about the trend line growth of earning power
4. Stability and predictability of these quantitative and qualitative projections of the future economic value of the enterprise

> In general, investment practitioners now concede the existence of an intrinsic value that differs from price. Otherwise, the merit of substantial expenditures by both Wall Street and investment management organizations for the development of value estimates on broad lists of common stocks would be highly questionable.[27]

In other words, when a security analyst says something like "XYZ stock is selling at $30 per share, but on the basis of its fundamentals, it is worth $40 per share," the $40 value is that analyst's estimate of the stock's intrinsic value, but the trading price on that date is $30 per share. If the analyst is right, the stock price may make it to $40 per share, in which case the intrinsic value would equal the fair market value.

Graham and Dodd say that "perhaps a more descriptive title for this estimated value is central value . . . intrinsic value is in essence the central tendency in price."[28]

However, as mentioned, the term *intrinsic value* has not been restricted to securities analysis. It has been used in connection with valuations for other purposes.

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25. Sidney Cottle, Roger Murray, and Frank Block, *Graham and Dodd's Security Analysis*, 5th ed. (New York: McGraw-Hill, 1988).
26. Id. at 41.
27. Id. at 43.
28. Id.

Here is a representative example from a divorce case:

> The value of an item of marital property is its intrinsic worth to the parties; the worth to the husband and wife, the value to the marital partnership that the court is dissolving. (*Howell v. Howell*, 31 Va. App. 332, 523 S.E.2d 514 (2000))

Intrinsic value and investment value may seem like similar concepts, but they differ in that intrinsic value represents a judgment of value based on the perceived characteristics adhering to an investment itself, while investment value is more reliant on characteristics adhering to a particular purchaser or owner.[29]

While using the language of "intrinsic worth," the court applied a standard of value more closely associated with fair value, as treated in dissenting and oppressed stockholder matters.

Below is another representative example from a dissenting stockholder case:

> In *Robbins v. Beatty*, 246 Iowa 80, 91, 67 N.W.2d 12, 18, we define "real value" as the "intrinsic value, determined from a consideration of every relevant factor bearing on the question of value," including "the rate of dividends paid, the security afforded that dividends will be regularly paid, possibility that dividends will be increased or diminished, the size of the accumulated surplus applicable to payment of dividends, record of the corporation, its prospects for the future, selling price of stocks of like character, value of its assets, book values, market conditions, and reputation of the corporation. It is unwise to attempt to state every factor that may bear on value of stock in a particular case." *Woodward v. Quigley*, 257 Iowa 1077; 133 N.W.2d 38; 1965 Iowa Sup. LEXIS 599

As can be seen, courts may use the term *intrinsic value* rather liberally. Because of this, if practitioners are requested to determine the intrinsic value of a company or a fractional interest in a company, they should seek further definition or clarification of what type of value is being sought.[30]

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29. Pratt, Reilly, and Schweihs, *Valuing a Business*, at 31.

30. Jay E. Fishman, Shannon P. Pratt, and J. Clifford Griffith, "PPC's Guide to Business Valuation," (Fort Worth, TX: Thompson PPC 2004), at 201.10.

Book Value

We do not go into depth about book value, as it is not viewed as a standard of value in the way standards of value are discussed in this book. *Book value* is an accounting term and refers to an asset's historical cost reduced by any allowances for unrealized losses or depreciation, impairment, and amortization. Essentially, for a company, book value is the value of owner's equity on a balance sheet, that is, assets less liabilities.[31]

COMMON OPERATIONAL PREMISES UNDERLYING THE STANDARD OF VALUE

While value in exchange and value to the holder are general premises under which the standards of value fall, other operational premises further refine the assumptions that should be made under a given standard of value. For instance, in finding fair market value (a standard falling under a value in exchange premise), typically the valuation professional is looking to establish a value of a company either as a going concern or, when appropriate, upon liquidation. This operational premise of value may have a substantial effect on the value of property.

These operational premises impact the amount that will be paid upon the exchange of a business. For example, most businesses are valued under the premise that they will continue operating as going concerns. However, when valuing a controlling interest, there are times when the amount realized upon the liquidation of the assets and extinguishment of all liabilities is more appropriate. Either could be higher, depending on the nature of a business and the composition of its balance sheet. An accounting practice might have a high going concern value but a low liquidation value. A golf driving range, however, might be worth more if the land could be zoned for property development and sold in liquidation.

Going Concern

Most judicial valuations look to determine the value of a company as a going concern. *Black's Law Dictionary* defines *going concern value* as: "the value of a commercial enterprise's assets or of the enterprise itself as an active business

31. Pratt, Reilly, and Schweihs, *Valuing a Business*, at 308.

with future earning power as opposed to the liquidation value of the business or of the assets."[32]

In judicial valuations, it is often assumed that a company will continue functioning as it had been during and after the valuation. The circumstances of a business may be different because of the event necessitating or triggering the valuation, such as the death of a shareholder or key person, or the departure of a dissenting or oppressed shareholder. In other cases, the business may continue as usual, as in the case of a valuation upon divorce.

Liquidation Value

Black's Law Dictionary defines *liquidation value* as "the value of a business or of an asset when it is sold in liquidation, as opposed to being sold in the ordinary course of business."[33] This definition broadly encompasses the idea of liquidation value, that is, that assets and liabilities are valued individually. However, there may be additional refinements to the assumptions under liquidation value, mostly dealing with the time and circumstances surrounding the disposal of the assets and extinguishment of liabilities. Methodologically, liquidation value considers not only the proceeds from selling the assets of a business but also takes into consideration any associated expenses.[34]

The liquidation value of a business is most relevant in the case of an unrestricted 100% control interest.[35] There are different levels of liquidation. In the valuation of machinery and equipment, these levels are fairly well developed; there is orderly liquidation, liquidation value in place, and liquidation in a forced sale. As discussed, each level deals with the time and circumstances surrounding the disposition of the machinery and equipment. Pratt, Reilly, and Schweihs have attempted to apply these definitions to valuing a business:[36]

- *Value as an orderly disposition is a value in exchange on a piecemeal basis.* A value in exchange that contemplates the price at which the assets of a business will be sold with normal exposure to their appropriate secondary markets.

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32. Garner, *Black's Law Dictionary*, at 1587.

33. Id.

34. Fishman, Pratt, and Griffith, "PPC's Guide to Business Valuation," at 201.12.

35. Michael Bolotsky, "Valuation of Common Equity Securities When Asset Liquidation is an Alternative," in *Financial Valuation: Businesses and Business Interests*, ed. James Warren Zukin. New York: Warren Gorham & Lamont, 1990 with annual supplements), at 10-3.

36. Pratt, Reilly, and Schweihs, *Valuing a Business*, at 33.

- *Value as a forced liquidation.* A value in exchange that contemplates the price at which assets will be sold on a piecemeal basis, but instead of normal exposure to the market, these assets will have less than normal exposure.
- *Value as an assemblage of assets.* A value in exchange, consisting of the value of the assets in place, but not in their current use in the production of income and not as a going concern business enterprise.

OTHER ISSUES

Fair Value in Alternate Contexts

In this book, we discuss fair value in the context of judicial valuations in oppression, dissent, and divorce and in the regulatory context of financial reporting. Although we do not go into further detail in this book, other contexts for fair value deserve mention.

Fair value is a central element in fairness opinions. A fairness opinion is generally prepared by a qualified financial advisor in the form of a letter, to state whether the financial terms of a proposed transaction are fair from a financial point of view. Fairness opinions are advisable in a variety of situations, including acquisitions, share buybacks, sales of assets, and related transactions. Typically, this standard applies regardless of whether the transaction falls under the state's statutory guidelines for shareholders who avail themselves of the appraisal remedy.[37]

The term *fair value* is also frequently used in the securities and futures markets. While it is not generally defined in this context, there are some specific definitions. Capital Markets Risk Advisors explains fair value as referring to: " . . . the price at which a single unit of an instrument would trade between disinterested parties in an arm's length transaction. Fair value does not generally take into account control premiums or discounts for large or illiquid positions."[38]

Standard and Poor's Advisor Insight gives this explanation for its use of what it calls "fair value" (this description is closer to the definition of intrinsic value, as we discussed earlier): "helps determine if the stock is a good buy based on S&P's proprietary quantitative model and our analysis of what the

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37. Robert Reilly and Robert Schweihs *The Handbook of Advanced Business Valuation* (New York: McGraw-Hill, 2000), 311–313.

38. Capital Market Risk Advisors, www.cmra.com/html/body_glossary.html.

stock is currently worth."[39] These assessments, however, are all outside the scope of our studies for the purposes of this book, as we are primarily concerned with the tax, judicial, and regulatory treatment of standards of value, rather than their use in the financial markets.

Fair Market Value in Alternate Contexts

In this book, we are looking at fair market value solely in the context of a business valuation. One of the most common applications of fair market value is in the valuation of real property. However, in the valuation of real property, it is referred to as *market value*. The 2006 *Uniform Standards of Professional Appraisal Practice* defines *market value* as:

> A type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of ownership or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.[40]

Fair market value in real estate is generally expressed in terms of the highest and best use for the property, as established by the Tax Court in the early twentieth century as may be seen in the Tax Court case *Kaplan v. United States*.[41] In this case, the owners of a parcel of property in Arizona were assessed a tax deficiency based on their acquisition of that property as payment for services rendered. While the taxpayers' assessor valued the property at $54,000, the Tax commissioner valued the property at $120,000 based on what he considered to be comparable sales in the area. The court acknowledged that the land should be assessed at its highest and most profitable use, given sufficient exposure to the market and the various other requirements of fair market value. In this case, however, the majority of the property was unimproved desert land located in the flood plain of a nearby river. Only a small proportion of the property had the potential for development, and therefore the land could not be valued as comparable to land with the potential for development.

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39. S&P Advisor Insight Glossary, www.advisorinsight.com/pub/cust_serv/glossary.html.
40. http://commerce.appraisalfoundation.org/html/2006%20USPAP/DEFINITIONS.htm
41. 279 F. Supp. 709; 1967 U.S. Dist. LEXIS 10787; 68-1 U.S. Tax Cas. (CCH) P9113; 21 A.F.T.R.2d (RIA) 331.

It should be noted that in prior versions of this definition, the phrases *the most probable price* and *the highest price* for property have been used.[42] Interestingly, the term *highest price* used by real property appraisers in the United States is also used in Canadian business and property valuations.[43] In the United States, the concept of highest and best use may stretch into business valuations when determining whether to apply a value to the holder or value in exchange concept, or in determining whether to consider strategic purchasers. However, as mentioned, there are hundreds of different statutes that use fair market value, and most of them are beyond the scope of our analysis.

Standards of Value in the International Context

Just as the nature of business has changed within the United States in the past 150 years, the need for valuation guidelines has transcended national borders. Just as each state treats the standard of value differently across different areas of valuation, each country involved in business internationally may have its own independent standards and definitions of value.

In an attempt to resolve differences in definition, the International Valuation Standards Board (IVSB), a nongovernmental organization of the United Nations, has established guideline definitions. For example, *market value* is defined as:

> The estimated amount for which property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.[44]

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42. Pratt, Reilly, and Schweihs, *Valuing a Business* at 30.

43. "Market Value—The highest price in terms of money, which the property will bring to a willing seller if exposed for sale on the open market allowing a reasonable time to find a willing purchaser, buying with the knowledge of all the uses to which it is adapted and for which it is legally capable of being used, and with neither party acting under necessity, compulsion or peculiar and special circumstances." www.coldwellbanker.ca/genglossary.html.

44. *International Valuation Standards*, 7th ed. (London, England: International Valuation Standards Committee, 2005), at 38.

It defines *investment value, or worth*, as:

> The value of property to a particular investor, or a class of investors, for identified investment objectives. This subjective concept relates specific property to a specific investor, group of investors, or entity with identifiable investment objectives and/or criteria. The investment value, or worth, of a property asset may be higher or lower than the Market Value of the property asset. The term investment value, or worth, should not be confused with the Market Value of an investment property.[45]

Similarly, the recent Toronto Valuation Accord has attempted to bring nations together in terms of accounting policy and definitions, and the Royal Institute of Chartered Surveyors, a group out of the United Kingdom, has attempted to resolve the differences in the U.K.'s standards and the International Valuation Standards established by the IVSB.

A broader discussion of International Valuation Standards is available in Appendix A, where we have compiled further information and definitions regarding international standards of value.

SUMMARY

This chapter provides a brief introduction to the premises and standards that we will address throughout the book. In the chapters to come, we address the origins of the standards of value in varying contexts and the judicial and regulatory decisions that provide insight into the underlying assumptions inherent in them. We will further discuss the standards in each context and issues surrounding their application.

45. Id. at 110.

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Fair Market Value in Estate and Gift Tax

INTRODUCTION

In this chapter, we review the history and development of fair market value and address the elements comprising this standard of value, which is cited more frequently than any other standard of value. In fact, one court remarked:

> Disputes over valuation fill our dockets, and for good reason. We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue.[1]

Fair market value is a theoretical construct commonly used in judicial valuations. It is the most widely utilized standard of value, as it applies to all federal and many state tax matters including estate taxes, gift taxes, income taxes, and ad valorem taxes, as well as in certain states for marital dissolution cases and in a few states for shareholder oppression and dissent. In this chapter, our focus is on fair market value as it applies in federal estate, income, and gift tax matters because of the well-developed body of rulings, regulations, expert opinion, and case law regarding each element of this standard of value for those purposes. More specifically, we look at various court rulings that have addressed the theoretical underpinnings of fair market value.

1. *Auker v. Commissioner*, T.C. Memo. 1998-185.

In later chapters of this book, we discuss other standards of value that arise in judicial valuations. These standards, particularly fair value, may best be understood by comparison to the definition of fair market value and the assumptions that follow. Many of the assumptions in those standards are derived from an understanding of fair market value.

Hundreds of sources define fair market value in various ways and provide guidelines for its application.[2] Although the term is almost ubiquitous in valuation, there is often little consistency in the underlying assumptions and its application. Recently one commentator noted:

> Critics of the term "fair market value" correctly point out that its application is highly uncertain, sometimes with little connection with objective reality.[3]

These sentiments are not particularly new. In the 1930s, Bonbright commented:

> On the whole . . . the courts have preferred to keep the statutory language, fair market value, while not taking its implication too seriously.[4]

Later in this chapter, we discuss the hypothetical nature of fair market value and its similarities and differences with actual real-world transactions.

Common Definitions of Fair Market Value

Fair market value is probably the most pervasive standard of value that exists. Its popularity stems from its longevity and the considerable amount of attention paid to its theoretical underpinnings.

Although Congress has never defined fair market value,[5] the Estate Tax Regulation Section 20.2031-1 defines the term in this way:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any com-

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2. ASA College of Fellows Opinions, "The Opinion of the College on Defining Standards of Value," *Valuation* 347, no. 2 (June 1989) at 6.
3. John A. Bogdanski, *Federal Tax Valuation* (New York: Warren, Gorham & Lamont, 2002), at 1–25.
4. James C. Bonbright, *Valuation of Property* (Charlottesville, VA: Michie Company, 1937), at 983.
5. *Bank One v. Commissioner*, 120 T.C. 174; 2003 U.S. Tax Ct. LEXIS 13; 120 T.C. No. 11.

> pulsion to buy or to sell and both having reasonable knowledge of relevant facts.[6]

These regulations go on to explain that fair market value should not be determined by virtue of a forced sale, nor should it be determined in a market other than that where it is most commonly transacted. This definition clearly places fair market value under a value in exchange premise. Therefore, the price in question is the asset's value in a real or hypothetical exchange rather than its value in its current state to the current owner.

The American Institute of Certified Public Accountants defines fair market value similarly, going into slightly more detail:

> The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.[7]

Although this definition is somewhat different from that of the one in Estate Tax Regulations, it expresses many of the same underlying assumptions. Willing buyers and sellers are assumed to be able, and transactions are assumed to take place at arm's length.

Interestingly, later in this chapter we will see that British and Canadian courts include the term *highest price* in their definition of fair market value for business and real property valuation. Thus, in Britain and Canada, unlike in the United States, potential synergies can be reflected in fair market value. In the U.S, there continues to be an ongoing debate between analysts as to whether potential synergies should be included in a valuation.

History of Fair Market Value

While most practitioners are familiar with the definition of fair market value as it appears in the Internal Revenue Service's Revenue Ruling 59-60, the term *fair market value* has its roots in the early 19th century. One of the earliest mentions of fair market value is from a case involving a false invoice on 14 packages of pins shipped from England to the United States, discussed next.

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6. IRS Treasury Regulations, Estate Tax Regulation § 20.2031-1. IRS Treasury Regulations, Gift Tax Regulations 25.2512-1, define the term similarly.
7. http://bvfls.aicpa.org/Resources/Business+Valuation/Tools+and+Aids/Definitions+and+Terms/International+Glossary+of+Business+Valuation+Terms.htm.

United States v. Fourteen Packages of Pins

In the 1832 case of the *United States v. Fourteen Packages of Pins*,[8] a case dealing with tariffs, the court questioned a discrepancy in invoices prepared on two different dates in two different cities prior to the shipment. The earlier invoice, printed as a regular bill of sale between the buyers and sellers in London, showed a higher price than the later invoice printed in Liverpool, the city from which the pins were shipped.

Because of the discrepancy, the United States looked to prove that the second invoice was created only for the purpose of defrauding the ad valorem tax on the shipment. The judge instructed the jury in this way:

> All the evidence which has been given of prices, or market value, or *fair market value*, or current value, or true value, or actual value, is to bring you to the same conclusion, to a satisfactory answer to the question you are trying, to wit, is the valuation of these goods in this invoice a "false valuation," which is the offence described in the act of congress of 1830, on which this information is founded? Were these goods really worth more in the London market? Were the buying and selling prices higher in that market than those charged in this invoice, at the time when this invoice was made up? However the phrases may vary in the different acts of congress, current value, actual value, or market value, the inquiry with you always is the same; does this invoice contain a true valuation of these pins, or a false one? The phraseology of the laws is important on this issue, only as it may assist you in answering and deciding the question whether these pins, or similar pins, were bought and sold in the London market, in June, 1830, at these prices? Or is the valuation false and untrue, and the prices not those at which such pins were bought and sold at that time and place? *You are not to take a sale under particular circumstances which may have depressed or raised the price, but the fair and just price of buying and selling in the market.*[9] [Emphasis added.]

The jury found in favor of the United States.

Although *United States v. Fourteen Packages of Pins* introduced the term and the principle of an uncompelled fair and just price, other elements of fair market value evolved along with tax law in the United States. To put this evolution into context, we provide a short background on the institution of federal taxes from the late eighteenth to the early twentieth century and look at the development and purpose of various taxes that were instituted (and in some cases repealed) during this period.

8. Id.

9. Id.

In the late eighteenth and early nineteenth century, the states experimented with various taxes to raise revenue including tariffs, property taxes, and progressive income taxes. By the Civil War, most states had instituted a property tax that not only covered real estate and fixtures, but also intangible personal property, such as cash, credits, notes, stocks, bonds, and mortgages. The government also relied considerably on tariffs to raise revenues. During the Civil War, the need to bring in revenue to fund wartime expenditures led the Republican Congress to increase tariffs and excise taxes. This led to the creation of the Office of the Commissioner of Internal Revenue.[10]

In a further attempt to raise money to fund Civil War expenditures, in 1862 the federal government instituted an income tax. The first income tax imposed a basic rate of 3% on incomes above a personal exemption of $800. Subsequently, the tax was modified to impose a 5% tax on incomes between $600 and $5,000 and 10% on incomes over that level. In 1865, the income tax produced 21% of federal tax revenues. After the war, however, more affluent citizens lobbied Congress to discontinue the tax. In 1872, the tax was allowed to expire, but high tariffs and certain taxes on alcohol, tobacco, and luxury items remained in place from the Civil War tax system.[11]

When the Democrats took control of Congress in the 1890s, they attempted to again raise an income tax affecting mainly the wealthiest families. However, because of the direct nature of the tax and the fact that the federal government had failed to allocate the tax across states according to population, the tax was ruled unconstitutional in the 1895 Supreme Court decision *Pollock v. Farmers' Loan and Trust Co.*[12]

In 1888, the idea of taxing an estate for an intergenerational wealth transfer was raised by economist Richard T. Ely, who believed that each person should start equally in the race of life. The nation's wealthiest citizens viewed the tax as less threatening than an income tax, and some supported the idealism embodied by the tax. This led the Republican leadership to institute the tax in 1898, when funds were needed for intervention in the Boxer Rebellion among other conflicts. The tax was repealed in 1902.[13]

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10. W. Elliot Brownlee, *Federal Taxation in America—A Short History*, 2nd ed. (Washington, DC: Woodrow Wilson Center Press, 2004), Chapter 1.

11. Id.

12. 157 U.S. 429; 15 S. Ct. 673; 39 L. Ed. 759; 1895 U.S. LEXIS 2215; 3 A.F.T.R. (P-H) 2557.

13. Brownlee, *Federal Taxation in America*.

Over the following years, support for taxation grew. In 1913, the Underwood-Simmons Tariff Act reestablished the income tax and established a "normal" rate of 1% on nearly all personal and corporate income with a personal exemption of $3,000. After several years of income tax, about 2% of American households paid taxes.[14]

In *Bank One Corporation v. Commissioner*,[15] Judge David Laro traces the modern history of fair market value and the establishment of the Internal Revenue Service. A summary based on the material presented in Judge Laro's decision follows.

Fair market value's modern history begins with the implementation of the modern income tax with the Revenue Act of 1918.[16] This act provides that, for purposes of determining gain or loss on the exchange of property, the value of any property received equals the cash value of its fair market value.

Over time, various judicial tribunals defined the term by articulating certain elements that should be addressed in a determination of fair market value. The Revenue Act of 1918 created an Advisory Tax Board, whose function was to advise on the interpretation or administration of income, war profits, or excess profits tax.[17] While this board was only in existence for a short time, in 1919, it recommended that fair market value should be the "*fair value that both a buyer and a seller, who are acting freely and not under compulsion and who are reasonably knowledgeable about all material facts, would agree to in a market of potential buyers at a fair and reasonable price*."[18]

Soon after, the Board of Tax Appeals, the predecessor of the current Tax Court, was formed by the Revenue Act of 1924.[19] In a 1925 decision, this board described the buyer and seller as "willing" in a fair market value context.[20] In the same decision, the board advised on subsequent events, stating that the fair market value must be determined without regard to any event that occurs after the date of valuation.

Two years later, the Board of Tax Appeals adopted the Advisory Tax Board's opinion on the willingness of the buyer and seller under no compul-

14. Id.

15. 120 T.C. No. 11.

16. Chapter 18, 40 Stat.1057. Section 202(b), 40 Stat. 1060.

17. *Williamsport Wire Rope Co. v. United States*, 277 U.S. 551 (1928), Footnote 7.

18. T.B.R. 57, 1 C.B. 40 (1919).

19. *Williamsport Wire Rope Co. v. United States.*

20. *Hewes v. Commissioner*, 2 B.T.A. 1279, 1282 (1925)

sion.[21] The Board of Tax Appeals soon after adopted the concept that the buyer or seller in question was not a particular person, but a hypothetical person mindful of all the relevant facts.[22]

In the 1930s, the concept of the "highest and best use" for the subject of the valuation was recognized as a requirement for fair market value of real property, when the court held that two adjacent pieces of land should be valued at the same per square foot, regardless of the fact that one was being used in its highest and best use while the other was not.[23] While the term *highest and best use* is generally used in real property valuations, it is not explicitly used in U.S. business valuations but rather covered under the assumption that the business should be operated to maximize its shareholders' wealth. As will be discussed, Canada and Britain utilize the concept of highest and best use in business valuations.

The next section decomposes the definition of fair market value and discusses some of the issues that have arisen in interpreting it. Further, we highlight several important cases and IRS Revenue Rulings that have enhanced our understanding of fair market value. Further, we discuss the implications of each element of the definition and their effects on the appraisal process. Throughout the chapter, we look at these elements through the prism provided by various tax cases that have addressed this issue.

ELEMENTS OF FAIR MARKET VALUE

We begin by looking at the premise of value applicable in fair market value, the basic assumptions that the premises provide, and one court's view of how premises of value affects the ultimate valuation. We then decompose the definition and define its constituent parts:

- Price at which a property would change hands
- The willing buyer
- The willing seller
- Neither being under any compulsion
- Both having reasonable knowledge of the relevant facts
- Valuation date and use of subsequent events

21. *Hudson River Woolen Mills v. Commissioner*, 9 B.T.A. 862, 868 (1927).

22. *Natl. Water Main Cleaning Co. v. Commissioner*, 16 B.T.A. 223 (1929).

23. *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 60 (1936).

Price at Which a Property Would Change Hands

Premise of Value

Determining fair market value requires the establishment of the premise of value to understand exactly how the business should be valued. The general premise driving the theoretical underpinnings of fair market value is that fair market value is a value in exchange. This value in exchange is estimated whether the property is actually up for sale or not; it is presumed to be for sale in a hypothetical transaction at a point where there is a meeting of the minds between a willing buyer and willing seller. As such, fair market value is premised on the value of the property in exchange for cash in a hypothetical sale consummated between a willing buyer and willing seller. Simply stated, when the property is sold, the seller gets cash and the buyer gets the property.

How will the property be sold? The valuation of an ongoing business is usually conducted under the premise that the business will continue as a going concern. The going concern premise provides the framework that drives the other assumptions in the appraisal process. In other situations, a business may be valued under a liquidation premise. It may be liquidated and broken up for the value of its underlying assets.

The value in exchange presumption is different from the premise of value concerning the operational characteristics of the enterprise i.e. going concern or liquidation. As it applies to the enterprise, the premise of value is the value of the enterprise in a hypothetical sale either operating as a going concern or, when appropriate, in liquidation. Those are two different concepts: value in exchange deals with the base from which the property is valued; while consideration of the enterprise as a going concern or in liquidation deals with operational characteristics of the business rather than the ideological framework of the valuation.

Thus, under the value in exchange premise, a business can be viewed as a going concern or upon liquidation, a determination that can depend on a number of factors including the nature and condition of the company. A company may be worth more in liquidation than as a going concern. In making such an assessment, the practitioner may consider the likelihood of liquidation (and the rights of the shareholder to liquidate). Such was the issue in *Estate of Watts v. Commissioner*.[24]

24. 823 F.2d 483; 1987 U.S. App. LEXIS 10281; 87-2 U.S. Tax Cas. (CCH) P13,726; 60 A.F.T.R.2d (RIA) 6117.

Estate of Watts v. Commissioner

Martha Watts owned a 15% interest in a lumber company, subject to a shareholders' agreement that provided guidelines for death of a partner, dissolution, and disposition of the partnership interests. Upon her death, her interest in the lumber company was valued by the estate's expert at $2,550,000. Upon audit, the commissioner valued her partnership interest at $20,006,000, based on the fair market value of the corporation's underlying assets upon liquidation rather than the value of the company as a going concern.

In the Tax Court case, the estate argued that the interest should be valued as a going concern. The commissioner looked to value the partnership interest in liquidation. The Tax Court sided with the estate on the grounds that there was no intention of the remaining partners to liquidate the corporation, and valued the shares at $2,550,000.

The commissioner appealed the Tax Court's decision based on the intention of the partners. The Court of Appeals agreed that the Tax Court erred in its judgment when it based the valuation on the intention of the partners, but did not reverse the decision to value the partnership as a going concern.

The Court of Appeals noted that as a minority shareholder, the estate's shares did not come with the rights to liquidate the company. Therefore, regardless of the intentions of the other partners, the estate's shares should be valued on a going concern basis.

This case has been distinguished from cases where partnership agreements have differing requirements upon the death or departure of a partner, including less clear guidance on the continuation of the corporate form at the shareholder's death.[25] As we have discussed, the particular facts and circumstances of a given case may have substantial effect on the final outcome.

Price versus Value: Cash or Cash Equivalent

The definition of fair market value begins with finding the price at which a property would change hands in a transaction. *Black's Law Dictionary* defines *price* as "The amount of money or other consideration asked for or given in exchange for something else; the cost at which something is bought or sold";[26] value is defined as "1: the significance, desirability, or utility of something to the general public. 2: The monetary worth or price of something; the amount of goods, services, or money that something will command in an exchange."[27]

25. *Estate of McFarland v. Commissioner*, T.C. Memo 1996-424.
26. Bryan A. Garner, *Black's Law Dictionary*, 8th ed. (St. Paul, MN: Thompson West., 2004), at 1226.
27. Id. at 1587.

Although these definitions use the terms *price* and *value* interchangeably, they are not always viewed to mean the same things. As was discussed in Chapter 1, there can be a significant difference between price and value. The important issue is that the first element of the definition of fair market value establishes that the premise of value is a value in exchange. Value is determined in a hypothetical transaction regardless of whether the asset is expected to be sold. Moreover, the term *price* requires a single-point estimate, not a range of value. As will be discussed, value is determined at the single point where the expectations of the buyer and the expectations of the seller meet. The point estimate is viewed in terms of cash or cash equivalent. The concept of cash and cash equivalency is a critical component of this standard of value. The fact that the definition of fair market value refers to price generally indicates that value should be expressed in terms of money or money's equivalent, that is, cash today or the present value of future consideration.

This is an important distinction in that many real-world transactions take place in stock for stock deals that may be either more or less valuable than a cash transaction.[28] By receiving stock, the seller is subject to more risk because of the lack of liquidity of the stock. Therefore, while there may be, over time, an upside to this form of payment should the stock appreciate, there is also the possibility that the stock will decline in value. This risk does not occur in an all-cash transaction; nor are the potential gains available with stock available with cash. The fair market value construct does not allow the kind of flexibility seen in real-world transactions, as all of these considerations are impounded in a single-point estimate.

Willing Buyer

Marketplace

> The value at any particular time is the result of supply and demand; and is always that which is necessary to create a market for the existing supply.[29]

By definition, fair market value will be the price a hypothetical willing buyer and a hypothetical willing seller will arrive at after successfully negotiating a

28. Black and Kraakman, "Delaware's Takeover Law: The Uncertain Search for Hidden Value," 96 *Northwestern University Law Review* (Winter 2002), at 521.

29. John Stewart Mill, *Principles of Political Economy*, 7th ed., ed. William J. Ashley (London: Longmans, Green and Co., 1909), Book III, Chapter III.

sale of the property or asset in question.[30] This theoretical meeting of the minds needs to occur in some kind of marketplace. As stated by a 1923 case in the Third Circuit, *Walter v. Duffy*,[31] the existence of a market suggests the existence of both supply and demand for a property. Offers to sell without buyers to buy are not evidence of fair market value, and neither are offers to buy without anyone willing to sell.

A marketplace should not be made up of only sellers, nor can it be made up only of buyers. While the buyer is viewed as willing, this buyer will only buy for a rational economic amount. Similarly, sellers will only sell for a rational economic amount. A market will only be created when the rational economic analysis of value intersects between buyers and sellers.

The most probable market for a business may not be easily identifiable. Minority shares in closely held corporations are usually not readily marketable. In the case of various closely held businesses or business interests, there may be no readily apparent market or probable buyers or sellers. The courts typically look for evidence of what a willing buyer and seller would agree on if they indeed existed. The court in *Alvary v. United States*,[32] for example, suggested that there is a difference between value and liquidity, and a lack of readily accessible buyers does not mean that they do not exist. The risks of a private corporation may be higher due to the lack of liquidity, but in turn there may be a higher potential for reward. A willing buyer of a private corporation will look to analyze the same information that a willing buyer of a public corporation would, comparing its risks and returns to other potential uses for that investment.

Individual Buyer or Pool of Buyers

On the surface, in a strict fair market value interpretation, a marketplace of hypothetical buyers and sellers will bid and eventually reach an agreeable price. The marketplace, however, may be made up of a variety of different types of buyers.[33] There might be entrepreneurs looking to continue the business on their own. There might be financial buyers who see the business as a good investment. There may also be synergistic buyers who see a conjunctive value with other acquisitions or owned assets.

30. Bogdanski, *Federal Tax Valuation*, at 2.02[2][a].
31. 287 F. 41, 45 (3d Cir. 1923).
32. 302 F2d 790, 794 (2nd Cir. 1962).
33. Roger J. Grabowski, "Identifying Pool of Willing Buyers May Introduce Synergy to Fair Market Value," *Shannon Pratt's Business Valuation Update*, Business Valuation Resources, 7, No 4 (April 2001).

As discussed earlier, the Estate Tax Regulations require that the value of the property be measured in the market where it would most likely be sold. When assessing the price that a hypothetical willing buyer would pay, the practitioner seeks to identify that marketplace. By definition, buyers will have reasonable and relevant knowledge of the facts. This reasonable knowledge will include an understanding of prior transactions and identification of other shareholders. There may be an instance in which only a specific pool of buyers make up the usual marketplace for a certain block of stock. The practitioner should carefully analyze the marketplace so as to identify who would constitute the most likely pool or pools of potential buyers.

The issue of marketplace was addressed in the *Estate of Newhouse v. Commissioner*,[34] where the valuation involved a block of common stock in a large media conglomerate.

Estate of Newhouse v. Commissioner

In this case, the decedent had owned all of the class A voting stock and class B nonvoting stock in a giant media corporation involving numerous divisions and locations involved in the publication of over 50 magazines and newspapers in 22 markets. Other family members held the preferred shares in the company.

The estate had the shares appraised by Chemical Bank and arrived at a total value of $247,076,000. The commissioner valued the shares at $1,323,400,000. The commissioner determined that the estate valuation performed by Chemical Bank was deficient by $609,519,855 in taxes.

The taxpayers argued that the only potential buyers for the stock would be other large media businesses. These potential buyers could not engage in the transaction, however, because they would violate antitrust laws. In addition, no other buyers would purchase the business without eliminating the preferred stock, which would be an expensive and prohibitively difficult process that would lower the value of the company to an outside purchaser.

The court sided with the taxpayer in considering that the market would be made up of a specific potential pool of buyers rather than nonspecific hypothetical buyers.

Later, in *Estate of Mueller v. Commissioner*,[35] the court identified a characteristic of the market by stating: "We assume that the potential buyers of the shares would bid up the price of the shares until the person who values the

34. 94 TC 193(1990)

35. *Estate of Mueller v. Commissioner*, TC Memo. No 1992-284 at 1415, 63 TCM 3027-17.

shares most highly . . . wins the bidding." However, the court also stated that it need not identify a particular potential buyer or class of buyers, as the concern in determining fair market value should be the hypothetical buyer: This suggests that regardless of who the bidders are, the highest price a bidder is willing to pay may be higher than what the market would bring. Indeed, many valuation practitioners believe that fair market value would be best expressed by the amount the second highest bidder would pay.

Alternatively, according to *Estate of Winkler v. Commissioner*,[36] the willing buyer does not and, indeed, should not necessarily belong to a particular group of individuals. This case addressed the situation when the block of stock in question is 10% of the voting shares of a corporation, where one family held 50% of the company and another family held 40%. These shares could be considered a swing vote, and the court decided that the willing buyer should not be identified as a member of either family, but, instead, the stock should be viewed as an independent unit and valued as if an independent third party were the potential buyer.

Even in a hypothetical transaction, the court may be sensitive to the real owners and the particular facts and circumstances of a given case. This may influence the final determination of value more than the requirements of any stated standard. The court's view of who constitutes a willing buyer appears to be greatly influenced by the facts and circumstances of each individual case.

Synergistic Buyers

When a controlling block of shares is the subject of valuation, a willing buyer with reasonable and relevant knowledge of the marketplace will understand that there may be synergistic buyers bidding for the business. These synergistic buyers may give up a portion of the synergistic value to the sellers in order to outbid other buyers.[37] Some believe that there is an interrelationship between the synergistic value to a seller and the highest and best use to a buyer.

The 1936 case of *St. Joseph Stock Yards Co. v. United States*[38] introduced the concept of the highest and best use in real estate valuations. Interestingly, while the highest and best use concept is not explicitly applied to business valuations in the United States, the term *highest price* is used as part of fair

36. T.C. Memo 1989-231; 1989 Tax Ct. Memo LEXIS 231; 57 T.C.M. (CCH) 373; T.C.M. (RIA) 8923.

37. Grabowski, "Identifying Pool of Willing Buyers."

38. *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 60 (1936).

market value in Canadian business valuations. The Canadian definition of fair market value is:

> The highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.[39]

British and Canadian courts view fair market value as the highest price that could be achieved upon sale, as there may be consideration of a purchaser willing to include the value of synergies in their offer. Courts in the United States generally look to consider synergistic buyers in the context of investment value.[40] However, many courts have looked to determine the highest bid price that could be achieved by willing buyers. Both U.S. and Canadian practitioners acknowledge that if, in addition to ordinary purchasers, several special-interest purchasers are involved in the bidding, the market itself will eventually exclude the ordinary purchasers as the new equilibrium price would reflect the synergistic value.[41]

In Canada, if a willing and able strategic buyer can be identified, a strategic purpose premium may be added to the stand-alone fair market value to reflect the additional amount a strategic purchaser would pay, although that premium would be difficult to quantify. However, cases in both Canada and Great Britain do not allow a *hypothetical* strategic purchaser.[42] Instead, in order to apply a strategic premium, there must be evidence that an actual purchaser exists, has made an offer, is able to pay that price, and that these facts were known publicly.[43]

Although Canada has the "highest price" requirement, a premium is not necessarily required to reflect the highest price. A single strategic purchaser will not have to pay far above the fair market value to outbid regular market purchasers. If there were others willing to compete with the strategic purchaser

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39. www.bvappraisers.org/glossary/glossary.pdf.
40. Ian Campbell. *Canada Valuation Service* (Scarborough, ON: Carswell Publishers, October 2004), at 4-28.
41. Shannon P. Pratt, *The Market Approach to Valuing Businesses* (Hoboken, NJ: John Wiley & Sons, 2001), at 142.
42. Richard M. Wise, "The Effect of Special Interest Purchasers on Fair Market Value in Canada," *Business Valuation Review* (December 2003).
43. *Dominion Metal & Refining Works, Ltd. v. The Queen*, 86 DTC 6311 (Trial Division).

at the higher price, a new market would be created where the equilibrium price will reflect any strategic premiums.[44]

In *Mueller v. Commissioner*,[45] the court looked to an expert analysis to determine the fair market value of a family corporation that was in the midst of a sale at the time of the decedent's death. The court received three separate valuations, one of which represented a range of values over which the fair market value could fall. All these valuations considered a discount from the executed purchase price (due to uncertainty of sale and illiquidity) a few months after the decedent's death. One expert asserted that the willing buyer would be looking to obtain the low-end price and the willing seller would be looking to obtain the high-end price, and then averaged the two to find the fair market value. The court did not accept the midpoint in the range, but instead considered an auction-based environment, where the willing buyers will outbid each other until a maximum bid price is reached. The court ultimately accepted the high-end value.

The case of *BTR Dunlop Holdings, Inc. v. Commissioner*[46] addressed the issue of whether synergistic buyers should be considered as a factor in determining fair market value.

BTR Dunlop Holdings, Inc. v. Commissioner

In this case, BTR Dunlap, a wholly owned U.S. subsidiary of an international corporation, purchased Schlegel Corporation, a European company with various subsidiaries involved in the production of automobile and building products. The main issue in this case was the value of Schlegel UK, a British subsidiary of Schlegel with plants throughout England. While the petitioner's (BTR Dunlap) experts attempted to value the entity on a stand-alone basis, the respondent (Commissioner) looked to value it as a synergistic acquisition.

Several experts were retained to value Schlegel UK and Schlegel GMBH at the date of purchase for tax purposes. While the petitioner (BTR Dunlap Holdings, the holding company for the now-merged shares of BTR Dunlap and Schlegel Corporation) asserted values of $21,846,000 and $9,400,000 for Schlegel UK and Schlegel GMBH respectively, the IRS came up with values of $49,069,000 and $13,246,000 respectively. The experts retained in the case

44. Wise, Richard. "The Effect of Special Interest Purchasers of Fair Market Value in Canada," *Business Valuation Review*, Quarterly Journal of the Business Valuation Committee of the American Society of Appraisers, Vol. 22, No. 4. December 2003.

45. T.C. Memo 1992-284; 1992 Tax Ct. Memo LEXIS 310; 63 T.C.M. (CCH) 3027.

46. T.C. Memo 1999-377; 1999 Tax Ct. Memo LEXIS 432; 78 T.C.M. (CCH) 797.

came up with a range of values, using both market and income approaches, and allowed the impact of synergies to varying degrees.

The respondent's expert used a capital asset pricing model (CAPM) formula with a beta of .84 for Schlegel UK. He viewed the company as part of a strategic purchase to come to the $49,069,000 figure. The other valuation experts came to lower values, excluding the impact of synergies, or claiming that these synergies were minimal. The court's decision reflected that property should be valued at its highest and best use and the fact that synergistic purchasers available at the time of the company's sale provided sufficient evidence that synergy should be reflected in the valuation.

One of the petitioner's experts who excluded synergies from his calculation was asked whether he would sell the business for his figure. He replied that the business would be worth more to him and therefore he would not sell it at that figure. The court rejected the notion that the stand-alone price would be that which a willing buyer and a willing seller would agree on.

While not agreeing with the respondent expert's specific price, the court did agree that synergies must be accounted for in the ultimate valuation. To find the appropriate capitalization rate, the court adjusted the beta from the respondent's valuation upward to 1.18 and excluded the small-company risk premium and company-specific risk premium one of the petitioner's experts had applied. In the final determination, the court adjusted the valuations to arrive at a 20% capitalization rate, which included consideration of potential synergistic purchasers.

In the real world, we do not know whether the buyer with the highest synergistic value will prevail. Typically, no buyer is going to offer more than the market clearing price, and there may be several buyers willing to pay that price.[47] In a fair market value context, by assuming reasonable knowledge and ability to negotiate at arm's length, it is likely that if synergistic buyers are available, they will bid to reach the highest price available for a business. Unfortunately, there is no conclusive guidance on whether potential synergies are applicable in every determination of fair market value. Whether synergies are a relevant consideration may depend on the facts and circumstances of the case.

Valuation of Different Classes of Stock

An interesting issue arises when valuing different types of stock held by one person. Nonvoting shares are generally less valuable than those with voting power and are generally valued at a discount when valued as stand-alone shares. However, when held in conjunction with control voting shares of a

47. Grabowski, "Identifying Pool of Willing Buyers."

corporation, are they any less valuable to a potential willing buyer? The question is, would the buyer purchase one block of stock (both voting and nonvoting) at one price, or would the stock be considered as two blocks because of the two types of shares within? *The Estate of Curry v. United States*[48] addressed this issue.

Estate of Curry v. United States

In this case, the estate held both voting and nonvoting shares of a privately held corporation. Initially, the jury accepted the estate's valuation, as it valued the two types of shares separately, with a nonvoting share discount for one block and a control premium for the other. The court had not informed the jury of the government's instructions, that the value of the nonvoting stock should be determined at the same level as the voting stock.

Upon review, the Court of Appeals concluded that the trial court had erred in rejecting the government's instruction that the stock should be viewed as a whole, as that is how it exists in the estate; as a block of shares having voting control over the corporation. The court suggested that the trial court arbitrarily disaggregated the shares under one possible subsequent transaction scenario.

The court quoted a previous Ninth Circuit decision that said " . . . There is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one."[49]

In addition, if fair market value assumes that a willing buyer will seek to maximize his advantage, he would purchase the whole block, rather than a portion thereof; otherwise the non-voting shares would be at a significant disadvantage. Conversely, a willing seller would seek to sell the whole block in order to maximize the value of his shares.[50]

Estate of Simplot v. Commissioner[51] is another example of a case dealing with the valuation of different classes of stock.

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48. 706 F.2d 1424; 1983 U.S. App. LEXIS 28894; 83-1 U.S. Tax Cas. (CCH) P13,518; 51 A.F.T.R.2d (RIA) 1232. This case was heard in the United States Federal District Court, in front of a jury.

49. *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

50. 706 F.2d 1424; 1983 U.S. App. LEXIS 28894; 83-1 U.S. Tax Cas. (CCH) P13,518; 51 A.F.T.R.2d (RIA) 1232.

Estate of Simplot v. Commissioner

In *Estate of Simplot v. Commissioner*, Class A voting shares and Class B nonvoting shares were initially valued differently in an estate valuation. The decedent, Richard Simplot, held 23.55% of the class A voting shares and 2.79% of class B nonvoting shares.

The estate obtained a valuation by Morgan Stanley that valued both class A and B shares at $2,650 per share. The commissioner of Internal Revenue valued Class A shares with a premium as control shares and came to a value of $801,994 per share, and valued Class B shares at $3,585 per share. A deficiency of $17,662,886 was assessed with penalties of $7,057,554.

Upon petition, the Tax Court reasoned that the voting shares were substantially more valuable because a hypothetical buyer would be able to play a role in the company as an owner of voting shares. Additionally, the shares held by the decedent represented the largest single block of shares.

The court valued Class A shares at $331,595.70, subject to a 35% lack of marketability discount, arriving at a value of $215,539 per share, and valued Class B shares at $3,417 per share. The Tax Court determined a deficiency of $2,162,052 and removed the penalties.

The Ninth Circuit Court of Appeals reversed the Tax Court's judgment, citing that the Tax Court had valued all Class A shares as a whole and took a pro rata value rather than valuing the minority share held by the estate. In addition, upon liquidation, the Class A shareholders would be no better off than Class B shareholders, and the dividends paid were the same. Therefore, there would be no economic advantage of holding a minority share of voting stock leading to the application of a premium. The judgment of the Tax Court was reversed and remanded for judgment in favor of the estate.

This holding should not be confused with the treatment of discounts addressed in Revenue Ruling 93-12 (family attribution). This Revenue Ruling addresses the situation where the holder owns a noncontrolling share of stock, but the family as a whole owns a control share (either before or after the decedent's shares are acquired). This ruling instructs that the gifted or bequeathed shares should *not* be valued as a family unit, but should be valued in their form as held by the estate. Revenue Ruling 93-12 also specifically refers to a corporation with a single class of stock, and therefore is not in conflict with either case just described.[52] The ruling refers to the particular buyer or seller, while the "one-block" concept may be applied to any willing seller owning both classes of stock.

51. 249 F.3d 1191; 2001 U.S. App. LEXIS 9220.

52. IRS Revenue Ruling 93-12.

Willing Seller

Like the willing buyer, the willing seller considers certain information before deciding to engage in a transaction, including liquidity, alternate uses for the investment, future cash flows, and risk.[53] A willing seller is one who can be convinced to sell for the right price, for a variety of purposes, including gaining liquidity or desiring the ability to invest in a higher-yielding investment. The hypothetical buyer evaluates the same economic and financial conditions as the seller. Therefore, when hypothetical seller chooses not to sell, theoretically, he or she willingly buys the asset by retaining the interest with the asset's existing opportunity costs and associated liquidity (or illiquidity). The owner prefers owning the property to the alternative of selling it.

The Tax Court has been critical of those who view fair market value from only the perspective of the buyer. Both the buyers' and the sellers' perspectives should be considered. In the case of *Mandelbaum v. Commissioner*,[54] the court addressed one expert's over-reliance on a willing buyer while ignoring the need for a willing seller.

Mandelbaum v. Commissioner

In a family-owned retail conglomerate, Big M, Inc., the court sought to devise a fair market value for the purposes of a gift tax over a period of five years. The respondent's (IRS's) expert asserted a 30% marketability discount was appropriate, relying on three "restricted stock" studies, the notion that the shareholders' agreements do not seriously affect marketability, and the fact that the risk associated with holding Big M stock is neutralized by the size of the company and the stable gross profits.

The petitioner's (taxpayer's) expert, however, contended that a 75% marketability discount applies to the value for the first four years in question while a 70% discount applies for the last. This expert concluded that Big M's stock was virtually illiquid and assumed that an investor would have to wait 10 to 20 years for the investment to become liquid. The expert relied on the fact that members of the Mandelbaum family have always owned Big M, the family had no plans to seek outside investors, Big M's senior management was far from retirement, and the gifts at issue did not affect management.

The court rejected both experts' valuations and looked to determine the marketability discount independently. In its view, the respondent's expert did not put enough weight on the fact that there was a shareholder agreement

53. Z. Christopher Mercer, *Quantifying Marketability Discounts* (Memphis, TN: Peabody Publishing, LP, 1997), at 178.

54. T.C. Memo 1995-255; 1995 Tax Ct. Memo LEXIS 256; 69 T.C.M. (CCH) 2852.

Exhibit 2.1 Factors and Adjusted Benchmark Percentages in Mandelbaum

FACTOR	CONCLUSION
Studies of private versus public sales of the stock	Benchmark for the marketability discounts should be set between 35% and 45%
Financial statement analysis	Below-average discount
Company's dividend policy	Below-average discount
Nature of the company, its history, its position in the industry, and its economic outlook	Below-average discount
Company's management	Below-average discount
Amount of control in transferred shares	Average discount
Restrictions on transferability of stock	Above-average discount
Holding period for stock	Neutral
Company's redemption policy	Below-average discount
Costs associated with making a public offering	Above-average discount
Court's Final Conclusion:	**30% Marketability Discount**

> in place that would restrict value. The petitioner's expert placed too much weight on the willing buyer's expectations in terms of rate of return and the restrictive nature of the shareholder agreement, and misidentified the willing buyers by interviewing the types of investors who would require a higher rate of return. In providing an above-average marketability discount, the petitioner's expert ignored the perspective of a hypothetical willing seller.
>
> In the court's own review, it used the petitioner's expert's determination of the average marketability discount and reviewed the factors in Exhibit 2.1 to come to its conclusion on the size of the applicable marketability discount (which coincidentally equaled the respondent's conclusion):
>
> Reviewing these factors and the conclusions that followed, the court found that because of the facts and circumstances of the case, a below-average discount was required. It applied a 30% discount.

This case points out that consideration of a willing buyer is not enough. A willing buyer seeking stock in Big M would likely demand a large discount on its value based on the family nature of the company and the agreements in place. However, if shareholders of Big M were willing to sell, that might lead to a substantially different value.

Earlier we briefly discussed the family attribution principle in Revenue Ruling 93-12. This issue is best understood from the point of view of the willing seller. In the case of *Bright v. United States*,[55] the government attempted to add a control premium to noncontrolling shares of the decedent's wife because the husband owned the balance of the shares that would add up to a controlling value when combined with the wife's shares. The government claimed that the husband would not be willing to sell his 27.5% of the shares unless it was part of the 55% control block combined with the decedent's shares. The court cited several cases where this type of family attribution was rejected, ultimately rejecting the government's argument and affirming the district court's ruling that the interest to be valued was only the 27.5% common stock interest. This brings us back to the fact that a seller is a *hypothetical* willing seller, selling in a *hypothetical* market, rather than a *specific* individual selling in a *specific* market. The question was not the value the estate would accept if it held 27.5% of shares that could potentially be sold as part of a 55% control block, as the government contended, but instead the value that a willing seller would accept for 27.5% of a property's shares.

A similar issue was discussed in the case of *Propstra v. United States*.[56] In this case, the Court of Appeals addressed issues of the willing seller and control as well as of the effect of subsequent events on claims against property.

Propstra v. United States

At the death of Arthur Price, his estate was comprised mainly of property shared by him and his wife, the executrix of the estate. John Propstra was the estate's personal representative. Upon Price's death and the valuation of his estate for tax purposes, his wife made two adjustments: One was a 15% lack of marketability discount for an undivided one-half interest in parcels of real estate and another adjustment for liens against the property for penalties and assessments by the Salt River Valley Water Users' Association that remained unsettled.

On the first issue of the discount for partial ownership, the government argued that the estate must prove that the property was likely to be sold as a partial interest in a parcel of real estate rather than as an undivided interest by the estate. The court found that there was no reason to see a hypothetical seller as necessarily belonging to the estate and that indeed the

55. 658 F.2d 999; 1981 U.S. App. LEXIS 17205; 81-2 U.S. Tax Cas. (CCH) P13,436; 48 A.F.T.R.2d (RIA) 6159; 48 A.F.T.R.2d (RIA) 6292.

56. 680 F.2d 1248; 1982 U.S. App. LEXIS 17696; 82-2 U.S. Tax Cas. (CCH) P13,475; 50 A.F.T.R.2d (RIA) 6153.

property to be valued at fair market value and by its definition was the one-half interest. The court found this situation analogous to that in *Bright v. United States*.[57]

On the second issue of the lien, at the time of the initial tax payment, Mrs. Price was looking to settle the claims with the Salt River Valley Water Users' Association. At that time, however, the association's bylaws did not allow the settlement claims for less than the full amount due, and the tax deduction was based on this understanding. After the decedent's death and the payment of the estate taxes, the association amended its bylaws and settled the claims against the property owned by the Prices for less than the full amount owed. The government looked to recoup the taxes that the estate had deducted because the full lien on the property at the time of death.

The Court of Appeals found that at the time of death, there was no anticipation that the association would settle the claim due to its bylaws at the time, regardless of Mrs. Price's hope that the claim would be settled. It ruled that as a matter of law, "when claims are for sums certain and are legally enforceable as of the date of death, post-death events are not relevant in computing the permissible deduction."

No Compulsion to Buy or Sell

In the real world, the parties involved in a transaction may be compelled to buy or sell based on involvement in bankruptcy or insolvency, a need for immediate liquidity, the need of an immediate sale for charitable purposes, or a variety of factors.[58] This is another reason that a sale price in and of itself is not necessarily evidence of fair market value. In a fair market value transaction, the buyer and seller have equal negotiating power. The buyer is looking for the lowest price at which to buy, and a seller is looking for the highest price to sell.[59] There will be competition in the marketplace from other bidders willing to offer a higher price or from other sellers willing to sell for less. The fact that there is no compulsion to sell also suggests that the company be valued with ample exposure to an appropriate market, rather than in a forced liquidation.[60]

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57. 658 F.2d 999; 1981 U.S. App. LEXIS 17205; 81-2 U.S. Tax Cas. (CCH) P13,436; 48 A.F.T.R.2d (RIA) 6159; 48 A.F.T.R.2d (RIA) 6292.

58. Bogdanski, *Federal Tax Valuation*, at 2.01 [2][b].

59. Jay Fishman and Bonnie O'Rourke, "Value: More than a Superficial Understanding Is Required," *Journal of the American Academy of Matrimonial Lawyers* 15, No. 2 (1998).

60. Id.

In the 1923 Tax Court case *Walter v. Duffy*,[61] the court addressed the value of stock in what was judged to be a forced liquidation.

Walter v. Duffy

Emeline C. Blanchard owned 1,890 shares of Prudential Life Insurance stock. The government looked to assess and tax the increase in value of the stock based on the value of a sale in 1915, where 1,881.41 shares were transferred for $455 per share.

Unaware of the cost of Blanchard's initial purchase, the IRS based the incremental increase on the difference between $455 per share and a sale at $262.50 per share that had occurred two years prior to this transfer.

However, the individual who had sold the shares for the $262.50 price testified that he had sold the shares solely to achieve necessary liquidity to satisfy several loan debts. This was evidence that the seller was compelled to seek a quick sale to satisfy creditors. Had he not been so compelled, the stock would have had greater exposure to the market, and he likely could have held out for a higher figure.

The court held that the $262.50 value could not have been a fair market price and a reassessment was ordered by virtue of a new trial.

There may be many sorts of compulsion. Financial pressure might cause a buyer or seller to act more quickly, thereby causing insufficient exposure to the marketplace. In the case of *Troxel Manufacturing Co. v. Commissioner*,[62] the sale of the property was seen to be made in haste, as the seller was in urgent need of cash and had to sacrifice a particular property at a price less than its supposed real value. The court in that case decided that the sale was not an arm's-length transaction and that the price reached was not representative of fair market value. However, the desire for cash in lieu of property may be viewed by some as a preference rather than compulsion, as represented by the dissenting opinion in *McGuire v. Commissioner*,[63] where a dissenting judge states that a seller is not necessarily unwilling if the decision to sell is a matter of wanting cash over property.

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61. 287 F. 41, 45 (3d Cir. 1923).
62. 1BTA 653,655 (1925).
63. 44 TC 801,813 (1965).

Importance of Restrictive Agreements

Transactions in a hypothetical market may not be subject to the restrictions that may exist on an open market. That does not mean, however, that these restrictions cannot or should not be considered in a fair market value transaction. Instead, buyers are often assumed to account for these restrictions in assessing the value of the business interest because they themselves will be subject to these restrictions after purchase.[64]

The Internal Revenue Code (IRC) section 2703(b)[65] sets forth four general considerations in determining the applicability of a buy-sell agreement to fair market value.

1. The agreement must be a bona fide business arrangement.
2. It must not be a device to transfer property to family member for less than full and adequate consideration.
3. The agreement must be entered into pursuant to an arm's-length transaction.
4. It must also be binding both before and after the holder's death.[66]

The courts generally have respected restrictions on transfers in determining fair market value, often applying discounts for lack of marketability. In some divorce cases, great weight is afforded restrictive agreements in determining value as long as that agreement is kept current and is used regularly in the course of business; other cases have found these agreements to have no true influence on value as they have never been used. The Tax Court was confronted with the issue of a restrictive agreement in the *Estate of Lauder v. Commissioner*.[67]

Estate of Lauder v. Commissioner

The Estate of Lauder v. Commissioner addressed the valuation of shares in the decedent's estate based on the applicability of a restrictive agreement that afforded the corporation the right of first refusal in the purchase of a departed shareholder's shares at book value.

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64. Campbell, *Canada Valuation Service*, at 4-32.
65. U.S. Code Title 26, Section 2703(b).
66. Stephen C. Gara and Craig J. Langstraat, "Property Valuation for Transfer Taxes," 12 *Akron Tax Journal* Volume 125. 1996. at 139.
67. T.C. Memo 1994-527; 1994 Tax Ct. Memo LEXIS 535; 68 T.C.M. (CCH) 985.

The terms of the agreement were executed upon Lauder's death. The initial tax court's review (*Estate of Lauder v. Commissioner, T.C. Memo. 1992-736*) decided that the agreement was not determinative of fair market value, but instead a device by which shareholders could transfer their shares to their family for less than adequate consideration (thereby violating the requirement of IRC section 2703(b)). The court held that the shareholders' agreement was not controlling for the valuation of the decedent's stock at his death because it did not reflect fair market value at the time it was executed.

In the subsequent case to value the shares, (*Estate of Lauder v. Commissioner, T.C. Memo. 1994-527*) the court reviewed the valuations provided by various experts, and ultimately adopted a valuation method proposed by Lehman Brothers, because their analysis emphasized "the price/earnings ratios of comparable companies within the industry, provides the most objective and reliable basis for determining the fair market value of the stock in question."

The court valued the company using a 12.2 multiple of price to earnings and applied a 40% discount due to illiquidity to arrive at the fair market value of the stock.

Another significant case, *Estate of Joyce Hall v. Commissioner*,[68] may be distinguished from *Lauder* in its consideration that the fair market value of a corporation is affected by certain restrictions in the shareholder agreements. In this case, the agreements were *not* found to be in place simply for the purpose of an intergenerational wealth transfer.

Estate of Joyce Hall v. Commissioner

In this case, the company in question, Hallmark, was intentionally kept private by the decedent and his family. There were three classes of stock, class A preferred stock, class B common voting stock, and class C common nonvoting stock. The estate included shares of both B and C common stock. All classes of stock were subject to restrictions.

Subject to a 1963 indenture, these shares were required to be offered to a "permitted transferee," that is, Hallmark, members of the Hall family or their estates, and trusts set up for their benefits. Only after this exercise could the stock be sold to an outsider. Additionally, the indenture provided that class B shares could be purchased at their adjusted book value, with the possibility of a payment plan for cash and installments. Should the shares

68. 92 T.C. 312; 1989 U.S. Tax Ct. LEXIS 24; 92 T.C. No. 19.

be purchased by an outside holder, the interest would still be subject to the same restrictions on any subsequent transfer. The same sale restrictions were in place for the class C common shares.

In 1981, Hall entered into an option agreement with Hallmark to purchase his shares not subject to other buy-sell provisions. Upon Hall's death, Hallmark's directors voted to exercise that option and purchase those shares at the adjusted book value as of December 31, 1981.

The adjusted book value was computed annually by virtue of a formula provided by the 1963 indenture. At the valuation date, Hallmark computed the adjusted book value at $1.98157 per class B common share and $1.87835 per class C common share.

The commissioner argued that the adjusted book value could not be the fair market value because of the possibility of "permitted transferees" buying the stock at a higher price. The court did not allow this contention because, unlike *Lauder*, there was no evidence that even a permitted buyer would pay more than the adjusted book value, and in addition, this contention suggested the relevant buyer for the purposes of valuation was a *specific* class of buyer, a concept that ignored the requirement of a *hypothetical* willing buyer.

The court decided: "Agreements and restrictions not invalid on their face cannot be disregarded on such tenuous evidence of coincidence. . . . After weighing the respective opinions of the parties' experts, we cannot conclude that the fair market value is more than the adjusted book value of the stock."

Alternatively, the value set by a restrictive agreement was ignored in *Estate of Obering v. Commissioner*.[69] In this matter, the agreement gave the first option to the corporation and the other shareholders to purchase the stock at a set price, but allowed sale to the public should the corporation or the shareholders not elect to make the purchase. Because the agreement did not completely exclude a third party from purchasing the stock, the court precluded its representation of fair market value.

In addition to the requirements set forth by IRC section 2703(b),[70] buy-sell agreements are scrutinized for their reasonableness, whether they are periodically reviewed, and whether the price arrived at is representative of an arm's-length transaction. This is especially important when the shares of a company are held by family members, where often buy-sell agreements are viewed as testamentary devices that transfer shares at artificially low values. The courts

69. 48 T.C.M. (CCH) 733 (1984).

70. U.S. Code Title 26, Section 2701.

will likely also look at the events and circumstances surrounding the execution of the agreement in determining whether it is a valid agreement. These events might include relationship of the parties, the purpose of the agreement, and the source of the agreement price.[71]

Reasonable Knowledge of Relevant Facts

Known and Knowable

Fair market value requires that both the willing buyer and the willing seller be reasonably informed of the relevant facts affecting the property in question. This information is generally referred to as that which is "known or knowable" at the valuation date. As discussed earlier, in determining fair market value, a reasonable degree of knowledge is assumed. A valuation at fair market value should include information that is known by any party to the transaction as well as any information that may not be apparent at the valuation date but would have been knowable at that time by the parties involved.[72]

The Fifth Circuit Court of Appeals case *United States v. Simmons*[73] demonstrates that value may exist, even if it is unknown at the valuation date. In this case, after the decedent's death, the estate hired an accountant to investigate the decedent's tax filings. After discovering evidence of a deficiency payment made in error, the estate filed a claim for a refund. In the meantime, when the estate filed its estate tax returns, it assessed the claim at no value because there was no certainty that it would ever have any value. Eventually, the claim did settle for $41,187. In a trial to determine whether the $41,187 should be included in the estate, the jury found that the claim had no value at the decedent's death. The Court of Appeals did not agree. The court reasoned that even if the fact that the claim had value was unknown, the estate suspected that value existed because it retained professionals to investigate the decedent's tax records. Consequently, the Court of Appeals ruled that, although the estate may not have known that value existed, value (even if not in the full amount of the settlement) did indeed exist at the time of death.

Reasonable knowledge (as intended by the definition of fair market value) does not require that a buyer have all information and be totally informed, as

71. Gara and Langstraat, "Property Valuation for Transfer Taxes," at 139.
72. Bogdanski, *Federal Tax Valuation*, at 2.01[3][a].
73. 346 F.2d 213; 1965 U.S. App. LEXIS 5425; 65-2 U.S. Tax Cas. (CCH) P12,321; 15 A.F.T.R.2d (RIA) 1430.

some previous revenue procedures have suggested.[74] Additionally, Revenue Ruling 78-367 suggests that sellers will overemphasize the favorable facts and buyers will attempt to elicit all the negative information pertaining to a sale. These are two extreme views. In the real world, the requirement of perfect knowledge is likely to be unachievable. In determining fair market value, only reasonable knowledge of the relevant facts should be assumed. Therefore, cases addressing this point have insisted only on reasonable knowledge of the relevant facts.[75] As one commentator noted:

> Reasonable knowledge is a level of awareness that usually falls somewhere between perfect knowledge and complete ignorance—even if the actual owner of the property is at one extreme or the other.[76]

Estate of Tully v. United States[77] held that knowable information that may not be known by the owner can affect the determination of value. In this case, the decedent was not aware that company officials had been illegally rigging bids for contracts with the company's biggest customer. This information came to light four years after the valuation date. The court viewed the bid rigging as a knowable event (although unknown) that could affect value at the valuation date. The court reasoned that information was available at the valuation date that could have led to the discovery of this wrongdoing, particularly, that the gross profits of the business were so high compared to industry standards that careful inspection of the records could have led to the discovery of this impropriety. Therefore, in determining the company's value, the court discounted the value by 30% due to the information that could have been discovered on the valuation date with proper investigation.[78]

Postvaluation-Date Information and Subsequent Events

Since valuation is as of a particular point in time, practitioners are required to reach their conclusions based on information that is known or knowable (or reasonably foreseeable) at the valuation date. Typically, in a retrospective valuation, postvaluation-date information may be available. Subsequent events that were foreseeable at the valuation date may be considered in a valuation.

74. IRS Revenue Procedure 66-49.
75. Bogdanski, *Federal Tax Valuation*, at 2.01[3][a].
76. Id. at 2.01[3][a] 2-47.
77. 41 AFTR.2d 1477 (Ct. Cl. Tr. Div. 1978) (not officially reported) at 1490.
78. The court also applied a discount for lack of control for unrelated reasons.

However, if an event was completely unforeseen at the date of valuation, it is generally not considered. Although the practitioner might *want* this data to have been available at the valuation date, the possibility of occurrence is not the same as a recognizable probability, and it is important for the practitioner to use judgment in determining that information was truly knowable as of that time. A court may go to great lengths to determine what was known or knowable at the valuation date regarding information or factors affecting value.

The Tax Court's decision in the case *Couzens v. Commissioner*[79] described the ability to include subsequent events if indeed they were reasonably foreseeable at the date of valuation. The court stated:

> Serious objection was urged by [the government] to the admission in evidence of data as to events which occurred after [the valuation period]. It was urged that such facts were necessarily unknown on that date and hence could not be considered. . . . [I]t is true that value . . . is not to be judged by subsequent events. There is, however, substantial importance of the reasonable expectations entertained on that date. *Subsequent events may serve to establish that the expectations were entertained and also that such expectations were reasonable and intelligent*. Our consideration of them has been confined to this purpose. [Emphasis added.]

Other cases in the Tax Court have dealt with unexpected windfalls after the valuation date. In the case of *Ridgely v. U.S.*, the decedent owned a 368-acre farm valued at $372 per acre.[80] Around the time of death, the family tried to sell 40 acres of the farm to a local school board for $3,000 per acre. The family reduced the sale price to $2,000 and finally to $1,000. The school board declined to purchase the land because the location was not desirable. The decedent died in January 1962. In February of that year, General Foods began a search for land for a new Jell-O plant. In May 1962, General Foods purchased 112 acres of land for $2,700 per acre. While the IRS claimed that the entire tract was worth $2,700 per acre, the court did not consider the General Foods transaction as an indicator of value, as no one could have foreseen the purchase at the time of death.

As mentioned previously, in the *Estate of Tully*, the court allowed the use of postvaluation-date information some four years after the valuation date to determine what was knowable at the valuation date.[81] The courts have generally

79. *Couzens v. Commissioner*, 11 B.T.A. 1040; 1928 BTA LEXIS 3663.

80. 20 AFTR 2d 5946 (1967).

81. 41 AFTR 2d 1477 (Ct. Cl. Tr. Div. 1978) (not officially reported) at 1490.

acknowledged that evidence of value at the valuation date may be considered, while events affecting value after the valuation date, that were not reasonably foreseeable, may not be considered. An example of this is the case of *Estate of Jung v. Commissioner*, where the price of a postvaluation-date sale was used to value the company.[82]

Estate of Jung v. Commissioner

In the case of *Estate of Jung v. Commissioner*, a postvaluation-date sale was used to demonstrate that the business was undervalued in the initial estate valuation. The case involved 20.74% of shares outstanding in Jung Corp., an integrated manufacturer and distributor of elastics.

The court looked to determine the fair market value of the decedent's interest at the date of death. The business was valued at the date of death in 1984 at $33 million, and a 35% discount for lack of marketability was be applied to the decedent's pro-rata share. Two years later, in 1986, a majority of shares were sold to an outside company and the remainder was liquidated. The ultimate value of the company's equity appeared to have been over $60 million.

The court's opinion made clear that the sale of the company was not foreseeable at the valuation date; however, the court was persuaded by the IRS argument that the sale soon after the valuation was evidence that the value was understated at the valuation date, rather than an event that affected value.

Similarly, in *Estate of Scanlan v. Commissioner*,[83] prior to the decedent's death, shares were gifted to six family members and appraised at $34.84 per share. The date-of-death value was $35.20. Both figures included a 35% marketability discount derived by comparison with publicly traded companies. After the decedent's death, the company received an offer of $75.15 per share, and family members exercised their right to have the company buy out any other shareholders at that price. The IRS considered this information and valued the stock at $72.15 per share and applied a 4% minority discount. The family argued that the offers were for the entire company, not the estate's minority share. As it was so near the valuation date, the court allowed the offer to be considered, but then applied a 30% combined minority and marketability discount and arrived at a value of $50.21 per share.

82. 101 T.C. 412; 1993 U.S. Tax Ct. LEXIS 69; 101 T.C. No. 28.

83. T.C. Memo. 1996-331 (7/24/96).

The same issue was addressed in *Estate of Cidulka v. Commissioner*,[84] where a sale of a commercial billboard corporation four years after the date of death was utilized to establish fair market value. The court acknowledged that four years may be considered too remote to have bearing on the valuation of the stock at the earlier date, but the multiplier for the later sale was similar to that of the sales of comparable companies around the valuation date, and therefore the evidence of the later sale was applicable to the valuation at the valuation date. As will be seen in the next chapter, in some venues this principle has been extended to the determination of fair value in dissenting shareholder actions.

Generally, the courts are careful to note whether later events have changed the value of the property. The distinction between a subsequent event affecting value as contrasted with the event providing evidence of value may be best illustrated by an example set forth in case of *First National Bank v. United States*.[85] The court stated:

> For instance, if the proposition advanced is that a farm had a Fair Market Value of $800,000 on March 13, the fact that oil was unexpectedly discovered on June 13 (causing the Fair Market Value of the property to skyrocket) makes the proposition advanced no more or less likely. However, the fact that someone under no compulsion to buy and with knowledge of the relevant facts bought the property on June 13 for $1,000,000 is relevant, for it makes the proposition advanced (i.e., that the Fair Market Value on March 13 was $800,000) less likely.[86]

As can be seen, the use of postvaluation-date information dealing both with events that affect value (known or knowable) and those that provide evidence of value (subsequent transactions) depends on the facts and circumstances of each particular case. Indeed, a plethora of cases have addressed this issue. Exhibit 2.2 presents a compendium of cases compiled by Michael Mard of the Financial Valuation Group dealing with subsequent events in estate and gift tax cases. The cases on this list span from 1929 to 2005, and the chart references the key considerations of each decision.

The cases listed in the exhibit provide evidence that courts do consider events occurring after the valuation date. Actual factors considered by the court

84. T.C. Memo 1996-149; 1996 Tax Ct. Memo LEXIS 157; 71 T.C.M. (CCH) 2555.

85. 763 F.2d 891; 1985 U.S. App. LEXIS 19780; 85-2 U.S. Tax Cas. (CCH) P13,620; 56 A.F.T.R.2d (RIA) 6492; 18 Fed. R. Evid. Serv. (Callaghan) 290.

86. Id.

Exhibit 2.2 Compendium of Cases

DATE	JURISDICTION	REFERS TO CASE(S)	REFERENCE TO USE OF SUBSEQUENT INFORMATION
1929	United States Supreme Court	ITHACA TRUST CO. v. U.S. (279 U.S. 151 (1929))	The value of the thing to be taxed must be estimated as of the time when the act is done. Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes true.
1956	United States Court of Appeals, Eighth Circuit	FITTS' Estate v. Commissioner, 237 F 2d 729 (8th Cir. 1956)	It was determined in this case that actual sales made in reasonable amounts in arm's-length transactions, in the normal course of business, within a reasonable time frame after or before the date of value, are the best criteria of market value.
1964	United States Court of Appeals, Seventh Circuit	Chester D. TRIPP v. Commissioner (No. 14560 (1964))	In this case, the court chose to use the purchase price of an antique jewelry collection (given to charity two and one-half years after date of purchase) to establish value because it found "no substantial evidence that any situation arose or development occurred in the interim which increased the value of the collection."
1972	United States Tax Court	Estate of David SMITH (57 TCM 650)	The dissenting Tax Court judge stated that more weight should be given to the actual sales of a sculptor's art both before and after his death as uncontested evidence of value.
1975	United States Supreme Court	LOWE v. Commissioner (4236 U.S. 827 (1975))	Sales after the valuation date "may be used to corroborate the ultimate determination of value."
1983	United States Tax Court	Estate of JEPHSO v. Commissioner (81 TCM 999)	The Tax Court ruled that ". . . subsequent events may be considered for the limited purpose of substantiating reasonable expectations."

1987	United States Tax Court	Estate of Saul R. GILFORD (88 TCM 38)	In this case the price of decedent's stock was determined by the price it was sold for in a merger six months after the date of death.
1987	United States Tax Court	Estate of Euil S. SPRUILL (88 TCM 1197)	In this case, the court considered the actual selling price of real estate that was sold 14 months after the date of death to determine value.
1989	United States Tax Court	Estate of Ruben RODRIGUEZ (56 TCM 1033)	Evidence showed that the business lost customers and suffered a sharp decline in profits after the death of the decedent. The court upheld the reduction in value due to loss of key employee.
1989	United States Claims Court	KRAPF, Jr. v. U.S. (89-2 USTC par. 9448 (U.S. Claims Court 1989))	In this case, the court made two exceptions to the general rule that valuations must be made without reference to events that occur after the valuation date by stating, "First, post-gift date can be used in valuation when there has been no material change of circumstances or conditions in the cooperation between the valuation date . . . and the subsequent information). Second, the post-gift evidence is indicative of gift value when the subsequent information could have been foreseen on the valuation date."
1989	United States Court of Appeals, District of Columbia Circuit	Charles s. Foltz v. U.S. News & World report (98-7151 U.S. App. (D.C. Jan. 13, 1989))	The court noted: "The approach to be used is not retrospective, but prospective. One must look at the situation as of the time that each employee separated from the company. Therefore, the appropriate inquiry is whether the company was properly valued during the class period, not whether former employees become eligible for a greater share of benefits upon the contingency of a subsequent sale."

(*continues*)

Exhibit 2.2 Continued

DATE	JURISDICTION	REFERS TO CASE(S)	REFERENCE TO USE OF SUBSEQUENT INFORMATION
1992	United States Tax Court	Estate of Bessie I. MUELLER (63 TCM (CCH) 3027)	In this case subsequent events, which occurred 67 days after date of death, were admissible by the Tax Court and allowed to set the value of the shares of stock in question at the date of death on the premise that merger negotiations were initiated prior to the date of death.
1992	United States District Court, M.D. Pennsylvania	GETTYSBURG National Bank v. U.S. (1992 WL 472022 (M.D. Pa.))	This case deals with a suit brought to recognize a sale price lower than the appraised value submitted in the estate tax return. The court allowed the use of a real estate sales price that occurred 16 months after the date of death to determine value at the date of death.
1993	United States Tax Court	Estate of JUNG v. Commissioner (101 TCM 412 (1993))	A common argument as evidenced by this case is that a subsequent sale does not affect the value on an earlier valuation date, rather it is evidence to that value.
1993	United States District Court, S.D. Florida	RUBENSTEIN v. U.S. (826 F. Supp. 448 (S.D. Florida 1993))	This court allowed a pending settlement of a claim made subsequent to the valuation date to be considered in the determination of value, even though a lawsuit had yet to be filed at the date of death.
1994	United States Tax Court	Estate of Robert C. SCULL v. Commissioner (67 TCM (CCH) 2953)	The Tax Court ruled that actual selling price at an art auction held 10 1/2 months after the date of death of Scull was the best evidence of the fair market value of works of art in the estate.
1994	United States Tax Court	SALTZMAN v. Commissioner (TCM 1544, 1559)	The Tax Court ruled that "The test to consider a later sale is not whether the sale is forseeable, but is rather whether or not later events have materially changed the value of the property."

1994	United States District Court, E.D. Virginia, Norfolk Division	Estate of Virginia C. ANDREWS v. U.S. (850 F. Supp. 1279)	The court ruled that events occurring subsequent to death permit consideration of evidence of actual price received after date of death so long as sale occurred within reasonable time after death and no intervening events drastically changed the value of the asset.
1995	United States Tax Court	Estate of Dominick A. NECASTRO (68 TCM 227)	The Tax Court did not allow a reduction in the value of property based on the possibility that contamination might have existed at the valuation date. However, nearly four years after the valuation date, postmortem information was obtained and admitted, which resulted in a revised valuation.
1995	United States Federal District Court, Seventh Circuit	The FIRST NATIONAL BANK OF KENOSHA v. U.S. (763 F.2d 891)	In this case, the estate had been approached 15 months after the valuation date about a purchase of the property. The court allowed the postmortem event into evidence thus impacting the jury's determination of value.
1995	United States Tax Court	Estate of Max SHLENSKY (36 TCM 629)	In this case, subsequent events that occurred 15 months after the date of death were admissible by the Tax Court and allowed the value of the real property in question to be set at the date of death on the premise that the facts and circumstances that gave rise to the transaction had mot materially changed during the subsequent period.
1995	United States Federal District Court, Fifth Circuit	U.S. v. G. SIMMONS (346 F.2d 213)	This case dealing with an income tax refund stated that the amount of the refund was not agreed on until five years after the valuation date. The court held that reasonable knowledge of the facts would have revealed the refund claim had value and, as such, the court allowed the value to be set by the subsequent event.

(*continues*)

Exhibit 2.2 Continued

DATE	JURISDICTION	REFERS TO CASE(S)	REFERENCE TO USE OF SUBSEQUENT INFORMATION
1996	United States Tax Court	Estate of Joseph CIDULKA v. Commissioner (TCM 1996-149 (Mar. 26, 1996))	The Tax Court relied primarily on a sale of the company, structured as an asset sale, to the company's competitor four years following the valuation date. Not only was the sale removed four years in time, but it involved a high level of investment value as opposed to fair market value. The price could also have been influenced by the structure of the transaction as an asset sale, while the estate owned stock.
1996	United States Tax Court	Estate of Arthur G. SCANLAN v. Commissioner (TCM 1996-331 (July 25, 1996))	Decedent died in July 1991. The court relied on an offer to buy the entire company in March 1993 (resulting in a sale consummated in January 1994) and discounted the sale price by 30% to account for both a marketability and minority discount, as well as the change in the setting from the date of the decedent's death.
1997	United States Tax Court	Nathan and Geraldine MORTON v. Commissioner (TCM 1997-166 (April 1, 1997))	The Tax Court stated, "Subsequent events or conditions which affect the value of the property can be taken into account only if they are reasonably foreseeable on the valuation date . . . Subsequent events which merely provide evidence of the value of the property on the valuation date can be taken into account regardless of whether they are foreseeable on the valuation date."
1998	United States Tax Court	Estate of Emanual TROMPETER v. Commissioner (TCM 1998-35)	The court revealed that it disagreed with the estate and believed that certain postmortem events, although they do not set the market value of the stock, would have an impact on the value.

1998	United States Tax Court	Estate of Milton FELDMAR (56 TCM 1998)	The court rejected both IRS arguments that no key man discount was in order and that the company could use the $2 million life insurance policy settlement to replace him (key man) without loss to the company.
2001	United States Court of Appeals, Sixth Circuit	GROSS v. Commissioner (2001 F. App. 0405P (6th Cir.))	The IRS expert utilized pre- and postvaluation date transactions to determine an appropriate lack of marketability discount. The Tax Court found that reliance on such figures was appropriate because they demonstrated more accurately than the flawed earlier studies what willing buyers and willing sellers were actually doing at the time of valuation.
2001	United States Court of Appeals, Tenth Circuit	Estate of Evelyn M. McMORRIS (99-9031 U.S. App. (10th Cir. Mar. 20, 2001))	The Appeals Court ruled that the estate tax deduction for the decedent's income tax liabilities should not be reduced by the amount of an unexpected income tax refund that the estate received after the date of death (i.e., after the valuation date.)
2001	United States Court of Appeals, Eleventh Circuit	Estate of O'NEAL v. U.S. (00-11663 U.S. App. (11th Cir. July 26, 2001))	The Appeals Court ruled that the deduction (for claims against the estate) must be valued as of the date of Mrs. O'Neal's death. All events that have occurred after her death that may alter the value of the estate must be disregarded.
2005	United States Tax Court	Estate of Helen NOBLE (TCM 2005-2)	The court found subsequent sale of shares to be determinant of fair market value.

range from later sales of the asset in question to later sales of comparable companies.

In any case where a transaction occurred after the valuation date and was substantially different from the estimate of value at the valuation date, the analyst would be well advised to attempt to reconcile the two values. This reconciliation could include changes in market conditions, control versus minority status, or a variety of other factors.

Notional Market

As previously noted, judicial valuations make up only a small percentage of price determinations. In the market, every day, supply and demand dictate price in the thousands of transactions that take place, and these transactions largely influence the judicial valuations that follow.[87] Judicial valuations do not, however, take place in a vacuum, and the court generally uses wide discretion, regardless of the stated standard of value to achieve what it perceives as an equitable result.[88]

In the case of *Andrews v. Commissioner*,[89] the court acknowledged that in reality, there was a likelihood in the closely held corporation at hand that the stock would be sold to identifiable parties. However, cases like *Bright v. United States*[90] have clarified that while not completely independent of real-world factors, fair market value must be determined with respect to that which a hypothetical willing buyer and seller (who are assumed to exist) would pay for the property rather than that which an actual or specific buyer would pay.

As we have discussed, fair market value transactions do not necessarily take place on the open market. The "notional market" is a concept that is used mainly in Britain and Canada to distinguish a hypothetical market for the determination of fair market value from a real one where transactions are actually consummated. The requirements of fair market value may not always reflect what would happen in the open market, nor is it usually possible for a completely hypothetical sale to stand on its own without any real-world forces.

87. James C. Bonbright, "The Problem of Judicial Valuations" 27 *Columbia Law Review* (May 1927) at 497.

88. Id. at 503.

89. 79 T.C. 938; 1982 U.S. Tax Ct. LEXIS 12; 79 T.C. No. 58.

90. 658 F.2d 999; 1981 U.S. App. LEXIS 17205; 81-2 U.S. Tax Cas. (CCH) P13,436; 48 A.F.T.R.2d (RIA) 6159; 48 A.F.T.R.2d (RIA) 6292.

91. William B. Barker, "A Comparative Approach to Income Tax Law in the United Kingdom and the United States," 46 *Catholic University Law Review* (Fall 1996), at 40.

The notional market looks to identify a sale price without an actual sale.[91] This may occur in the context of an estate or gift tax filing, divorce, the appraisal remedy, commercial litigation, or a variety of other valuations that do not involve actual sales of property.[92] Although a British and Canadian concept, the notional market represents many of the underlying assumptions of fair market value in the United States.[93]

In an open market transaction, the buyers and sellers are identifiable and negotiations between them eventually will lead to an agreed-upon price. In a notional market, the buyer and the seller are not any one person or entity in particular, therefore the pool of potential buyers is larger. In the notional market, buyers and sellers are assumed to be at arm's length and willing, even though in reality they may not be.[94]

In addition, while on the open market the buyer and seller may pursue the information necessary to make an informed sale, on a notional market there is an assumption that both buyer and seller have reasonable knowledge of relevant information. In United Kingdom and Canadian fair market value cases, *full* knowledge is assumed. In the United States, only *reasonable* knowledge is required.[95] In the open market, due to earnouts, contingency payments, and similar deal structures, there are occasions when the final price is not known at the date of sale. In the notional market, these types of payments must be estimated at the valuation date.

Exhibit 2.3, prepared by Jay E. Fishman and Bonnie O'Rourke, compares the elements of a notional market with those of an open market.

The notional market assumes: an arm's-length transaction; economic rather than sentimental value; equally informed and uncompelled parties; equal financial strength and bargaining ability; a consistent market; and a free, open, and unrestricted market environment.[96] The real world does not always work in these terms, and that is often why often there are discrepancies between fair market value and open market price, due to a lack of information,

92. Campbell, *Canada Valuation Service*, at 4-20.

93. Fishman and O'Rourke "Value," at 321.

94. Campbell, *Canada Valuation Service*, at 4-20.

95. Id.

96. Fishman and O'Rourke, "Value."

97. TC Memo. No. 1962-153 at 919,21 TCM 845, aff'd 332 F2d 725 (3d Cir. 1963).

Exhibit 2.3 Notional versus Open Market Transactions

NOTIONAL MARKET	OPEN MARKET
Arm's length	Some transactions include non–arm's-length parties
Economic value	May include sentimental value
Equally informed	One party may not be as informed as the other
Equally uncompelled	One party may be more "compelled" to transact than the other
Consistent market	Marketplace could include booms and panics
Free, open, unrestricted	Restrictions a possibility
Equal financial strength	One party may be financially stronger
Equal bargaining ability	One party may be in a better bargaining position

Jay E. Fishman and Bonnie O'Rourke, "Value: More Than a Superficial Understanding is Required," Journal of the American Academy of Matrimonial Lawyers 15 (1998) at 322.

compulsion, or other factors. An example of this is the 1962 Tax Court decision, *Dees v. Commissioner*.[97]

Dees v. Commissioner

In this case, W.W. Dees acquired shares of an insurance company that he and two other colleagues had set up in the 1950s. They had also established an underwriting company, which owned the majority of the insurance company's common stock. To raise money to fund this venture; however, the holding company sold its shares to the public The tax commissioner determined that Dees's tax payments on his personal income tax return for 1953 and 1954 were deficient; the primary valuation issue was determining the fair market value of certain shares.

The Tax Court decided that the difference between Dees's cost ($1.25 for 5,000 shares, $1.00 for 5,000 shares, and 3,800 shares free as a bonus) and the fair market value of the stock should be taxable as compensation. The court then intended to determine the fair market value of those shares at the applicable dates.

Upon the first sales to the public, the stock sold at $16.00 (or $20.00 per share in subscription contract sales payable over three years), with $12.80 per share remittance to the insurance company. The tax commissioner looked to collect a deficiency on the taxable portion of the shares purchased at a price far less than the public sales price. According to the commissioner, for two separate blocks of shares purchased on different dates, Dees should pay tax on the difference between the purchase price he paid and the value the stock at which it was sold to the public.

> The insurance company had been using salespeople to aggressively market their stock. A salesperson might solicit potential buyers up to 15 times to purchase shares of the corporation. Nearly all the shares owned by individuals outside the company were owned in 25-, 50-, or 100-share blocks.
>
> In determining the fair market value of the shares, the court decided that although the public was paying $16.00 and $20.00 per share around the valuation dates, the shares should be valued at $5.00 and $5.50 respectively.
>
> At the time of the original purchase, during the formative stage of the company, the book value of the shares was approximately $3.00. At the subsequent purchase, the shares were worth little more.
>
> Individuals purchasing the stock from the salespeople were not provided with relevant financial information about the company, and therefore the court viewed the purchasers as uninformed, with the price paid being representative of their ignorance and gullibility as well as the company's aggressive (but not illegal) sales techniques rather than reasonable knowledge of the relevant facts about the corporation's operation.

This case not only relates directly to the known and knowable information required in establishing fair market value, but it also shows the difference between open market prices and the assumptions necessary to arrive at fair market value. As was discussed in Chapter 1, there are times when the intrinsic value of a stock is different from its trading price. This is the essence of security analysis in the public market. However, in this case it is apparent that the higher price paid by the public was the result of sales tactics and not a difference due to the intrinsic value of the stock.

While attempting to adhere to the strict guidelines of the willing seller and the willing buyer construct, it may be impossible to ignore the circumstances of real individuals acting out of varying motivations. As one commentator noted:

> Though black-letter law may hold that the willing buyer and seller are hypothetical parties, rather than real ones, the circumstances of actual buyers, sellers, and owners are often important in the determining fair market value. Case law on assemblage values, corporate liquidation arguments, charitable donee conduct, and other valuation issues reveal that real parties' individual needs and desires sometimes play a significant role in the valuation analysis.[98]

Ideally, the desired market for a determination of fair market value may be akin to the notional market as discussed earlier, but real-world issues are likely to affect any valuation. The notional concept does not preclude the prac-

98. Bogdanski, *Federal Tax Valuation*, at 2.01[2][c] 2-45.

titioner from investigating all available market information but may place constraints on its use—for example, in transactions involving those synergies not available to all buyers.

The incorporation of actual market data into a valuation can be a good indicator of how a company will fair on the market, whether in the open market or in determining fair market value. This can be seen in the Tax Court's willingness to place weight on the guideline public company method despite seemingly broad criteria for what constitutes meaningful comparison.

Earlier we discussed *Estate of Joyce Hall v. Commissioner*[99] in terms of restrictive agreements, but the court also comments on the use of guideline public companies. The decedent owned shares in Hallmark, the greeting card company. American Greetings was acknowledged as the other leading firm in the greeting cards industry, and the only publicly traded greeting card company that compared to Hallmark. The commissioner's expert based his valuation of the decedent's shares on a comparison with American Greetings. He claimed that American Greetings was the only public company with a similar capital structure and product mix. Alternatively, the taxpayer's expert, not wanting to rely on one guideline public company as the sole basis for comparison, chose a variety of publicly traded companies, such as AT Cross, Coca-Cola, and Lenox, Inc., which he considered comparable to Hallmark based on certain similarities but not in the same industry. The expert believed that these public companies had business and financial characteristics similar to Hallmark, in that they were leaders in their industries producing brand name consumer goods. The court ultimately applied the taxpayer's expert's logic, finding one company too narrow a comparison for the determination of fair market value under the notion that "the good fortune of one company in an industry may be at the expense of its direct competitors."[100] In this case, the court allowed broad criteria in choosing guideline public companies for comparison purposes with Hallmark.

However, such broad criteria (shared economic influences) are not always accepted. In some circumstances, the court may consider the subject company unique. For example, in the case of *Righter v. U.S.*,[101] which involved the valuation of a game company, the court decided that diversified publicly traded

99. 92 T.C. 312; 1989 U.S. Tax Ct. LEXIS 24; 92 T.C. No. 19

100. 92 T.C. 312; 1989 U.S. Tax Ct. LEXIS 24; 92 T.C. No. 19 at 340

101. 439 F.2d 1244 (1971).

toy and game companies were not sufficiently useful as guideline companies when compared to a company producing only two types of games appealing to specific age groups.

This is contrasted with the court's decision in the *Estate of Joyce Hall v. Commissioner*. Similarly, in the *Estate of Gallo v. Commissioner*,[102] in valuing a wine company, the court accepted the estate's expert's use of guideline public companies representing a variety of brewing, distilling, and food processing companies subject to similar market forces.

Righter is an older case that demonstrates a restrictive view of what constitutes a guideline public company. As has been seen in more recent cases, the court has used the broader concept of *shared economic influences* as a criterion of what constitutes a usable guideline public company.

Finally, after selecting the appropriate comparable companies, care must also be used in determining the comparable level of value, i.e. marketable shares should not be compared directly with nonmarketable shares and minority shares cannot be directly compared with majority or control shares without proper adjustments.

Common Discounts

Discounts for Lack of Control

All else being equal, shares with decision-making power in a corporation are usually considered more valuable than shares that lack these prerogatives. However, majority ownership is not necessarily a guarantee of increased value. The statutes of each state have some influence over the degree of control a particular block of stock possesses. Some states require supermajority votes to authorize actions such as mergers, sales, or liquidations. The articles of incorporation or bylaws of a company may require similar supermajority approval. Any ownership position of a corporation that is less than 100% comes with disadvantages. The business decisions made by a shareholder without 100% ownership may be the subject of contention with minority shareholders through dissent or oppression statutes. In a state with supermajority requirements, control shares are often worth more if the block of shares are at or exceed the supermajority threshold. Conversely, if ownership of a minority share prevents the controlling shareholder from achieving the supermajority threshold, it may

102. T.C. Memo 1985-363.

not be discounted as heavily as a smaller block of shares as it has the ability to block a corporate action.

There are inherent risks in making an investment that does not come with control. These include the chance that:

- Poor decisions by the majority could lead to losses for the company.
- A change in direction will take place that the minority shareholder does not support.
- The majority shareholders could victimize the minority shareholders in any number of ways, including cancellation of dividends, freeze-outs, squeeze-outs, or other actions that are unfair to the minority shareholders.

These risks will be discussed further in Chapter 3 of this book, but the bottom line is that, minority shares are typically worth less than controlling shares. However, it is worth noting that in some circumstances, the aggregate minority could exceed the value of the enterprise.

The first case we have found in which a minority discount was judicially recognized was the 1935 tax case *Cravens v. Welch.*[103] In this case, the taxpayer was looking to deduct the losses from the value of his minority interest shares in a close corporation from his income. The shareholder determined that the value of the stock at the applicable date was $2.25 per share, which was the pro-rata share of the enterprise value. The IRS, however, claimed that the value was $1.21 per share because a minority interest was being valued. The court held in favor of the IRS and the minority discount, in all likelihood to support the conclusion of the government witness.[104] While in this instance the minority discount was beneficial to the IRS, the concept of the minority discount has remained, and has since become a mechanism by which a shareholder can reduce the taxable value of his or her minority shares.

In the case of *Sol Koffler v. Commissioner*,[105] the court discussed the lack of control discount when comparing a minority shares of a private company to their publicly traded equivalent. The court stated:

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103. 10 F. Supp. 94 (D.C. Cal. 1935).

104. Edwin T. Hood, John J. Mylan, and Timothy P. O'Sullivan, "Valuation of Closely Held Business Interests," 65 *University of Missouri at Kansas City Law Review*, 399 (Spring 1997).

105. T.C. Memo 1978-159.

> Almost any available block of publicly-traded stock sold in day-to-day transactions, whether over the counter or on one of the exchanges, is a minority interest which could not determine dividend or other company policy. But the important consideration is that there is a day-to-day market for such stock, and in the absence of some unusual circumstance a purchaser can convert his investment to cash at any time. He would have no such assurance with respect to the minority block of ALW stock.

Another court described the adjustment as reflecting "the minority shareholder's inability to compel liquidation and thereby realize a pro rata share of the corporation's net asset value."[106] That distinction leads to the necessity of discounting minority shares for their lack of control and similarly, if more cash flow can be extracted from the company, adding a premium to control shares when compared with the shares of guideline public companies.

Discounts for Lack of Marketability

The fair market value of a private business or business interest may suffer due to a lack of marketability. While a minority discount adjusts for lack of control over an entity, a marketability discount compensates for the inability to convert the interest immediately into cash.[107]

The *International Glossary of Business Valuation Terms* defines marketability as "the ability to quickly convert property to cash at minimal cost."[108] The owner of a publicly traded security may execute a trade and liquidate the asset within three business days. The sale of minority shares in a privately held company may take time and expense in identifying likely and able buyers and negotiating a transaction. In this notional market, the inability to liquidate one's position immediately requires consideration of a discount for lack of marketability.

However, the issue of applying a discount for lack of marketability for a controlling interest is unsettled. Some Tax Court decisions reference such a discount, and others argue no such discount is required as enterprises are not typically sold through the public exchanges. The authors believe that discounts

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106. *Estate of Thomas A. Fleming, et al. v. Commissioner*, T.C. Memo 1997-484 (October 27, 1997).

107. Gara and Langstraat, "Property Valuation for Transfer Taxes," at 154.

108. David Laro and Shannon P. Pratt, *Business Valuation and Taxes* (Hoboken, NJ: John Wiley & Sons, 2005), at 284.

for lack of marketability for controlling interests are applicable in *some* circumstances. Those circumstances are fact sensitive.

After addressing the marketability of the company as a whole, applicable shareholder-level discounts may need to be applied. Because public minority stock can be sold relatively quickly and easily (many times on a public exchange, such as the New York Stock Exchange, where there are potentially thousands of buyers), minority shares of a private company suffer by comparison. The universe of buyers for private minority stock is typically much smaller. Restricted stock studies have revealed the significant differential in value between freely tradable shares and those that are restricted from trading on an open market for a certain time period.[109]

Investors prefer liquidity to illiquidity. A liquid asset may be sold quickly for a variety of reasons: lack of confidence in management, a belief that value will decrease, or the possibility of a need for cash. With an illiquid asset, it may be difficult or expensive to obtain cash, so investors may be forced to hold the asset even if value is declining or management policies are poor.[110]

As discussed earlier, the court in *Mandelbaum v. Commissioner*[111] addressed the applicability of the marketability discount on minority shares of private company stock gifted over the course of several years. In quantifying the discount, the court reviewed the factors shown previously in Exhibit 2.1 and adjusted benchmark percentages for lack of marketability based on the results.

Blockage Discounts

A blockage discount may be appropriate when a block of public stock is so large in relation to its total trading volume that it could not be offered for sale without depressing the market. Essentially, a discount is needed because the market would be flooded by the sale and supply would outweigh demand.[112] The discount may be calculated based on the estimated amount of time it would take to sell the entire quantity in smaller lots. This may be applicable to large blocks of public shares[113] or holdings other types of assets like an art

109. Id.

110. Laro and Pratt, *Business Valuation and Taxes*, at 285.

111. T.C. Memo 1995-255; 1995 Tax Ct. Memo LEXIS 256; 69 T.C.M. (CCH) 2852.

112. Gara and Langstraat, “Property Valuation for Transfer Taxes,” at 158

113. *Estate of Friedberg v. Commissioner*, 63 T.C.M. (CCH) 3080, 3081-82 (1992).

114. *Estate of O’Keeffe v. Commissioner*, 63 T.C.M. (CCH) at 2704.

collection, that if sold en masse, could have a depressing effect on the marketplace.[114] In the public marketplace there is a debate as to whether a specific block of stock should be discounted for blockage or, when appropriate, afforded a premium for control.

Estate of O'Keeffe v. Commissioner[115] was a case valuing artwork rather than stock, but for demonstration purposes, it clearly illustrates why a discount for blockage may be appropriate. The court looked at the individual market values of each piece of a large art collection and concluded that, if all the artwork entered the market at the same time, it would depress the marketplace. Therefore, the value of the collection as a whole was less than the aggregate total of each individual piece of art. The court divided the collection into two groups and allowed the application of a 25% discount for the more salable group and a 75% discount for the less salable group.

Key Person Discounts

While the hypothetical nature of buyers and sellers are generally relied upon in a determination of fair market value, in certain circumstances it is important to consider the actual position of a particular individual, sometimes the position that a decedent held within a company and the effect of his or her death.

Key person discounts reflect the reliance of a company on a particular individual. This could be for a variety of reasons, including thin management, a wealth of personal relationships that benefit a business, knowledge and experience in the marketplace, or any other factors that, absent key person life insurance, might make any individual very difficult to replace. It has been suggested that the magnitude of this discount may be quantified by identifying the cash flows with and without the continued presence of the key person. Several identifiable factors may influence the application of a key person discount, including:[116]

- Services rendered by the key person
- Extent of the corporation's dependence on that person
- If the key person is still active, the likelihood of his or her loss
- Depth and quality of other management personnel
- Availability of adequate replacement

115. Id.

116. Steven Bolten and Yan Wang "Key Person Discounts," *Business Valuation: Discounts and Premiums* (Hoboken, NJ: John Wiley & Sons, 2003), at 3.

- Key person's compensation and probable compensation for a replacement
- Value of irreplaceable factors and skills lost
- Risks associated with operation under new management personnel
- Lost debt capacity

There are also potential offsets to the loss of a key person. These are:

- Life or disability insurance proceeds payable to the company that are not specifically designated for other purposes, such as repurchase of a decedent's stock
- Amount of compensation saved if the replacement's probable compensation is lower than that of the key person
- Covenants not to compete
- Depth in middle management

The Tax Court case *Estate of Feldmar v. Commissioner*[117] addressed the implications of a key man on the value of a company's stock. A company selling nontraditional insurance products had been founded by the decedent and relied on his unique marketing skills. The court recognized that the value of the corporation would be less without that individual than it would be with the continued presence of that individual, and a reasonable investor would require a discount to make up for the loss of the key person in buying the company. The respondent claimed that the life insurance policy made up for the loss of the key person. The court, however, viewed the policy as a nonoperating asset. The respondent also claimed that management could be replaced by the salary that was now available due to the decedent's death, but the court found the current management of the company incapable of carrying on without the key individual. Ultimately, the court discounted the value of the corporation by 25% to account for the loss of the key person.

Other cases have addressed this issue as well, including the previously mentioned *Sol Koffler v. Commissioner*, in which the court applied a 15% thin management discount.

Trapped-in Capital Gains Discounts

In a case where a company holds assets that have appreciated substantially over time, there may be capital gain that will eventually trigger a capital gains

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117. *Estate of Feldmar v. Commissioner*, T.C. Memo 1988-429, 56 T.C.M. (CCH) 118 (1988).

tax upon sale. Recently the courts have allowed for discounts that adjust for the need to pay eventual taxes. The main argument against the trapped-in capital gains discount is that the asset is not necessarily going to be sold. However, the repeal of the General Utilities Doctrine (the general rule was that a corporation recognized no gain or loss on the distribution of appreciated property to its shareholders[118]) brought renewed attention to this issue. One of the more recent cases on the subject is *Eisenberg v. Commissioner*.[119]

Eisenberg v. Commissioner

The case of *Eisenberg v. Commissioner* illustrates the necessity of considering trapped-in capital gains. In gifting her shares of stock to her son and two grandchildren over the course of three years, the appellant reduced the value of the shares for gift tax purposes to account for the trapped-in capital gains tax she would have incurred had the corporation been liquidated or sold. She later received notice of a tax deficiency, solely on the grounds of the reduction of value to account for the trapped-in capital gains.

The Tax Court decided that precedent dictated that no discount for trapped-in capital gains was permitted when there was no evidence to suggest that liquidation or sale was likely to occur. Additionally, the court found that no hypothetical willing buyer would purchase the corporation with a view toward liquidation or sale, and, therefore, the trapped-in capital gains would be a nonissue.

On appeal, the appellant (Mrs. Eisenberg) argued that no willing buyer would purchase the stock without taking the trapped-in capital gains into account. The Second Circuit Court of Appeals found the appellant's argument more compelling, stating: "The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying."[120]

Therefore, the court concluded that the valuation should take those potential taxes into account when determining value.

In its decision, the court also looked to a recent decision addressing similar issues, *Davis v. Commissioner*,[121] which examined whether the corporation's built-in capital gains tax should be accounted for in the valuation of stock.

118. Pillsbury Winthrop Shaw and Pittman, LLP "Tax Page" http://pmstax.com/acqbasic/genUtil.shtml

119. 155 F.3d 50 (2d Cir. 1998).

120. Id. at 25.

121. 1998 U.S. Tax Ct. LEXIS 35, Daily Tax Report (BNA) No. 126, at K-17 (T.C. June 30, 1998).

Both experts in that case recommended that the built-in capital gains tax be taken into account, regardless of whether liquidation or sale of the corporation or its assets was contemplated.

SUMMARY

This chapter has addressed the history and development of fair market value and its well-established definition. Fair market value is a legal construct related to tax, regulatory, and judicial issues, especially federal estate and gift taxes. Its use and associated assumptions grew as federal taxation became more widespread. We have analyzed court cases that have shaped the definition of fair market value and seen that largely, although certain overarching guidelines apply, the facts and circumstances of each case has often influenced the outcome of a fair market value assessment.

To better guide the application of fair market value, the IRS has established regulations and revenue rulings (the best-known of which is Revenue Ruling 59-60) with which valuations should comply. The Estate and Gift Tax Regulations establish the general requirements of fair market value, all of which are applied as hypothetical constructs:

- The price at which a property would change hands
- A willing buyer
- A willing seller
- Neither being under any compulsion
- Both having reasonable knowledge of the relevant facts
- Specific value as of a specific valuation date
- Applicability of subsequent events

Within these general hypothetical considerations, specific issues develop, including the nature of the buyer and seller and the marketplace created:

- Synergistic buyers
- Valuing individual classes of stock together or separately
- Applicability of restrictive agreements
- Subsequent events and postvaluation-date information
- Applicability of entity- and shareholder-level discounts

In determining fair market value, the courts consistently value the stock that is in the hands of the shareholder, whether for purposes of estate, gift, or income tax. The ultimate value represents a value in exchange and lack of control and lack of marketability discounts are commonly applied, as are control premiums (if appropriate and depending on the cash flow used). However, the courts have not been fully consistent across jurisdictions in their treatment of the issues discussed. Circumstances and practical considerations may make each case unique, and therefore each judge or jury decides on a specific fact pattern.

The fair market value standard forms the basis of understanding the fair value standard in dissent and oppression. Furthermore, the concepts applied in fair market value are used in many states for value in divorce. Therefore, Chapter 3, "Fair Value in Shareholder Dissent and Oppression" and Chapter 4, "Standards of Value in Divorce," build on the concepts discussed in this chapter.

3

Fair Value in Shareholder Dissent and Oppression

INTRODUCTION

In this chapter, we address theory and application of fair value in judicial matters regarding shareholders who dissent from a corporate action and those who avail themselves of the buy-out provision in dissolution statutes under situations of deadlock and oppression. The term *fair value* used here is not the same as that referred to in accounting literature. Fair value in the context of financial reporting is discussed in another chapter. In dissenter's rights and oppression cases, fair value is a legislatively and judicially mandated concept. Moreover, as dissenters' and oppressed shareholder's rights evolved in the courts, those who chose to use this term did so to distinguish the concept from fair market value.

Because dissent and oppression matters deal with corporate actions, they are governed by statutes on a state-by-state basis. Fair value in this context is a legal term used in the vast majority of dissenter's rights and oppressed shareholders statutes, but only broadly defined. Accordingly, the term has been left to judicial interpretation.

There can be as many interpretations of fair value as there are states. In fact, in some instances, there are differing interpretations within a state. Because the interpretation of this standard of value is left to the courts, it is helpful to consider the different contexts in which the term is used.

Our analysis includes the development of dissenting shareholders' rights (sometimes called appraisal rights). We also address the development of a minority shareholder's right to petition for dissolution of a company, specifically in situations where oppression has occurred, and receive the fair value of his or her shares through a buy-out or a judicially directed dissolution of the corporation. We then examine the evolution of the standard and definition of fair value. To understand fair value as a standard of value in the context of dissenter's rights and oppression cases, we examine how various courts address current valuation concepts and techniques, especially the application of shareholder level discounts for lack of control and lack of marketability and the application of control premiums.

A minority shareholder is any owner of shares who lacks a sufficient number of shares of a corporation to control its policies. Generally, in a fair market value context, minority shares are not worth as much as their pro rata share of the value of the enterprise. One primary factor in valuing a minority interest is the degree to which minority shares lack the prerogatives of control. The prerogatives of control can be valuable benefits accruing to a majority shareholder and not necessarily shared by a corresponding minority shareholder.[1] Controlling shareholders may also engage in activities that are harmful to the interests of the minority shareholders. They may:

- Terminate the minority shareholder as an employee, director, or officer of the corporation
- Change his or her salary
- Completely freeze out the minority shareholder
- Otherwise abuse the minoity shareholder

These particular actions may result in a dissenter's rights or shareholder oppression action.

Dissenter's rights proceedings generally involve a minority shareholder who disagrees with the direction the board of directors is taking the company. A disagreement will generally involve a merger, sale of assets, or other major

1. The prerogatives of control involve the benefits of ownership control, which are basically comprised of the abilities that controlling shareholders have to direct the company's business and management.

change to the nature of the investment, such that the shareholder is no longer involved in the company.

Oppression cases often include more egregious actions than do dissent cases. Oppressed shareholders are those who have been treated unfairly or prejudicially by the majority shareholders or the board of directors. Those cases often involve shareholder employees. Oppression cases can involve termination of dividends, compensation, or employment, or a siphoning of corporate assets for the benefit of the majority at the expense of the minority. In some states, shareholders may petition to dissolve the corporation in order to regain what was taken from them. The corporation may elect to buy their shares at fair value, or the courts may order the buy-out, if provided for by the individual state's statute.

Because of the relative lack of control and the lack of liquidity faced by many minority shareholders, in a valuation to determine fair market value, appraisers often apply discounts for lack of control and a lack of marketability to the pro rata share of the value of the enterprise. In proceedings that seek to determine fair value, however, the controversy over the past decades has been whether the application of one or both discounts is appropriate to oppressed or dissenting shareholders in a judicial proceeding.

Fair value is the standard of value used to determine the cash price dissenting and oppressed shareholders will receive in exchange for their shares of stock. Currently, this much-debated standard of value is widely understood to mean the proportionate value of the company as a whole. Today, this understanding is essentially correct in many jurisdictions, as the courts increasingly have interpreted fair value to be a pro rata share of the entity-level value rather than the value of the individual minority shares themselves. While the general trend in many states is not to allow or to limit the use of minority and marketability discounts by statute or case law, some states still allow the discounts either by precedent, a court's discretion, or special circumstances.

In 1950, the Delaware Supreme Court defined fair value in *Tri-Continental Corp. v. Battye*[2] as the value which had been taken from the shareholder. To the present, the debate continues as to the nature of what has been taken and whether the value should relate to subject interest of the shareholder or a percentage of the company as a whole.

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

Two influential legal associations, the American Bar Association (ABA)[3] and the American Law Institute (ALI),[4] have each created their own definitions of fair value. By considering relevant case law from past decades, these organizations have influenced legislative and judicial understanding of fair value by publishing definitions in the Model Business Corporation Act (MBCA, from the ABA) and the *Principles of Corporate Governance* (from the ALI). The individual states' statutes have largely drawn from these institutions to establish their definitions of fair value, whose meanings are later reinterpreted by the courts in subsequent decisions. The nature of this process has led the states to interpret fair value in light of decisions in other jurisdictions as well as changes in valuation theory. Determining the purpose for which the statutes were enacted helps us better understand how fair value should be applied in these cases. In doing so, we must address the development of the modern definitions of fair value and how they have been interpreted by the courts.

The fair value standard has been loosely defined in dissenter's rights statutes, which have been widely affected by the standards recommended by the MBCA.[5] However, the courts' decisions in dissent and oppression cases have had the most profound effect on defining fair value. The related case law, legal institutions, and statutes have all contributed to the development of the concept of fair value.

3. "The ABA provides law school accreditation, continuing legal education, information about the law, programs to assist lawyers and judges in their work, and initiatives to improve the legal system for the public." From the ABA's Web site at www.abanet.org. The MBCA is a model statute designed for use by state legislatures in revising and updating their corporation statutes, reflecting current views about business corporations. Robert W. Hamilton, "The Revised Model Business Corporation Act: Comment and Observation: Reflections of a Reporter," 63 *Texas Law Review*,1455 (May 1985) at 1456.

4. "The American Law Institute works to promote the clarification and simplification of the law and its better adaptation to social needs, to secure the better administration of justice, and to encourage and carry on scholarly and work." The institute drafts for consideration by its council and its membership and then publishes various restatements of the law, model codes, and other proposals for law reform. From the ALI's Web site at www.ALI.org. The basic purpose of the *Principles of Corporate Governance* was to "clarify the duties and obligations of corporate directors and officers and to provide guidelines for discharging those responsibilities in an efficient manner, with minimum risks of personal liability." American Law Institute, *Principles of Corporate Governance* (St. Paul, MN: American Law Institute Publishers, 1992), at President's Foreward, XXI.

5. Fair value generally is undefined in dissolution statutes.

FAIR VALUE

Early References to Fair Value

Although nearly ubiquitous in dissent and oppression statutes, fair value is never specifically defined. Over the course of the nineteenth century, fair value was used to reference a variety of commodities: an interest in a sailing vessel while a group was heading to California for the gold rush,[6] an interest in the ownership of slaves,[7] the value of rolling stock, and so on.[8]

Why is the concept so indefinite? The use of the term *fair value*, rather than *fair market value*, suggests that the willing buyer–willing seller test inherent in fair market value may not apply. Many cases explicitly recognize that fair value and fair market value do not mean the same thing.[9] The most important differentiating factor is that in dissent and oppression cases, one of the parties is not considered willing. Either the corporation is being forced to buy, or the shareholder is being forced to sell or compelled to remain. Also, unlike common applications of fair market value, the use of a less-well-defined term allows the court to interpret value based on circumstances of each individual case.

For instance, in *Tri-Continental Corp. v. Battye*,[10] the court established a concept of fair value that would be widely referenced in future cases in analysis of the subject. The court stated:

> The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder's proportionate interest in the corporate enterprise is meant the true or intrinsic value

6. *Lorenzo D. Davis & Others v. Daniel B. Allen*, 75 Mass. 322; 1857 Mass. LEXIS 336, 1857.
7. *Montgomery v. Rose*, Court of Virginia, Special Court of Appeals 1855 Va. LEXIS 65; 1 Patton & H. 5, January 1855.
8. *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.
9. *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 383, 734 A.2d 738, 748 (N.J. 1999) (hereafter *Lawson*). "Fair Value is not the same as, or short-hand for, 'Fair Market Value,' Fair Value carries with it the statutory purposes that shareholders be fairly compensated, which may or may not equate with the market's judgment about the stock's value. This is particularly appropriate in the close corporation setting where there is no ready market for the shares and consequently no Fair Market Value"
10. 74 A.2d 71, 72 (Del. 1950).

> of his stock which has been taken by the merger. In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into fixing the value.

Fair Value as Defined by Various Authorities and Statutes

In order to address this standard of value for the purposes of minority shareholder cases, let us address definitions offered by the American Bar Association's Model Business Corporation Act. Statutes vary, but most draw inspiration from the MBCA or the later published Revised Model Business Corporation Act (RMBCA).

The 1969 Model Business Corporation Act, the first in which the ABA explicitly defined fair value, contains the following definition:

> such corporation shall pay to such shareholder, upon surrender of the certificate or certificates representing such shares, the fair value thereof as of the day prior to the date on which the vote was taken approving the proposed corporate action, excluding any appreciation or depreciation in anticipation of such corporate action.

In 1984, the ABA issued the Revised Model Business Corporation Act, which added the phrase: "unless exclusion would be inequitable." Accordingly, many states use the definition established by the 1984 RMBCA. The definition of fair value in this treatise reads:

> The value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.

The 1984 definition provides a guideline, however nonspecific, by which fair value should be determined. The company should be valued on the day before the corporate action occurs, and without any of the effects of the action unless their exclusion would be unfair. The passage does not give instructions on what method or valuation technique should be utilized to determine the fair value, nor does it define "inequitable." Twenty-one states[11] currently use this

11. Alabama, Arizona, Arkansas, Colorado, Hawaii, Illinois, Indiana, Kentucky, Massachusetts, Michigan, Missouri, Montana, Nebraska, Nevada, New Hampshire, North Carolina, Oregon, South Carolina, Vermont, Washington, Wyoming.

exact definition of fair value. In our view, the intentional ambiguity in this definition allows for wide interpretation of the assumptions that underlie this standard of value. Comments published by the ABA explain that this definition leaves the matter to the courts to determine "the details by which fair value is to be determined within the broad outlines of the definition."[12]

While insuring that the courts have wide discretion, the ambiguity can create confusion on the part of appraisers and appraisal users. Valuation professionals are well advised to discuss this with their attorney so as to come to an understanding of the specific interpretation relevant to the jurisdiction.

Although state statutes more often use the RMBCA's definition of fair value, six states have utilized the American Law Institute's concept of fair value in case law.[13] In the *Principles of Corporate Governance*, published in 1992, the ALI defined fair value as:

> . . . the value of the eligible holder's proportionate interest in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability. Fair value should be determined using the customary valuation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rise to appraisal.[14]

In 1999, following the development of substantial case law on dissent and oppression, as well as the publication of the *Principles of Corporate Governance*, the RMBCA was revised so that the definition of fair value reads:

> The value of the shares immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation pursuant to section 13.02(a)(5).

Although still not outlining a specific method of calculating value, the 1999 RMBCA definition mirrors the ALI's *Principles of Corporate Governance*, in

12. American Bar Association, A Report of the Committee of Corporate Laws, "Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Close Corporations," *The Business Lawyer* 54 No. 209 (November 1998).
13. Colorado, Minnesota, New Jersey, Arizona, Connecticut, Utah.
14. American Law Institute, *Principles of Corporate Governance* (St. Paul, MN: American Law Institute Publishers, 1992), at § 7.22.

that it adds two important concepts to the framework: the use of customary and current valuation techniques, and the rejection of the use of marketability and minority discounts except, "*if appropriate, for amendments to the certificate of incorporation pursuant to section 13.02(a)(5)*." The dissenters' rights statutes of nine states[15] currently follow this definition.[16]

Other states have developed their own definitions of fair value or have used different standards of value in their statutes. For example, New Jersey has used fair value as its statutory standard since 1968.[17] In the dissolution statute, the explanation of fair value makes allowances for "equitable adjustments" in conjunction with oppression proceedings.

Ohio and Louisiana use fair cash value in their statutes. Ohio uses the willing buyer/willing seller definition in its statute along with the term *fair cash value*. Decisions in Ohio involving closely held businesses have largely utilized significant discounts in valuing minority shares. Additionally, when the stock of a company is publicly traded, the Ohio court usually relies on that value as opposed to a hypothetical sale price for the entire corporation as indicated in *Armstrong v. Marathon Oil*.[18]

California uses a fair market value in dissent and the term *fair value in liquidation* in oppression. Its dissolution (oppression) statute states:

> The *fair value* shall be determined on the basis of the liquidation value as of the valuation date but taking into account the possibility, if any, of sale of the entire business *as a going concern in a liquidation*. [emphasis added]

California's dissent statute states:

> The *fair market value* shall be determined as of the day before the first announcement of the terms of the proposed reorganization or short-form

15. Connecticut, Florida, Idaho, Iowa, Maine, Mississippi, South Dakota, Virginia, West Virginia.
16. According to the American Bar Association, Committee on Corporate Laws, "Revised Model Business Corporation Act" (1999), Section 13.02(a)(5) of the RMBCA states that "any other amendment to the articles of incorporation, merger, share exchange or disposition of assets *to the extent provided by the articles of incorporation, bylaws or a resolution of the board of directors*." [emphasis added] The official comment to the 1999 RMBCA states that if the corporation grants appraisal rights voluntarily for certain transactions that do not affect the entire corporation, the court can use its discretion in applying discounts.
17. *Balsamides v. Protameen Chemicals, Inc.*, 160 N.J. 352, 734 A.2d 721, 736 (N.J. 1999).
18. 513 NE2d 776 Ohio 1987.

merger, excluding any appreciation or depreciation in consequence of the proposed action, but adjusted for any stock split, reverse stock split, or share dividend which becomes effective thereafter.

The term *fair value in liquidation* as used in California's oppression statute is unique. Most states look to determine fair value in these circumstances under the assumption that the business will continue to operate as a going concern.

DISSENTERS' RIGHTS

Overview and History

In the early nineteenth century, common law[19] held that corporate decisions were to be made by consensus, meaning 100% shareholder approval was required. The prevailing perspective on business was that the investment made by the minority shareholder contractually connected the corporation to the shareholder, and the shareholder should not be required to comply with fundamental changes that he did not support. Therefore, any single shareholder could utilize his common law veto in order to prevent corporate action.[20]

This perspective could have a paralyzing effect on the decision-making process in a corporation. A minority shareholder could impulsively or arbitrarily threaten to reject a corporate action solely to collect a premium on an initial investment.[21] With the increasing need for flexibility caused by the industrial revolution, the country's growing infrastructure, and the birth and growth of the transcontinental railroads, corporations came to realize that consensus was not efficient for forward movement and growth.[22]

In 1892, the Illinois Supreme Court affirmed majority rule and the role of the minority shareholder in its decision in *Wheeler v. Pullman Iron & Steel*

19. Common law is a system of laws that had originated and developed in England based on court decisions and the doctrines implicit in those decisions, and on customs and uses rather than written law. http://www.answers.com/topic/common-law

20. Michael Aiken, "A Minority Shareholder's Rights in Dissension—How Does Delaware Do It and What Can Louisiana Learn?" 50 *Loyola Law Review*, 231 (Spring 2004), at 235.

21. John D. Emory, "The Role of Discounts in Determining Fair Value Under Wisconsin's Dissenter's Rights Statutes: The Case for Discounts," 1155 *Wisconsin Law Review* (University of Wisconsin) (1995), at 1163.

22. Mary Siegel, "Back to the Future: Appraisal Rights in the Twenty-First Century," 32 *Harvard Journal of Legislation*, 79 (Winter 1995), at 87.

Co.[23] The court decided that the fundamental law of corporations should be that the majority should control policy. It revised the concept of the minority shareholder's investment, such that by investing in the corporation, the minority shareholder agrees to abide by the decisions sanctioned by the majority or the board of directors elected by the majority.[24]

Following the decision in *Wheeler*, the courts, recognizing the paralyzing effect of unanimity, became more sympathetic towards majority rule. Initially majority rule was in place only in cases of insolvency, but later it was considered controlling in mergers, asset sales, and so on, as long as the majority's decision was in the best interest of the corporation.[25] As a result, minority shareholders were left without the power to challenge such corporate decisions or the ability to exit the corporation if they disagreed with the actions of the majority. This in turn, led to the emergence of appraisal rights.

An 1875 Ohio case was early evidence of the emergence of fair value appraisal rights. In its decision, the Ohio Supreme Court stated:

> . . . our legislature has seen proper to provide that stockholders in a railroad corporation shall not be carried into a new or consolidated company against their consent. From this provision it is plain that a stockholder not only can not be compelled to become a member of the consolidated corporation, but the consolidation can not proceed until he is paid the *fair value* of his stock. It is impossible to force upon him the liabilities and responsibilities attaching to the new corporation; it is impossible to change the character of the enterprise in which he agreed to embark his money, until he has been paid the fair value of his investment.[26]

Before the appearance of appraisal statutes, shareholders would sue for injunctive relief and to receive the value of their shares in cash. They would petition the courts to stop the corporation from pursuing a course of action

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23. *Wheeler v. Pullman Iron & Steel Co.*, 143 Ill. 197, 207–08, 32 N.E. 420, 423 (1892): "Every one purchasing or subscribing for stock in a corporation impliedly agrees that he will be bound by the acts and proceedings done or sanctioned by a majority of the shareholders, or by the agents of the corporation [directors] duly chosen by such majority, within the scope of the powers conferred by the charter."
24. Charles W. Murdock, "The Evolution of Effective Remedies for Minority Shareholders and Its Impact upon Valuation of Minority Shares," 65 *Notre Dame Law Review*, No. 425 (1990), at 429.
25. Siegel, "Back to the Future."
26. *The Mansfield, Coldwater and Lake Michigan Railroad Company v. Joseph A. Stout*, 26 Ohio St. 241; 1875 Ohio LEXIS 397.

until their desire to exit was satisfied. The courts would award a fair value in cash to shareholders, enabling them to escape the choice of either forced membership in a new corporation or pro rata share in cash of the transaction's proceeds.[27] In order to protect the interest of minority shareholders, legislatures began to enact statutes with appraisal rights to allow the minority to dissent from a corporate transaction and receive a judicial determination of the fair value of their shares in the original corporation in cash.[28] The statutes also were enacted to prevent expensive and drawn-out injunction procedures and to allow corporations, during the dispute, to continue conducting business as usual.[29]

The U.S. Supreme Court clarified the purpose of dissenter's rights statutes in the 1941 case *Voeller v. Neilston Warehouse Co*.[30] In this case, Justice Black noted a Securities and Exchange Commission report describing the history and necessity of establishing majority rule and a remedy for minority shareholders:

> At common law, unanimous shareholder consent was a prerequisite to fundamental changes in the corporation. This made it possible for an arbitrary minority to establish a nuisance value for its shares by refusing to cooperate. To address this situation, legislatures authorized corporations to make changes by a majority vote. This, however, opened the door to victimization of the minority. To solve the dilemma, statutes permitting a dissenting minority to recover the appraised value of its shares were widely adopted.[31]

In 1927, the Uniform Business Corporation Act was introduced by the Commissioners for Uniform State Laws,[32] but it was adopted only by Louisiana, Washington, and Kentucky, likely because most states were not comfortable with the implied inflexibility of uniform laws and wanted to reserve their own legislative rights.[33] The ABA's Model Business Corporation Act (MBCA) gained much wider appeal and went on to provide a framework

27. Siegel, "Back to the Future," at 89.
28. Wertheimer, "Shareholders' Appraisal Remedy," at 619.
29. Siegel, "Back to the Future," at 87.
30. 311 U.S. 531, 535, 61 S. Ct. 376, 377, 85 L. Ed. 322, 326.
31. SEC Report on the Work of Protective and Reorganization Committees, Part VII, pp. 557, 590 Washington DC: U.S. Government Print Office (1938).
32. The National Conference of Commissioners on Uniform state laws was formed in 1892 for the purpose of providing states with non-partisan, well-conceived, and well-drafted legislation that brings clarity and stability to critical areas of the law. http://www.nccusl.org/Update/
33. Aiken, "A Minority Shareholder's Rights in Dissension," at 237.

for state corporation statutes across the country.[34] Over the course of the first half of the twentieth century, nearly all states adopted an appraisal statute.[35]

Growth in Popularity of the Appraisal Remedy

As a result of the wide-spread adoption of appraisal statutes, a considerable body of case law emerged in the twentieth century, suggesting numerous methodologies to arrive at fair value. One such well known methodology is the so-called Delaware block method. Midway through the twentieth century, the so-called Delaware block method was often used for determining value in the context of appraisal rights,[36] and was relied on almost exclusively by the Delaware courts until 1983. This method was also adopted in several other states due to their tendencies to rely on Delaware cases related to fair value.

The Delaware block method weights *investment value* (based on earnings and dividends), *market value* (usually based on its public trading price, guideline public company information, or guideline transaction information), and *asset value* (usually the net asset value based on current value of the underlying assets). These individual values are then assigned a selected weight to compute the fair value.[37] Many viewed the Delaware block method as somewhat mechanistic and not reflective of the techniques regularly employed by those in the financial community.

In 1984, the case of *Weinberger v. UOP, Inc.*[38] ended the total reliance on the Delaware block method by allowing the use of a broader range of valuation

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34. Robert W. Hamilton, "The Revised Model Business Corporation Act: Comment and Observation: Reflections of a Reporter," 63 *Texas Law Review*,1455 (May 1985) at 1457.
35. Robert B. Thompson, "Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law," 84 *Georgetown Law Review*, 1 (November 1995), Appendix Table 2: New York 1890; Maine 1891; Kentucky 1893; New Jersey 1896; Delaware 1899; Connecticut and Pennsylvania 1901; Alabama, Massachusetts, Nevada, and Virginia 1903; Montana and New Mexico 1905; Ohio 1906; Tennessee 1907; Maryland 1908; Vermont 1915; Illinois and New Hampshire 1919; Rhode Island 1920; Arkansas, Florida, North Carolina, and South Carolina 1925; Minnesota and Oregon 1927; Louisiana 1928; Idaho and Indiana 1929; California, District of Columbia, and Michigan 1931; Washington 1933; Hawaii 1937; Georgia 1938; Arizona and Kansas 1939; Colorado and Nebraska 1941; Missouri 1943; Iowa, Oklahoma, Wisconsin, and Wyoming 1947; Mississippi 1954; South Dakota and Texas 1955; Alaska and North Dakota 1957; Utah 1961; West Virginia 1974.
36. *In re General Realty & Utilities Corp.*, Del. Ch., 29 Del.Ch. 480, 52 A.2d 6, 11 (1947).
37. Jay E. Fishman, Shannon P. Pratt, and J. Clifford Griffith, "PPC's Guide to Business Valuation," Thompson PPC 2004, at 1502.21–23.
38. 457 A.2d 701, 713 (Del. 1983).

techniques. We discuss this case later in the chapter when we look at current and customary valuation techniques as part of the definition of fair value. The Delaware block was viewed as a rigid method and the ability to utilize techniques commonly used by the financial community led many minority shareholders to avail themselves of the appraisal remedy. As evidence, between 1972 and 1981, there were 19 reported appraisal decisions in the United States; between 1984 and 1994, there were 103 appraisal decisions involving 84 transactions. In addition, the MBCA changed its procedural requirements in 1978, providing that dissenting shareholders should be given notice of events that they could dissent from, and instituted guidelines on how to dissent.[39] Even with the easing of procedural requirements, there are strict guidelines that dissenters must follow to perfect their rights.

Context of Modern Appraisal Rights

Currently, the ABA and the ALI recognize various events that can trigger dissenter's rights. Each state has adopted different triggering events in its statutes, and these may have developed differently from those of the RMBCA and *Principles of Corporate Governance* because of the nature of the events that occurred in each state. Some common triggers are contained in the RMBCA, and include:

- Merger
- Share exchange
- Disposition of assets
- Amendment to the articles of incorporation that creates fractional shares
- Any other amendment to the articles from which shareholders may dissent
- Domestication from a foreign entity into a domestic entity
- Conversion of status to nonprofit
- Conversion to unincorporated entity

In most states, the process to dissent is as follows: a company's board of directors is required to give notice of an event from which dissenters may claim their rights. Before the vote, the dissenters give their notice to the board and demand payment of their shares. In doing so, the shareholders relinquish all rights, except to obtain payment of the fair value of their shares. The process

39. Siegel, "Back to the Future," 79 at n79.

and timetable of these events vary from state to state, but in most cases are strictly enforced. The process is referred to in most states as "perfecting dissenter's rights."

Certain states have statutory provisions whereby nonvoting stock is not eligible for appraisal rights. Twenty-five states follow the RMBCA and do not allow nonvoting stock to dissent. Three states explicitly allow nonvoting stock to dissent—Massachusetts, Kansas, and Utah. Delaware limits triggering events, but allows both voting and nonvoting stockholders to dissent.[40]

OPPRESSION REMEDY

Development of Oppression Remedy

The oppression remedy emerged for similar reasons as did dissenter's rights. As the courts moved to majority rule, which based decisions on the best interests of the corporation rather than the shareholders, minority shareholders could be harmed or excluded without the intervention of the courts. Shareholders would have to bring suit for an injunction or to dissolve the corporation in order to recover their interest.

As with dissent, certain events trigger the right to call for judicial dissolution of a corporation.[41] Generally they fall under the categories of mismanagement, waste, fraud, or illegal acts by management and the board of directors. However, majority behavior does not necessarily have to be illegal or fraudulent to be unfair to a minority shareholder. Illinois was the first state to codify oppression as a trigger for dissolution in the 1933 Illinois Business Corporation Act. The ABA later modeled the MBCA's dissolution statute after Illinois's example.[42] The 1953 MBCA stated that a shareholder could call for dissolution

40. Id. at n10, n241–242.

41. The case law and concepts we address in this chapter deal exclusively with oppression in corporations and focus mainly on close corporations. Partnerships are not subject to the same remedies because of the withdrawal rights available by statute in most states. For LLCs, case law is in its infancy because of the relative newness of the corporate form. For more information on the remedies to minority mistreatment in all three corporate forms, see Moll, Douglas. "Minority Oppression and the Limited Liability Company: Learning (or not) from Close Corporation History" University of Houston Public Law and Legal Theory Series 2006-A-01.

42. Murdock, "Evolution of Effective Remedies for Minority Shareholders," at 440.

if the acts of the directors or those in control of management are illegal, oppressive, or fraudulent.[43]

Currently several states have oppression as grounds for dissolution; others do not. Exhibit 3.1 outlines how the 50 states and the District of Columbia handle oppression as grounds for dissolution in their statutes.

Shareholder oppression occurs when the majority shareholders or the board of directors act in a manner that is detrimental to minority shareholders. Although oppression was once thought to encompass only illegal or fraudulent acts, the term has come to include conduct by the majority that breaches fiduciary duty, denies the minority shareholder his or her reasonable expectations in acquiring shares and entering into a shareholder agreement, or is burdensome, harsh, and wrongful to minority shareholder interests. Oppressive acts by the majority can be very damaging to a minority shareholder; for example, a majority decision may eliminate a minority shareholder's ability to receive dividends or other types of benefits from a corporation.

The shareholder oppression statutes are part of corporate dissolution statutes, which are the laws in place to provide guidelines for dissolving corporations. Many, if not most, states allow shareholder oppression as a triggering event for dissolution or a buy-out of the claimant's shares.[44] Dissolution statutes vary much more widely than dissenter's rights statutes.

Events triggering dissenter's rights are fairly universal and deal with a decision by the majority to which a dissenting shareholder objects (merger, share exchange, amendment to the articles of incorporation, etc). Dissolution statutes exist to provide procedures by which businesses may wrap up their business affairs and end their existence. Although most states use a combination of similar triggering events, the statutes are generally unique to each state.

The RMBCA provides three categories by which a corporation may dissolve: voluntary dissolution, administrative dissolution, and judicial dissolution. In voluntary dissolution, shareholders or the board of directors may vote and decide to dissolve a corporation. In administrative dissolution, the secretary of state may intervene to dissolve a corporation without the approval of the board members or majority of shareholders if they fail to pay

43. Duke Law Review, "Oppression as a Statutory Ground for Corporate Dissolution," 128 *Duke Law Journal* (1965), at n2.

44. The only exception is Michigan, where an action citing oppression can be brought by the shareholder outside the dissolution statute, although dissolution (among others) may still be the remedy.

Exhibit 3.1 Oppression as Grounds for Dissolution

STATES	OPPRESSION AS GROUNDS FOR DISSOLUTION?
Alabama, Arizona, Arkansas, Colorado, Connecticut, Hawaii, Idaho, Illinois, Iowa, Maine, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, New Mexico, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.	Yes
Alaska, California, Florida, Georgia, Kentucky, Minnesota, New Hampshire, North Carolina, North Dakota	Do not mention oppression specifically, but do allow for dissolution on the basis of majority behavior that is illegal, unfair, or fraudulent in some way
Delaware, District of Columbia, Indiana, Kansas, Louisiana, Massachusetts, Nevada, Ohio, Oklahoma, Texas	No

the appropriate taxes or deliver annual reports, or if their incorporation expires. In judicial dissolution, the court may dissolve a corporation if:

- The attorney general establishes fraud or abuse of authority
- Shareholders establish deadlock, illegal, oppressive, or fraudulent behavior, or waste of assets
- Creditors establish outstanding claims
- The corporation requests court supervision in its voluntary dissolution

Fair value comes into play only when a *shareholder* files for dissolution, rather than a creditor or the attorney general. If the company is dissolved administratively for fraud or abuse of authority, unless any fines are incurred, the shareholders will get a pro rata portion of the company's assets in dissolution. When creditors are the catalyst for dissolution, the shareholders will get a pro rata share after the creditor is paid. However, when a shareholder files for dissolution, there is the possibility that either the corporation will elect to buy out the minority's shares at fair value or the court may direct that buy-out.

The RMBCA sanctions a buy-out of stock in lieu of dissolution as an alternative remedy under the dissolution statutes when a shareholder files for judicial dissolution. The buy-out option largely developed in the late 1970s to compensate minority shareholders for oppressive acts taken against them.

Most states allow for the minority shareholder to file for judicial dissolution; some do not, and leave the action to other channels.[45] Delaware, for instance, does not cite shareholder oppression in the dissolution statute. Instead, it leaves the decision of wrongdoing to the consideration of fairness under an appraisal proceeding.

The dissolution statutes vary based on the events that trigger dissolution in each state. Almost all states had adopted a statute for involuntary dissolution by 1965, and 12 states had oppression as grounds for dissolution.[46] Twenty-four states have provided oppression as a basis for dissolution since then.[47] Others do not specifically allow minority shareholders to file for dissolution citing oppression, but do provide shareholders the ability to dissolve the company citing acts that basically constitute oppression.[48] Many of the states that allow shareholder dissolution also have a buy-out provision written into their statutes. In other states, although no statutory buy-out option exists, case law recognizes the use of a buy-out at fair value as an equitable remedy. Several states also have a minimum-percentage share ownership requirement to file a judicial dissolution action.[49]

45. Delaware and Indiana allow shareholder dissolution only in the case of deadlock. Kansas and Louisiana allow shareholder dissolution in the case of deadlock, but only if irreparable damage is being done to the corporation or shareholders. Massachusetts requires that no less than 40% outstanding shareholders can file for dissolution, but only in cases of shareholder or management deadlock. Michigan allows shareholders to file if they cannot agree on management and corporation is not able to function properly. Nevada and Ohio allow shareholder dissolution only if petitioned by a majority. Oklahoma, Texas, and the District of Columbia do not allow shareholders to petition for dissolution.

46. Alabama 1961; Alaska 1962; Illinois 1953; Iowa 1962; Missouri 1952; North Dakota 1960; Oregon 1961; Pennsylvania 1958; Texas 1956; Utah 1963; Virginia 1956; Wyoming 1963. From 128 Duke Law Review, "Oppression as a Statutory Ground for Corporate Dissolution," at 134.

47. Arizona, Arkansas, Colorado, Connecticut, Hawaii, Idaho, Maine, Maryland, Michigan, Mississippi, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, Rhode Island, South Carolina, South Dakota, Tennessee, Vermont, Washington, West Virginia, Wisconsin.

48. California, Alaska, Florida, Georgia, Kentucky, Minnesota, North Carolina, North Dakota.

49. This information can be found in each state's statutes. As of the publication of this book, Alaska and California require 33 1/3% share ownership to file a dissolution action. New York and Georgia require a 20% share ownership.

Alternative Remedies

As long as dissolution was the primary remedy for oppressed minority shareholders, the courts were hesitant to find in favor of the minority shareholder.[50] Oppressive conduct had to be egregious—a waste of assets, or gross fraud or illegality. Dissolution was viewed as drastic.

An example of a court's failure to dissolve a corporation in a clearly oppressive situation is the case of *Kruger v. Gerth*,[51] a 1965 New York decision. In that case, a corporation was formed by investors to benefit shareholders by way of employment and salary. When one partner died, his wife maintained her husband's share of the corporation but was no longer permitted to benefit from the salary. The corporation refused to buy her out, and the court refused to dissolve the corporation.

Dissolution remained the statutory remedy until the states began to institute buy-out provisions for the shares of oppressed shareholders.[52] In 1941, California was the first to institute a buy-out provision; its statute[53] provided an option for a corporation to offer petitioning minority shareholders the fair cash value for their shares in lieu of dissolution.[54]

In the 1970s, the courts that had adopted oppression as a trigger for dissolution began to explore alternative remedies to dissolution. Several judicial remedies for the oppressed shareholder emerged. The court could decide to:

- Require the company to liquidate and the proceeds be equitably distributed
- Find no oppression and keep status quo
- Order a purchase of the shares and let the company continue

A 1991 revision to the RMBCA introduced the statutory buy-out for shareholders filing for dissolution. The fair value buy-out as an alternative remedy was already in use in some states. It emerged in the late 1970s in cases like New York's *Topper v. Park Sheraton Pharmacy*, a case that is discussed further in the context of oppression remedy. Exhibit 3.2 provides a list of the

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50. 128 Duke Law Review, "Oppression as a Statutory Ground for Corporate Dissolution," at n2.
51. 16 N.Y.2d at 804, 210 N.E.2d at 356, 263 N.Y.S.2d at 2.
52. Murdock, "Evolution of Effective Remedies for Minority Shareholders," at 461.
53. 1941 Cal. Stat. 2058-59 (codified as amended at CAL. CORP. CODE § 2000 (West 1977 & Supp. 1989).
54. Murdock, "Evolution of Effective Remedies for Minority Shareholders."

Exhibit 3.2 Availability of the Statutory Buy-Out Remedy in Judicial Dissolution by State

STATES	ELECTION TO BUY-OUT
Alabama, Alaska, Arizona, California, Connecticut, Florida, Hawaii, Idaho, Illinois, Iowa, Maine, Michigan,[a] Minnesota, Mississippi, Nebraska, New Hampshire, New Jersey, New York, North Carolina,[b] Rhode Island, South Dakota, Virginia, West Virginia, Wyoming	Yes
Georgia, Maryland, Missouri, Oregon, South Carolina, Utah, Vermont, Wisconsin	Yes, but in close corporation provision only
Arkansas, Colorado, Kentucky, Montana, Nevada, New Mexico, North Dakota, Pennsylvania, Tennessee, Washington,	No
Delaware, District of Columbia, Indiana, Kansas, Louisiana, Massachusetts, Ohio, Oklahoma, Texas	No oppression as grounds for dissolution statute

[a]As Michigan has oppression independent of the dissolution statute, the court may order dissolution, purchase at fair value, or other remedy provided for in the statutes.

[b]North Carolina allows the company to avoid dissolution by a buy-out after the court decides that the situation merits dissolution.

states that have a statutory buy-out option, those that have it only in their close corporation statutes, and those that do not use the buy-out as a statutory remedy.

Context of Oppression Remedy

Although dissent and oppression cases are often grouped together, their nature is very different. Oppression is generally more personal. It often involves the loss of employment, exclusion from a close corporation that the stockholder may have helped build, or a family fallout that results in the breaking up of a corporation. Dissent is generally less personal. Dissenter's rights proceedings usually involve shareholders with small interests in a corporation. They may not even include individuals who regularly participate in the business.

There are also similarities between dissent and oppression cases. The primary similarity is that they both use the fair value standard. Many courts understand the fair value definitions as expressed by the dissenter's rights statutes to carry over to the dissolution statutes. The ALI asserts that fair value can be viewed differently for oppression and dissent, but many courts view it otherwise. For example, in New Jersey's oppression case *Balsamides v. Protameen Chemicals*,[55] the Supreme Court of New Jersey agreed with Washington's

55. *Balsamides v. Protameen Chemicals, Inc.*, 160 N.J. 352, 734 A.2d 721, 736 (N.J. 1999).

Supreme Court in *Robblee v. Robblee*[56] that there is no reason to believe that fair value means something different in reference to dissenting shareholders than it does in the context of oppressed shareholders. In addition, many oppression and dissent cases cite each other for guidelines on how to deal with various elements of valuation.

Both oppression and dissent were developed to protect minority shareholders from being excluded or abused by the majority. In states where the oppression remedy is unavailable, oppressed shareholders may claim dissenter's rights. Reverse stock splits are generally used to cash out minority shareholders by reducing the number of shares in a corporation such that, for example, certain members hold less than one share and are forced to sell it back to the corporation. The Northern District of Illinois Court decided in *Connector Service Corporation v. Jeffrey Briggs*[57] that the Delaware language governing reverse split cash-outs was similar to the language governing cash-out mergers and ordered the fair value of the stock to be determined using the same criteria as in a cash-out merger. This conclusion is consistent with the Delaware decision in *Metropolitan Life Insurance Co. v. Aramark Corp.*, which granted a quasi-appraisal remedy in a reverse split.[58]

Freeze-Outs and Squeeze-Outs

Freeze-outs often fall under the category of oppression. One characteristic of a close corporation is that often, its shareholders are also its employees. As a result, close corporations attract shareholders for a variety of reasons, but frequently, one will invest with the expectation of receiving a salary from employment and participation in the corporation. When an employee is frozen out of a corporation, it means that although he or she remains a shareholder, management eliminates the shareholder's job. Additionally, when applicable, the majority may elect to eliminate the payment of dividends. Although the ownership interest remains intact, the shareholder no longer receives the benefits he or she has received historically. In addition, there is no necessity for the company to buy out the shareholder, as it costs the company nothing to keep the shareholder locked in.[59] The case of *Topper v. Park Sheraton Pharmacy* (discussed in the next section) is an example of a freeze-out.

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56. 68 Wash. App. 69, 841 P.2d 1289, 1294 (Wash. Ct. App. 1992).

57. No. 97 C 7088 U.S. Dist. Ct., 1998 Lexis 18864 (N.D. Ill. Oct. 30, 1998).

58. 1998 Lexis 70 (Del. Ch. 1998)

59. Murdock, "Evolution of Effective Remedies for Minority Shareholders," at 441.

Squeeze-out mergers, which are generally designed to exclude minority shareholders from the future profits of a corporation, can trigger dissenter's rights as well. At the exclusion of the minority, a new company will be formed by the controlling shareholders. The minority shareholders will be cashed out in the transaction, without the ability to participate in any future profits. The only options the minority shareholders have are to exchange their shares for the cash price offered or exercise their dissenter's rights.[60] *Offenbecher v. Baron Services*[61] from Alabama is an example of a situation where a corporation effected a merger to exclude one minority shareholder.

James Offenbecher v. Baron Services, Inc.

In 1990, Baron Services was incorporated for the purpose of selling weather-radar systems and related software. James Offenbecher had designed some of the software, and Baron gave him 130 shares of Baron Services stock. Baron Services made no profit for several years, selling only 10 radar systems. In 1997, however, it sold 23 systems and profits increased to $735,261.

In early 1998, the board of directors of Baron Services decided to merge Baron Services into a separate Delaware corporation. The board planned a cash-out provision providing for a cash payment to any shareholder owning fewer than 150 shares of Baron Services and denying any such shareholder any ownership stake in the corporation after the merger. Offenbecher demanded his fair value.

Offenbecher argued that the trial court erred in determining how many shares were outstanding, but the court determined that Offenbecher did not have substantial proof. Offenbecher also argued that the trial court erred in accepting a 50% marketability discount in the valuation of his shares. This was based on the testimony of Baron Services' valuation expert, who indicated that since the company was closely held and not publicly traded, he was reducing the value of the shares to $547.77 per share.

Offenbecher's valuation expert valued each share at $1,653.85. One substantial difference between the two experts was the use of the marketability discount.

The court found that after the board's decision, the postmerger corporation generated almost $5 million in profit in the first five months. In the first 18 months, Offenbecher would have received over $1 million in distributions as a shareholder. After reviewing various commentators and cases on the

60. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 2nd ed. (Homewood, IL: Dow Jones-Irwin, 1989), at 389.
61. 874 So. 2d 532; 2002 Ala. Civ. App. LEXIS 365.

nature of a squeeze-out and the use of discounts, the Alabama Court of Appeals concluded that the squeeze-out of Offenbecher was made economically possible by the application of the marketability discount.

The Court of Appeals stated that in recognizing the discount, the trial court failed to recognize the role of modern appraisal remedy, and made it possible for the exact sort of squeeze-out that the appraisal remedy was designed to prevent. The court remanded the case for recalculation of the stock's value without the application of a marketability discount.

Recognizing Oppression

As oppression became more widely recognized over the course of the twentieth century, the courts eventually had to find ways in which to identify whether oppression had actually occurred. Some viewed oppression as akin to fraudulent or illegal acts. The Illinois court's decision in *Central Standard Life Insurance v. Davis*[62] in 1957 applied the term *oppression* more broadly than fraudulent or illegal activity despite finding in favor of the corporation.

Central Standard Life Insurance v. Davis

Central Standard Life Insurance owned 4,098 of 7,250 shares of 7.5% cumulative preferred stock in the Abraham Lincoln Hotel Company (Hotel Company) with par value of $100 per share. The preferred stock was issued alongside 8,000 shares of common stock issued at $5 per share. The hotel was operated by the Abraham Lincoln Hotel Operating Company (Operating Company) under leases from the Hotel Company. C. Hayden Davis owned 7,990 shares of the common stock in the hotel company, with two others owning 5 shares each. Davis also owned a majority of the common shares of the operating company.

Dividends were paid on the preferred stock in the first 7 years of the operation of the company, but for the subsequent 21 years, no dividends were paid. At the time of filing, cumulative dividends amounted to $1,051,800, and the par value of the outstanding preferred stock was $701,200, which would have to be paid to the preferred shareholders before anything could be paid to the holders of the common stock upon liquidation.

The complaint alleged that the operating history of the company revealed that it would never profit sufficiently to satisfy the outstanding dividends to the preferred stockholders. The plaintiffs, Central Standard Life Insurance, also alleged that the assets of the company were substantially less than the

62. Ill.2d 566, 576, 1441 N.E.2d 45, 51 (1957).

$1,753,000 owed to the preferred stockholders, and these assets were depreciating steadily.

The plaintiffs believed that the only way they would ever receive any benefits from the company would be for the company to dissolve. They brought suit that, under the current circumstances, refusal to dissolve the company was oppressive conduct to the minority shareholders. The company refused to dissolve, alleging that the assets of the company were worth more than $2 million and that the plaintiffs had no right to pursue the action.

There was conflicting evidence concerning the Hotel Company's assets. The plaintiffs' expert testified that the value of the Hotel Company was $700,000, excluding the furnishings that were owned by the Operating Company. The Hotel Company introduced an appraisal obtained for insurance purposes that asserted the reproduction value plus the value of the property, less depreciation, was $2,369,007.26.

In addition, the plaintiffs identified a contract that Davis entered into two years after the proceeding began, selling all his stock interest in both the Hotel Company and the Operating Company for $1,500,000.

The initial master in the case held the value of the companies irrelevant, in that as the plaintiff previously did not dissent in a stockholders' or board of directors' meeting, the actions of the defendants could not be illegal, oppressive, or fraudulent and that the case should be dismissed for want of equity.

The Appellate Court affirmed,[63] indicating that the definition of oppression was "unreasonably burdensome, unjustly severe, tyrannical, overpowering to spirit or senses." The court recognized that oppression must be separate from illegal and fraudulent, and the evidence did not establish oppression because there was no mismanagement or misapplication of assets.

The Illinois Supreme Court overturned the lower court's decision, stating that the plaintiff did not contend that there was any illegal or fraudulent conduct and admits that the hotel was run as efficiently as could be expected. The complaint was based only on the fact that the individual defendants refused to liquidate the company and the corporation had shown no indication that it would sufficiently profit in the future to supply the preferred shareholders their value before the expiration of the charter, over 60 years in the future.

The court concluded that the word *oppressive* does not carry the connotation of imminent disaster for the company, as some other cases had indicated, and agreed with the plaintiff's claim that the word *oppressive* does not necessarily indicate fraud or mismanagement, but can be more liberally applied. Despite this decision, no remedy was granted.

63. *Central Standard Life Ins. Co. v. Davis*, 10 Ill. App. 2d 245 141 N.E.2d 45, 1957.

As for the valuation, the court decided that although the plaintiff's expert was well experienced in the market for similar hotels, his rule-of-thumb valuation was not necessarily a good indication of value. The court also did not feel that the brick-and-mortar insurance valuation was acceptable as a valuation, nor was the sale-of-stock contract.

The court acknowledged that the Hotel Company had paid down its mortgage and increased its gross income from $400,000 in 1942 to over $1,000,000 in 1951. This case also admonished that dissolution was a drastic remedy, which should not be invoked lightly by the courts. In light of the fact that there might be the prospect of gain for this corporation, and the preferred shareholders could potentially begin seeing some value in the near future, the corporation was allowed to continue on undisturbed.

Reasonable Expectations

A breach of reasonable expectations was established as a fundamental determination of oppression based on the 1980 New York case *Topper v. Park Sheraton Pharmacy*.[64] In this case, the court found that the plaintiff's reasonable expectations were violated by an intentional freeze-out and ordered the buy-out of his shares.

Topper v. Park Sheraton Pharmacy

Three individuals, Topper, Goldstein, and Reingold, operated two pharmacies in prominent Manhattan hotels, the New York Sheraton and the New York Hilton. The shareholder agreements were executed in early 1979. The agreements provided no method for transfer or purchase of shares, nor did they specify terms of employment.

Topper associated himself with the other two individuals in the two corporations (Center City Enterprise, Inc. and Park Sheraton Pharmacy, Inc.) with the expectation of being an active participant in the operations of the corporations. In order to participate, Topper ended a 25-year employee relationship with Continental Drug Corporation, and he and his family left their home in North Miami, Florida to move to New York to engage in the two corporations. Topper invested his life savings in the venture and executed personal guarantees of a lease extension and promissory notes for the purchase price of his stock interest.

The majority stockholders affirm that in February 1980, they discharged Topper as an employee, terminated his salary (after his salary had been raised from $30,000 to $75,000 in the first year), removed him as an officer and as a

64. 107 Misc. 2d 25, 34, 433. NYS2d 359, 365 (1980).

> cosignatory on the corporate bank accounts, and changed the locks on the corporate offices to exclude him from entrance. The controlling shareholders claimed that the petitioner had suffered no harm, as his one-third interest remained intact. In addition, the corporation had not paid dividends.
>
> The court deemed that the actions of the majority constituted a freeze-out and were oppressive, as they violated Topper's reasonable expectations in joining the partnership. The court recognized that in a close corporation, the bargain of the participants is not necessarily reflected in the corporation's charter, by-laws, or other written agreement. In many small corporations, minority shareholders expect to participate in management and operations, and these expectations constitute the bargain of the parties by which subsequent conduct must be appraised.
>
> The court also stated that the business corporation law determines that oppression of the "rights and interests" of minority shareholders in a close corporation is an abuse of corporate power. These rights are derived from the expectations of the parties underlying the formation of the corporation. The court awarded Topper the right to the fair market value[65] of his shares as of the day prior to the date of petition, as empowered by the business corporation law.

The shareholders' agreement can provide a basis by which the courts can determine the reasonable expectations of a shareholder.[66] An ABA report suggests that courts observe the provisions of a shareholder agreement unless the circumstances of the case suggest otherwise. The shareholder agreement may indicate a previously agreed upon value or method for determining fair value that can be used in the case of dissenter's rights or oppression cases.[67]

In the unreported Connecticut case of *Stone v. Health*,[68] the plaintiff sought to dissolve the corporation as tensions became high among the doctors in the corporation. The plaintiff claimed she was entitled to a fair value of $338,000 as her share, but the shareholders' agreement stated that she was entitled to the net book value of the assets she had contributed to the corporation, a little over $13,000. No oppression was found by the court, and the court found

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65. It should be noted that although the courts were empowered to award fair value by New York Statute Section 1118, the court seems to have used the term *fair market value* as a substitute. It is unclear whether that substitution was intentional.

66. Ladd A. Hirsch, "Counseling the Small Business to be Litigation Savvy," speech presented at University of Houston Law Foundation, March 2003 (www.cdhlaw.com).

67. American Bar Association, A Report of the Committee of Corporate Laws, "Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Close Corporations," *The Business Lawyer* 46, No. 297 (1991).

68. 2000 Conn. Super. LEXIS 2987.

it was *not* inequitable or unfair under the circumstances to look to the stockholders' agreement for a determination of value.

This would seem to indicate that maintenance of and adherence to a shareholders' agreement provides a certain amount of clarity as to shareholder expectations, as long as a particularly egregious breach of the agreement has not occurred.[69]

Breach of Fiduciary Duty

As one of the landmark cases offering relief to oppressed shareholders, the Massachusetts case of *Donahue V. Rodd Electrotype of New England*[70] established that a breach of fiduciary duty (the obligation owed to minority shareholders by the majority), may determine whether shareholder oppression has occurred.

Donohue v. Rodd Electrotype of New England

In 1935, Harry C. Rodd, began working for the Royal Electrotype Company of New England, Inc. Rodd advanced quickly in the company, being elected as a director in 1936, and succeeding to the position of general manager and treasurer in 1946. Joseph Donahue was hired in 1936 as a "finisher" of electrotype plates. He ultimately achieved the positions of plant superintendent in 1946 and corporate vice president in 1955, although he never actually participated in the management of the business.

Rodd and Donahue acquired shares of the Royal Electrotype Company, Rodd acquiring 200 shares at $20 per share and Donahue acquiring 50 shares at $20 per share. Another individual owned 25 shares, while the parent company (Royal Electrotype of PA) retained 725 shares.

In June 1955, Royal Electrotype of New England purchased all 725 shares from the parent company at a total price of $135,000. The 25 shares owned by the other individual were also purchased. The stock purchases left Harry Rodd in control of the corporation. By 1955, he had already assumed the presidency and was the 80% majority shareholder. Donahue was the only minority shareholder. The company subsequently was named Rodd Electrotype of New England.

Harry Rodd's sons assumed control of the company between 1959 and 1967. Harry Rodd also pursued a gift program by which he distributed his shares among his two sons and his daughter, each child receiving 39 shares, with 2 shares being returned to the corporate treasury. In 1970, Harry Rodd

69. Hirsch, "Counseling the Small Business to be Litigation Savvy."

70. 367 Mass. 578; 328 N.E.2d 505, 1975.

was 77 years old. He wished to retire but insisted that some financial arrangements be made regarding his remaining 81 shares of stock. The directors of the company decided that they would purchase 45 shares for $800 a share ($36,000). Following this, each child was gifted additional shares such that each held 51 shares, while the Donahues owned 50. (Ownership was transferred to Donahue's wife, Euphemia [45 shares], and son, Robert [5 shares] after Joseph Donahue died in 1968.)

In 1971, the Donahues learned that the corporation had purchased Harry Rodd's shares. The minutes of the meeting show that the stockholders unanimously voted to ratify all acts of the company president, including the stock purchase agreement. Later, however, the trial judge found that the Donahues did not vote affirmatively.

After the meeting, Euphemia Donahue offered her shares to the corporation on the same terms given to Harry Rodd. The corporation refused to purchase the shares as it was not in a financial position to do so.

The plaintiff, Euphemia Donahue, characterized the purchase of Harry Rodd's shares as an unlawful distribution of corporate assets to controlling shareholders constituting a breach of fiduciary duty. The defendants claimed that the purchase was within the powers of the corporation and met the requirements of good faith and inherent fairness, and asserted that there is no right to equal opportunity in corporate stock purchases for the corporate treasury.

The court characterized the transaction as a preferential distribution of assets, as the controlling group distributed corporate assets to the stockholder whose shares were purchased but did not offer the same distribution to the minority shareholder. The controlling stockholder received an advantage over his fellow stockholders, which is inconsistent with the strict standard of fiduciary duty required in close corporations. In essence, the controlling shareholder turned corporate funds to personal use. The court granted relief to the minority shareholder on the grounds of equal opportunity.

The judgment required either that Harry Rodd remit the $36,000 with interest or that the plaintiff's 45 shares be purchased for $36,000 without interest.

Heavy-Handed and Arbitrary or Overbearing Conduct

Heavy-handed and arbitrary or overbearing conduct is the standard that Illinois uses to determine whether oppression has occurred. This definition seems to leave the most discretion to the court's judgment on oppressive conduct. This standard was established by the 1972 case *Compton v. Paul K. Harding Realty Co.*[71]

71. 6 Ill. App. 3d 488; 285 N.E.2d 574, 1972 Ill.

Compton v. Paul K. Harding Realty Co.

Martha L. Compton was an officer and a shareholder of the Paul Harding Realty Corporation, along with the defendant, Paul Harding. When they formed the business together in 1962, Harding led the discussions and planning on the formation of the corporation due to his more extensive experience in real estate.

Once the corporation was formed, Compton and Harding continued discussions in regard to an agreement between the shareholders. Compton testified that an agreement was drafted on yellow paper and later typed up by Harding. The provision that she had required was that the corporation was not to have any additional shareholders, other than Compton, Harding, and her brother, Forrest Leoty.

Compton asked Harding to sign it, but he claimed that the memo would have no force and effect as a contract, as it was simply a memorandum outlining how the corporation was to be operated. The document was undated, but typed on letterhead and signed by Compton, Harding, and Leoty. The memo stated:

> President as operating head shall have authority to set salaries and to do those things which normally are the responsibility of the operating head of the company.
>
> Manager—Salary of operating manager is to be set at $100 a week, basic. When business is showing a profit salary is to be increased to $175 a week. This salary is to be determined on the previous 90 days profit experience.
>
> Management shall consist of Paul K. Harding as president and manager, Martha L. Compton as executive vice president and treasurer.

The record of the case states that from the beginning, the corporation was loosely managed and the shares of the corporation were not distributed in accordance with the memorandum. Although the agreement stipulated that Harding's salary would be $100 per week, at the onset of business he received $175, soon raising it to $200. In the fall of 1964, the salary was raised to $250 per week. He also received commissions.

Compton contended that Harding was guilty of self-dealing and corporate mismanagement, raising his salary without notice to the shareholders and contrary to the terms of the agreement. If indeed the company had shown the necessary profit to support the $175 salary, he would have been paid $36,225 over the course of the year. Instead, he was paid $52,133.06.

The court found that between incorporation and the trial, Harding had taken $29,457 in excess of his contractual salary, which was to be paid back to the corporation before liquidation. It did not find that fraud had occurred. Harding claimed that the agreement he signed should have no effect, but the court stated that many close corporations have similar agreements and these have previously been recognized by the courts. Harding also contended that the salary considered to be in excess was not calculated properly. The court agreed, and after a review of the profits and losses of the corporation over the time period in question, the court reduced the repayment to $15,925.

Last, and most significant with respect to the precedent set by this case, Harding claimed that there was no statutory basis by which the court could order liquidation, as he had committed no fraud. The court looked to the statute indicating the availability of dissolution if the acts of the directors are illegal, oppressive, or fraudulent. The court referred to the case of *Central Standard Life Insurance v. Davis*, where the court held that oppression is not necessarily synonymous with illegal and fraudulent. The court went on to say the following, thereby establishing the doctrine of heavy-handed, arbitrary, and overbearing conduct as a test for oppression:

> We think there is ample evidence in the record showing an arbitrary, overbearing and heavy-handed course of conduct of the defendant Harding to justify the finding of oppression and the order of dissolution. Specific instances of such evidence include testimony regarding the failure of defendant Harding to call meetings of the board of directors or to consult with plaintiff Compton regarding management of corporate affairs, his imperious attitude when questioned about his salary and his dilatory reaction to the plaintiffs' requests.[72]

After a final accounting, Harding was ordered to pay $15,925 back to the corporation; costs of the receivership and liquidation would be enforced against the corporation itself, rather than Harding, as his actions were not necessarily illegal or fraudulent.

Next we turn to the use of the fair value standard in the context of dissenters' rights and shareholder oppression suits.

STANDARD OF VALUE IN THE 50 STATES

Exhibit 3.3 lays out the language used by each of the 50 states and the District of Columbia to define the standard of value in dissent and oppression statutes. The chart includes:

- The standard of value utilized
- The basis for the definition as written in the statute

72. Id. at 20.

Exhibit 3.3 Individual States' Definition of Value under Dissenter/Appraisal Statutes

STATES / TERRITORIES	STANDARD OF VALUE	BASIS FOR STATUTORY DEFINITION	INDIVIDUAL STATES DEFINITION OF VALUE UNDER DISSENTER'S / APPRAISAL RIGHTS ACTIONS
Alabama, Arizona, Arkansas, Colorado, Hawaii, Indiana, Illinois, Kentucky, Massachusetts, Michigan, Missouri, Montana, Nebraska, Nevada, New Hampshire, North Carolina, Oregon, South Carolina, Vermont, Washington, Wyoming	Fair Value	1984 RMBCA definition adopted	(i) Value of the shares immediately before the effectuation of the corporate action to which the shareholder objects (ii) excluding any appreciation or depreciation in anticipation of the corporate action (iii) unless exclusion would be inequitable.
Georgia, New Mexico, Rhode Island, Tennessee, Utah	Fair Value	1984 RMBCA definition partially adopted	(i) Value of the shares immediately before the effectuation of the corporate action to which the shareholder objects (ii) excluding any appreciation or depreciation in anticipation of the corporate action ~~(iii) unless exclusion would be inequitable.~~[a]
Minnesota, North Dakota	Fair Value	1984 RMBCA definition partially adopted	(i) Value of the shares immediately before the effectuation of the corporate action to which the shareholder objects ~~(ii) excluding any appreciation or depreciation in anticipation of the corporate action (iii) unless exclusion would be inequitable.~~
Maryland	Fair Value	Very similar to 1984 RMBCA	§ 3-202(b) : on the date of stockholder vote, free of any appreciation or depreciation which directly or indirectly results from the transaction objected to or from its proposal.
New Jersey	Fair Value	Very similar to 1984 RMBCA	***Dissent:*** § 14A:11-3: As of the day prior to the day of the meeting of the shareholders at which the action was approved . . . excluding any appreciation or depreciation resulting from the proposed action.
	Fair Value + Equitable Adjustments		***Oppression:*** §14A:12-7(8)(a): The purchase price of any shares so sold shall be their fair value as of the date of the commencement of the action or such earlier or later date deemed equitable by the court, plus or minus any adjustments deemed equitable by the court if the action was brought in whole or in part under paragraph 14A:12-7(1)(c).[b]

Pennsylvania	Fair Value	1984 RMBCA definition partially adopted, with all relevant factors clause	(i) Value of the shares immediately before the effectuation of the corporate action to which the shareholder objects, [taking into account all relevant factors], but (ii) excluding any appreciation or depreciation in anticipation of the corporate action (iii) unless exclusion would be inequitable.
Connecticut, Idaho, Iowa, Maine, Mississippi, South Dakota, Virginia,[c] West Virginia	Fair Value	1999 RMBCA definition adopted	Value of the shares immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable to the corporation and its remaining shareholders. Without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation pursuant 13.02(a)(5).
Florida	Fair Value	Definition similar to 1999 RMBCA with minor changes	§ 607.1301: Immediately before the effectuation of the corporate action to which the shareholder objects. Using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable to the corporation and its remaining shareholders. For a corporation with 10 or fewer shareholders, without discounting for lack of marketability or minority status.
Alaska, New York	Fair Value	In spirit of 1984 MBCA and 1999 RMBCA without discount verbiage	Nature of the transaction giving rise to the shareholder's right to receive payment for shares and its effects on the corporation and its shareholders, the concepts and methods then customary in the relevant securities and financial markets for determining the fair value of shares of a corporation engaging in a similar transaction under comparable circumstances and all other relevant factors.

(*continues*)

Exhibit 3.3 Continued

STATES / TERRITORIES	STANDARD OF VALUE	BASIS FOR STATUTORY DEFINITION	INDIVIDUAL STATES DEFINITION OF VALUE UNDER DISSENTER'S / APPRAISAL RIGHTS ACTIONS
Delaware, Oklahoma	Fair Value	Unique to these statutes	Exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors.
Wisconsin	Fair Value & FMV in business combinations	Unique to statute	§180-1301: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable. "Fair Value" with respect to a dissenter's shares in a business combination, means market value, as defined by §180.1130(9)(a)1-4.[d]
Kansas	"Value"	Unique to statute	§ 17-6712: The value of the stockholder's stock on the effective date of the merger or consolidation, exclusive of any element of value arising from the expectation or accomplishment of the merger or consolidation.
California	Fair Market Value	Similar to 1984 RMBCA	Dissent: § 1300: The fair market value shall be determined excluding any appreciation or depreciation in consequence of the proposed action, but adjusted for any stock split, reverse stock split, or share dividend which becomes effective thereafter
	Fair Value under Liquidation (premise of value)	Unique to statute	Oppression: § 2000: The fair value shall be determined on the basis of the liquidation value as of the valuation date but taking into account the possibility, if any, of sale of the entire business as a going concern in a liquidation.

Ohio	Fair Cash Value	Unique to statute	§ 1701.85: The amount that a willing seller who is under no compulsion to sell would be willing to accept and that a willing buyer who is under no compulsion to purchase would be willing to pay, but in no event shall the fair cash value of a share exceed the amount specified in the demand of the particular shareholder.
Louisiana	Fair Cash Value	Unique to statute	§ 140.2c: A value not less than the highest price paid per share by the acquiring person in the control share acquisition.
Texas	Fair Value	Unique to statute	2003 Tex. ALS 182 Subchapter H, Chapter 10: The value of the ownership interest on the date preceding the date of the action that is the subject of the appraisal. Any appreciation or depreciation in the value of the ownership interest occurring in anticipation of the proposed action or as a result of the action must be specifically excluded from the computation of the fair value of the ownership interest. (b) In computing the fair value of an ownership interest under this subchapter, consideration must be given to the value of the organization as a going concern without including in the computation of value any: (1) payment for a control premium or minority discount other than a discount attributable to the type of ownership interests held by the dissenting owner and, (2) limitation placed on the rights and preferences of those ownership interests.[e]

[a]The strikeouts show the sections of the 1984 RMBCA definition that were not adopted by these states.

[b]§14A:12-7(1)(c)—In the case of a corporation having 25 or less shareholders, the directors or those in control have acted fraudulently or illegally, mismanaged the corporation, or abused their authority as officers or directors or have acted oppressively or unfairly toward one or more minority shareholders in their capacities as shareholders, directors, officers, or employees.

[c]Virginia requires that a corporation have ten shareholders or less to be eligible for the non-discounting provision.

[d]§180.1130(9)(a)1-4: "If no report or quote is available under subd 1., 2., 3., the fair market value as determined in good faith by the board of directors of the resident domestic corporation." Subd. 1, 2, 3, refers to shares quoted on stock exchanges or by the National Association of Securities Dealers.

[e]The definition then goes on to state that this definition of fair value is only applicable for the purpose of dissent: "(c) The determination of the fair value of an ownership interest made for the purposes of this subchapter may not be used for purposes of making a determination of the fair value of that ownership interest for any other purpose or of the fair value of another ownership interest, including for the purposes of determining any minority or liquidity discount that might apply to a sale of an ownership interest. (TBCA 5.12.A(1) (part.).)"

- The statutory definition, whether drawn from the RMBCA or created independently by the state legislature

The majority of states use all or part of the RMBCA's definition of fair value. This definition involves several components, and in order to understand the requirements of the definition, it is important to break it down and understand each component separately.

BREAKING DOWN THE COMPONENTS OF FAIR VALUE

Before the Effectuation of the Corporate Action to Which the Shareholder Objects

This portion of the definition suggests a time frame for the valuation. It instructs the court to set a valuation date immediately prior to the corporate action from which the shareholder dissents. Most states say that valuation should reflect the value on the day before the corporate action (occurred or was voted on) to which the shareholder dissents. This indicates that the shareholder should not suffer or benefit from the proceeds or effects of the transaction he or she dissented from, including benefits from synergies arising from the prospective transaction.

For example, in the case of *Pittsburgh Terminal Corporation v. the Baltimore and Ohio Railroad*,[73] minority shareholders in PTC objected to a merger that would effectively cash out their interest in the corporation. They argued that the consideration they received was considerably less than an outsider would bid for a controlling interest in the corporation. Upon review, the court found that the controlling parties had effective control even before the merger, and therefore it would not be appropriate to place a premium on the share price in consideration of the merger.

In many cases the trial takes place long after the events occurred, and new information is available at the time of the trial. Events that are known and knowable as of the valuation date are generally to be considered in the appraisal. In the case of *Tri-Continental Corp. v. Battye*,[74] the court stated that in determining value, the appraiser and the courts must consider any facts that are known or that could be ascertained as of the date of the merger, as these are essential in determining value.

73. 875 F.2d 549; 1989 U.S. App. LEXIS 6910. Applying Maryland Law.

74. 74 A.2d (Del. 1950).

For example, in *Smith v. North Carolina Motor Speedway*,[75] while the dissenters focused on the growth and success of NASCAR in the three years after the acquisition, the defense claimed that subsequent success should not be relevant if not fully foreseeable at the date of the event. Apparently acknowledging that those subsequent events should not be considered, the jury awarded a price much closer to the defendant's value.[76]

In certain cases, future events are used to validate the calculation of value as of the valuation date, and are used as a sanity test for the valuation. For example, in *Lane v. Cancer Treatment Ctrs. of America, Inc.*,[77] the court allowed postvaluation date discovery for a year after the action to test the value ascertained in a premerger discounted cash flow calculation.

In New Jersey's *Lawson Mardon Wheaton v. Smith*,[78] the lower court refused to consider a postevent acquisition price. After recognizing that Delaware has allowed the use of postmerger information in appraisal in order to better determine value at the time of merger,[79] the New Jersey Supreme Court allowed the consideration of postevent information. The dissenter's assertion was that the share price that had been determined to be $41.50 per share in 1991 was questionable because in 1996, an acquisition price of $63 per share was offered. The court reasoned that the value of $41.50 per share in 1991 (when the company was doing well) should be questioned in light of an actual sale in 1996 at $63 per share (when the company was doing poorly).

The ALI recommends that in determining what a buyer would pay, the court may include a share of any gain reasonably expected to result from the combination, unless special circumstances exist that would make it unreasonable. The ALI goes on to comment that the implications of the statutes that say "immediately before the effectuation of the corporate action" could result in unfairness. For instance, in a case where the majority intends to freeze out the minority party in order to collect a price of $80 per share for a stock that had previously traded no higher than $50, the ALI recommends that $80 should be determined as the fair value.[80]

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75. No. 98-CVS-3766(NC Sup. Ct 2000).
76. Fishman, Pratt, and Griffith, "PPC's Guide to Business Valuation," at 1505.46.
77. No. CIV.A.12207, 1994 Del. Ch. LEXIS 67, at *10–11 (May 25, 1994).
78. 160 N.J. 383; 734 A.2d 738; 1999 N.J. LEXIS 835.
79. *Cede v. Technicolor, Inc.*, No. CIV.A.7129, 1990 Del. Ch. LEXIS 259 (Oct. 19, 1990), rev'd, 684 A.2d 289 (Del. 1996).
80. Id., at 315–322.

Valuation Date in Oppression Cases

If a corporation or its controlling shareholders are permitted by statute to elect to purchase the share of a minority shareholder who seeks involuntary dissolution on grounds of oppression, several valuation dates may apply. New York[81] uses the day before the date the petition was filed. Rhode Island[82] uses the date of filing. California[83] and New Jersey[84] suggest the date of filing, but leave the door open for the court to designate an alternative date if more equitable. For example, a court may use the date of the actual oppression if it believes that the minority will be adversely affected by changes in the company's value after the minority shareholder's role in management has unjustifiably ended.

Excluding Any Appreciation or Depreciation in Anticipation of the Corporate Action Unless Exclusion Would Be Inequitable

This portion of the definition requires valuing the company as if the corporate action did not take place, so as not to unfairly benefit either of the parties from the result of the action. However, this definition also suggests that postmerger information could be considered to the extent that it reflects appreciation unrelated to the merger.[85] Primarily, appreciation in value due to the normal course of business can be included, but the exclusion provision suggests that if the action was unfair or self-dealing by the majority, having enriched themselves at the expense of the dissenter, those acts may be considered in the determination of fair value. For example, if minority shareholders are excluded from a transaction, perhaps in a squeeze-out merger, and dissent from their exclusion, the courts may find that equitable relief would be to include the synergy from the transaction to provide compensation for the minority to account for actions of the majority. In addition, an often overlooked issue in valuation is that not all synergies should be disregarded. Only those synergies not available to a particular buyer may be indicative of investment value.

The ABA removed "excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable" from the fair value definition in the 1999 RMBCA. The ABA's commentary on the removal indicates that the provisions have not been susceptible to significant

81. N.Y. Bus. Corp. Law Sec. 1118(b).

82. R.I. Gen. Laws Sec 7-1-90.1.

83. California Corp. Code Sec.2000(f).

84. N.J. Stat. Ann Sec. 14A:12-7(8)(a)

85. Wertheimer, "Shareholders' Appraisal Remedy," at n432–437.

judicial interpretation and that their exclusion would allow for the broadening of the concept of fair value. Instead of using these lines, the ABA follows the ALI in recommending the use of customary and current techniques to keep up with evolving economic concepts.[86]

Customary and Current Valuation Techniques

The ALI's *Principles of Corporate Governance* state that "[f]air value should be determined using the customary valuation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rights to the appraisal."[87]

In the notes to this section, the ALI discusses why using customary valuation methods are necessary. It acknowledges that the main problem with valuation is definition and measurement. With respect to measurement, as corporations have different underlying assets, no universal technique of measurement can cover all industries. Therefore, it is necessary to allow flexibility in valuation so that the valuation professional and the courts can use their best judgment to find equitable outcomes.[88]

In 1983, the Delaware Supreme Court established the foundation for the use of current and customary valuation techniques used by the financial community in their decision in *Weinberger v. UOP, Inc*.[89] In this landmark decision regarding the determination of value in shareholder dissent cases, the court's opinion affirmed the concept that a company could be valued using alternative methods, rather than relying solely on the Delaware block method as the courts had before.

Weinberger v. UOP, Inc.

UOP, Inc. (formerly Universal Oil Products Company) was a diversified industrial company that engaged in petroleum and petrochemical services, construction, fabricated metal, transportation, chemicals, plastics, and other products and services. Its stock was publicly held and traded on the New York Stock Exchange. Signal Corporation, Inc., was a diversified technology

86. American Bar Association, Report of the Committee of Corporate Laws, "Changes in the Revised Model Business Corporation Act."

87. American Law Institute, *Principles of Corporate Governance*, at 315.

88. Id., at 318.

89. 457 A.2d 701; 1983 Del. LEXIS 371.

company operating through various subsidiaries, including the Garrett Corporation and Mack Trucks, Inc.

In 1975, negotiations took place and through tender offer and direct purchase, Signal obtained its 50.5% interest in UOP at $21 per share, while the stock was trading at slightly under $14. At UOP's annual meeting, Signal elected 6 members to the 13-member board. When the chief executive officer (CEO) of UOP retired in 1975, Signal replaced him with an executive of the Garret Corporation who took the old CEO's position on the board, as well.

UOP then went through some difficult years financially. During that time, Signal performed a study of the feasibility of acquiring the 49.5% balance of UOP's shares. The study indicated that acquiring the shares at any price under $24 would be a good value. Signal's executive committee proposed a merger by which the remaining shares would be cashed out at $21 per share. UOP's shares were trading at $14.50 the day prior to the announcement of the merger.

At the annual meeting, the merger was voted on, and 3,208,652 of the minority shares were voted (56% of the total 5,688,302 minority shares). Of these, 2,953,812 voted in favor of the merger and 254,850 voted against it. In May 1978, the merger was effectuated between UOP, Inc. and Sigco Inc., a wholly owned subsidiary of Signal. As a result, UOP became the wholly owned subsidiary of Signal Companies, and UOP's former minority shareholders were cashed out at $21 per share for their former interests in UOP.

The plaintiff, William Weinberger, brought action claiming that shareholders would not have exchanged their shares for the $21 price. He claimed that this number was grossly inadequate and unfair to their interests. Through the proceeding, he looked for the minority shareholders to be awarded damages or the appropriate value for their shares based on the substantial assets of the company. There were additional charges of abuse of authority, misleading shareholders, and a breach of fiduciary duty for failure to argue for a higher value of the shares.

The defendants held that their purpose was in no way illegal. They asserted that the $21 share price paid was a 40% premium over market price and was more than fair to the minority.

The Court of Chancery's opinion indicated that the merger was enacted in entire fairness. The court ruled that UOP's neglect to acquire appraisals of all property and assets was not a breach of fiduciary duty because the appraisals would have no bearing on the fairness of the merger. As for the alleged impropriety of the share price, the plaintiff brought in an expert who used comparative analysis based on an analysis of the premium paid over market in 10 other tender-offer merger combinations and a discounted cash flow method. By these methods, he asserted that the value of the shares was no less than $26 per share. The defendant's expert used the Delaware block method and weighted the market value, net asset value, and investment value to come to the conclusion that the $21 share price was fair to minority shareholders. The trial court agreed with the defendant's expert, consistent with the precedent of utilizing the Delaware block method to value shares.

Upon appeal, the Delaware Supreme Court overturned the ruling, stating that there were misrepresentations made by the directors in the failure to supply sufficient information to shareholders, including the consideration by the study conducted by Signal that $24 would be a good price to acquire the additional shares. Therefore, as the merger was not made in fairness, the plaintiff had a right to an appraisal of his shares.

The court relied on a 1981 amendment to the state's dissent statute referencing fair value, that directs the court to "take into account all relevant factors." The court concluded that there is a legislative intent to fully compensate shareholders for their loss.

Addressing the Delaware block method used by the defendant's expert, the court decided that this method excluded other generally accepted techniques used in the financial community and the courts, and was therefore outmoded. It stated that the standard should no longer be the exclusive technique used in valuation.

> We believe that a more liberal approach must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court, subject only to our interpretation of 8 Del. C. § 262(h).

The Court of Chancery's findings that both the circumstances of the merger and the price paid to the minority shareholder were fair were overturned, and the matter was remanded for further proceedings. In those proceedings, members of the plaintiffs' class of shares were awarded an additional $1.00 per share in damages plus interest.

Weinberger did not entirely do away with the use of the Delaware block method; instead, it allowed the possibility for a widely accepted alternative valuation procedure to be used as well as industry-appropriate valuation techniques. The appropriate valuation method is not the same in every case. But it is likely that a court will use the most relevant evidence presented to it to determine value. As current and customary techniques evolve, so will the case law. Interestingly, the discounted cash flow method, a method often not accepted by some courts, is widely used in dissent cases. In fact, the court in *Grimes v. Vitalink Communications Corporation*[90] commented that the discounted cash flow method was increasingly the method of choice in valuations in the Delaware Chancery Court.

90. 1997 Del. Ch. LEXIS 124.

Exhibit 3.4 addresses the statutory guidance provided for determining fair value (or other standard of value) in states that include discussion of the use of customary and current techniques, all relevant factors, or other guidance relating to the method of valuation in their statutes.

The Weinberger court's directive that all methods typically used by the financial community be considered in these matters, resulted in courts permitting the use of a number of methodologies recognized by the financial community. Examples of several methods that have been utilized include:

- *Discounted cash flow* (DCF). *Weinberger v. UOP, Inc.* used the discounted cash flow method in its departure from the standard Delaware block method. The discounted cash flow (DCF) methodology is widely used in the determination of fair value, especially in Delaware. In the 1995 case of *Kleinwort Benson Limited v. Silgan*,[91] the Delaware court acknowledged DCF as a better way of determining the value of a corporation than a market-based approach. The court weighted DCF more heavily than the market approach, stating that the DCF method should have greater weight because it values the corporation as a going concern, rather than comparing it to other companies. In *Grimes v. Vitalink*,[92] the court referenced *Kleinwort Benson Limited v. Silgan* as evidence that the Court of Chancery increasingly uses DCF in its valuations.
- *Guideline Methods.* These methods involve valuing a privately held company based on multiples generated from the market price of a guideline public company's traded shares (guideline public company method) or from guideline transactions involving both public and private companies (guideline transaction methods). Those values can vary greatly due to market conditions, and the courts often rely more heavily on other methods.
- *Excess earnings method.* Although not necessarily the preferred method of valuation, the excess earnings method has been employed in fair value cases. For example, in *Balsamides v. Protameen Chemicals, Inc.*,[93] the excess earnings method was used by the plaintiff's expert, claiming that the defendants would not provide the information needed to employ any other method.

91. Del. Ch., C.A. No. 11107, 1995 Del. Ch. LEXIS 75, Chandler, V.C. (June 15, 1995).

92. 1997 Del. Ch. LEXIS 124.

93. 160 N.J. 352, 734 A.2d 721, 736 (N.J. 1999).

Exhibit 3.4 Guidance Provided by Statutory Language with Respect to Valuation Techniques

STATE	GUIDANCE PROVIDED BY STATUTORY LANGUAGE WITH RESPECT TO VALUATION TECHNIQUES
Connecticut, Idaho, Iowa, Maine, Mississippi, West Virginia	Using *customary and current valuation concepts* generally employed for similar businesses in the context of the transaction requiring appraisal and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation. [emphasis added]
Alaska, New York	The *concepts and methods customary in the relevant securities and financial markets* for determining of a corporation engaging in a similar transaction under comparable circumstances and all other relevant factors. [emphasis added]
Delaware, Oklahoma	Value *exclusive of any element of value* arising from the accomplishment or expectation of the merger or consolidation, *together with a fair rate of interest including all other relevant factors.* [emphasis added]
Rhode Island	The court should take into account *all relevant factors* [emphasis added]
New Jersey (Oppression)	*Oppression following Dissent (definition):* The purchase price of any shares so sold shall be their fair value as of the date of the commencement of the action *or such earlier or later date deemed equitable by the court, plus or minus any adjustments deemed equitable by the court* if the action was brought in whole or in part under paragraph 14A:12-7(1)(c) [the oppression provision contained in the dissolution statute]. [emphasis added]
Ohio	The amount that a *willing seller* who is under no compulsion to sell would be willing to accept and that a *willing buyer* who is under no compulsion to purchase would be willing to pay, but in no event shall the fair cash value of a share exceed the amount specified in the demand of the particular shareholder [emphasis added]
California (Dissolution/Oppression)	The fair value shall be determined *on the basis of the liquidation value* as of the valuation date but taking into account the possibility, if any, of the *sale of the entire business as a going concern in liquidation.* [emphasis added]

- *Several methods.* In Nevada's *Steiner Corp. v. Benninghoff*,[94] the court weighted various methods in order to find a fair value of the stock. First, it looked to find enterprise value, weighting a DCF valuation 30% and what it called a mergers and acquisition method 70%. To find market value, the guideline company method was considered. Then enterprise value and market value were weighted 75% and 25% respectively. The Delaware Court of Chancery has used weighting in some recent cases as well. In *Andoloro v. PFPC Worldwide, Inc.*,[95] the court weighted DCF at 75% and comparable companies at 25%. In *In re United States Cellular Operating Company*,[96] the weighting was 70% DCF, 30% comparable acquisitions. In *Montgomery Cellular Holding Co., Inc. v. Dobler.*[97] The court gave a 30% weight to DCF, 5% to comparable companies, and 65% to comparable acquisitions.

In many states, the appraisal remedy is primarily directed towards privately held corporations. Many states have a "market exception" built into their statutes. These states do not offer an appraisal remedy if the company has publicly traded shares.[98] The 1984 RMBCA did not include the market exception, but the 1999 revisions make appraisal rights unavailable if the shares are listed on the New York Stock Exchange or the American Stock Exchange, or are designated as a national market system security by the National Association of Securities Dealers. In addition, pursuant to these revisions, in order for a minority shareholder to qualify for dissenter's rights, the company cannot have over 2,000 shareholders with a market value over $20 million (exclusive of the value of such shares held by its subsidiaries, senior executives, directors, and beneficial shareholders owning more than 10% of such shares).

Although in many states the market exception prevents publicly traded companies from being subject to appraisal remedy, the market approach to valuation can still be a useful tool in performing the valuation of a closely held corporation. For example, in the case of *Carl Borruso and William Lee v. Communications Telesystems International*,[99] the valuation expert used the guideline public company method, as there was insufficient information to ad-

94. 5 F. Supp. 2d (D. Nev. 1998).
95. 2005 WL 2045640 (Del. Ch 2005).
96. 2005 WL 43994 (Del. Ch. 2004).
97. 2004 WL 2271592 (Del. Ch. 2004) and affirmed at 2005 WL 1936157 (Del. 2005).
98. Siegel, "Back to the Future," 79 at n79.
99. C.A. No. 16316-NC, 1999 Lexis 197 (Del. Ch. Sept. 24, 1999).

equately apply the DCF method or other income multiples (e.g. earnings before income, taxes, depreciation, and amortization [EBITDA]).

The New Jersey courts recognized the importance of considering the market value in valuation in the case of *Dermody v. Sticco*,[100] referring to the market price as a valuable corroborative tool.

The North Dakota court in *Connector Service Corporation v. Jeffrey Briggs*[101] noted that a multiple of EBITDA was a better method than DCF because the EBITDA multiple was based on the multiples used by the subject company in two prior acquisitions.

It should be noted that merger and acquisition (M&A) market multiples may include the synergies. Appraisers usually avoid using any synergies that arise from the action to which the minority shareholder dissents, unless otherwise directed by legal counsel or the courts.

DISCOUNTS AND PREMIUMS

A major issue in many fair value cases is whether discounts and/or premiums are applicable. If applicable, the issue becomes the *magnitude* of such discounts and/or premiums. The primary issues are shareholder level discounts and applications of control premiums. The courts have debated whether minority shares should be valued by valuing the company on a pro-rata enterprise basis or by valuing the shares themselves with respect to their minority status. There have been arguments for and against the application of discounts. Sometimes the use of discounts or their nonuse can result in the unfair enrichment of one of the parties.

The issue becomes the definition of what the minority shareholder has lost. If viewed as a pro-rata share of the enterprise value, discounts would likely not apply. If, however, valuation is viewed as what the investor could reasonably realize without the intervention of the courts, discounts would likely be applied.

In determining fair market value, typically, lack of control and marketability discounts are considered and when applicable, used. As on an open market, the buyer would have to consider the lack of control and liquidity before agreeing to purchase minority shares. One argument states that the nonuse of discounts unfairly enriches the minority shareholder. It is argued further,

100. 191 N.J. Super. 192, 199, 465 A.2d 948 (Ch. Div. 1983).

101. No. 97 C 7088 U.S. Dist. Ct., 1998 Lexis 18864 (N.D. Ill. Oct. 30, 1998).

minority shareholders would never get an undiscounted price on the open market, and they would have been aware of this when they purchased the minority shares in the first place.

Probably the most popular arguments against discounts involve the original purpose of the statute, as evidenced by the quote from Justice Black mentioned earlier. If the statutes were created to protect the shareholder from the controlling shareholders, a minority discount would be contrary to logic, as the majority shareholders would obviously benefit from a reduction in the amount they would have to pay the minority. With respect to marketability discounts, one could argue that the statute proposes that the judicial proceeding itself creates a market for the shares, and therefore no marketability discount can be taken at the shareholder level. Alternatively, if indeed the minority investor is losing a pro rata proportion of the corporation in having to sell his or her shares, the application of discounts may be viewed as encouraging bad behavior by the majority, as they receive a premium for mistreating the minority.

Levels of Value

In a determination of value, one of the most important issues becomes the level of value at which the valuation arrives. In the market, a willing buyer is usually going to pay more per share for control shares than for minority shares. A willing buyer is going to pay more for marketable shares than for nonmarketable shares. Often, a strategic buyer, due to the potential synergies, is going to pay more for the purchase of control shares than a non-strategic buyer.

Discounts and premiums should also be viewed in light of the type of valuation methodology used and the resultant level of value arrived at based on that method. If indeed shareholder-level discounts (or premiums) are applicable, they should be applied after the valuation of the entity itself, including any applicable entity-level discounts.[102]

Here we have the levels of value.

- **Synergistic Value**—This is the highest value that would be paid for control shares, generally if the purchase was made for a specific purpose by the winning buyer.
- **Control Value**—The control value of a company is value that a typical buyer would pay for control of a company. This may be divided by the number of shares to find a pro-rata share of the company's control value.

102. David Laro and Shannon P. Pratt, *Business Valuation and Taxes—Procedure, Law and Perspective* (Hoboken, NJ: John Wiley & Sons, 2005), at 266.

- **Marketable Minority**—The next level is a minority share that may be publicly traded. Although it still lacks control, a marketable minority share is easily liquidated. For example, a share traded on the New York Stock Exchange is a marketable minority share.
- **Non-Marketable Minority**—The lowest level of value is the non-marketable minority share of a privately held company. This share does not have control over management, the board of directors, or a company's direction without cooperation from the majority. The non-marketable minority share is not traded on a public exchange, and, therefore, is not easily liquidated.

Exhibit 3.5 shows the adjustments needed to move between the levels of value.[103]

The exhibit represents a conceptual framework that should not be construed as definitive. For example, unless one can extract more cash flow, the so-called minority marketable shares may be trading at or close to control value. Applications of discounts and premiums are fact specific and should be applied on a case by case basis.

Other Shareholder Level Discounts

In addition to the frequently debated minority and marketability discounts at the shareholder level, other shareholder-level discounts may be applied, including blockage discounts and voting versus nonvoting share discounts. The concept of blockage applies to a block of publicly traded stock, when the block is so large relative to normal trading volume that an instant sale probably would be at a discounted price because supply would exceed demand. This concept can apply to real property, art, and antiques.[104]

Empirical studies of the price differential between minority voting and minority nonvoting publicly traded stock indicate that the market generally accords little, if any, value to minority voting rights. Where differentials in favor of minority voting stock exist, they generally have been under 5%.[105]

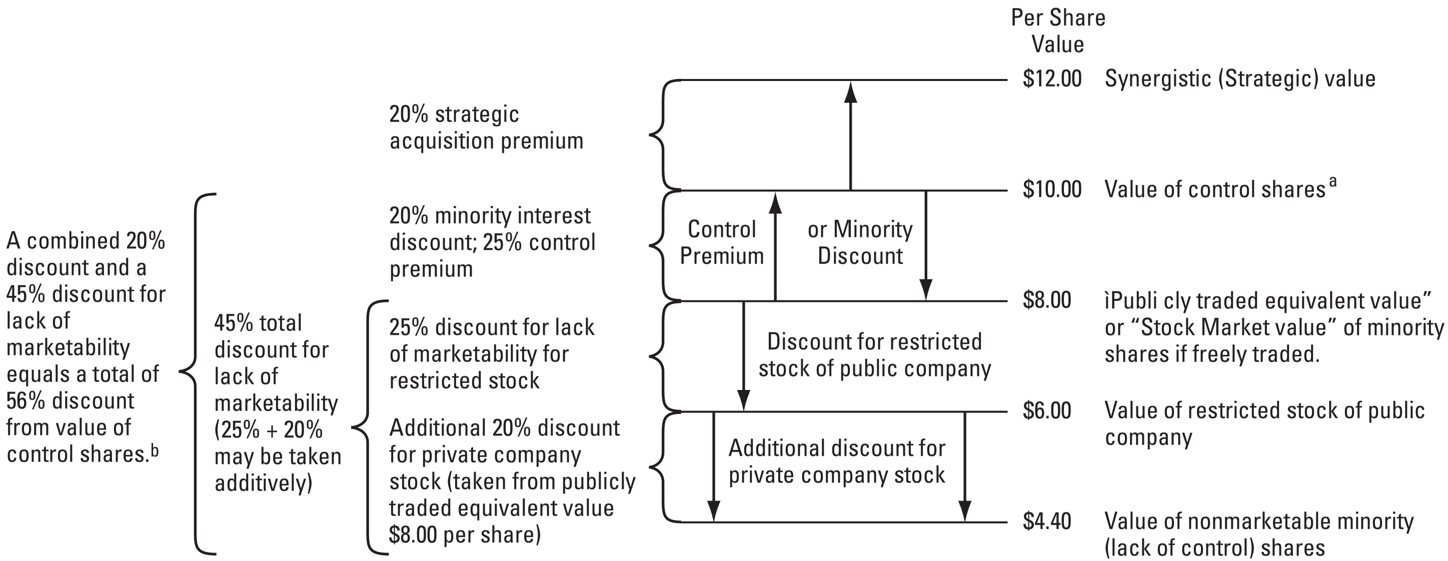
As previously mentioned, the courts have frequently rejected the notion of discounting shares because of minority status in fair value cases; the courts

103. Fishman, Pratt, and Griffith, "PPC's Guide to Business Valuation," Exhibit 8-8. The percentages in this chart are illustrative. The magnitude of discounts are fact specific.

104. Laro and Pratt, *Business Valuation and Taxes*, at 250.

105. Id. at 209.

Exhibit 3.5 Levels of Value in Terms of Characteristics of Ownership



[a]Control shares in a privately held company may also be subject to some discount for lack of marketability, but usually not nearly as much as minority shares.

[b]Minority and marketability discounts normally are multiplicative rather than additive. That is, they are taken in sequence:

$	10.00	Control value
–	2.00	Less: Minority interest discount (.20 × $10.00).
$	8.00	Marketable minority value
–	3.60	Less lack of Marketability discount (.45 × $8.00)
$	4.40	Per share value of nonmarketable minority shares

Source: Guide to business valuations. Exhibit 8.8

generally view the intention of the laws as protection of the value of those minority shares in situations where that value is intentionally being diminished by the controlling shareholders. The court in *Dreiseszun v. FLM*[106] stated: "The statute does not . . . intend that a minority stockholder be in any way penalized for resorting to the remedy afforded thereunder." Further, the New York case of *Blake v. Blake Agency, Inc.*[107] stated with respect to the appraisal statute: "Business Corporation Law §1104—a [dissolution statute] was enacted for the protection of minority shareholders, and the corporation should therefore not receive a windfall in the form of a discount because it elected to purchase the minority interest pursuant to Business Corporation Law § 1118 [election to purchase]." However, in these circumstances, discounts for lack of marketability are generally considered in New York. The Massachusetts court similarly stated in *BNE Massachusetts Corp. v. Sims*[108] that "[t]he task assigned to the court by § 92 is not to reconstruct an 'intrinsic value' of each share of the enterprise but, rather, to determine what a willing buyer realistically would pay for the enterprise as a whole on the statutory valuation date."

In many cases, the courts have been reluctant to set a precedent or a bright-line rule rejecting discounts, as there could be a circumstance where the application of a discount is viewed as necessary or fair to the affected party. For example, in *Advanced Communication Design, Inc. v. Follett*,[109] the court stated that it must be fair and equitable to all parties; therefore, the court applied a marketability discount to the value of the company because there was no way the company could achieve the liquidity necessary to compensate the departing shareholder. This was viewed as an example of an extraordinary circumstance.

In the Delaware case of *Cavalier Oil v. Harnett*,[110] the corporation argued that the minimal interest that the shareholder maintained in the corporation, 1.5% of outstanding common stock, was a "relevant factor" to be considered in the valuation for the purposes of the proceeding. The Vice Chancellor concluded (and the Supreme Court agreed) that the objective of the appraisal outlined by the statute was to value the corporation itself, rather than a specific fraction of shares in the hands of one shareholder; therefore, no shareholder level discounts should be applied.

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106. 577 S.W.2d at 906.

107. 107 A.D.2d 139, 149, 486 N.Y.S.2d 341, 349 (1985).

108. 588 N.E.2d 14 (Mass. App. Ct. 1992).

109. 615 N.W.2d 285, 292 (Minn. 2000).

110. 564 A.2d 1137; 1989 Del. LEXIS 325.

Entity-Level Discounts

Entity-level discounts are those that apply to the company as a whole. Some maintain controlling shares command a discount for lack of marketability pointing to studies that show that private companies sold as a whole generally sell for a value less than their publicly traded equivalents.[111] As such, entity level discounts should be deducted from the value indicated by the basic approach or approaches used to value the privately held business. Since they apply to the company as a whole, entity-level discounts should be deducted before considering shareholder-level discounts and premiums.[112]

The Delaware courts have historically understood the necessity of entity-level adjustments. In *Tri-Continental v. Battye*,[113] the company being valued was a closed-end investment company. Because of this structure, shareholders of the company had no right at any time to demand their proportionate share of the company's assets. For this reason and due to the company's various leverage requirements, the market value of the corporation as a whole was lower than its net asset value, and this was referred to as a discount. The important distinction, however, is that this discount was applied to the whole corporation, not just the shares of a minority shareholder.

Several entity-level discounts may be applied in a fair value determination. In addition to the consideration of an entity-level marketability discounts, when applicable, the valuator must be ready to defend the usage of a trapped-in capital gains discount, a portfolio (nonhomogeneous assets) discount, a contingent liabilities discount, or a key man discount. In *Hodas v. Spectrum Tech., Inc.*,[114] a Delaware appraisal action, the court accepted the value determined by the company's expert, concluding that the individual staying with the company was the key man. The expert applied a 20% key man discount, because the company could not be viewed as a going concern without the key man and would likely not continue at all if the key man left. The court rejected the 40% entity-level lack of marketability discount applied by the appraiser because of the lack of a readily available market.

111. Atulya Sarin, John Koeplin and Alan C. Shapiro, "The Private Company Discount." *Journal of Applied Corporate Finance*, Vol. 12, No. 4, Winter 2000

112. Laro and Pratt, *Business Valuation and Taxes*, at 266.

113. 74 A.2d 71, 72 (Del. 1950).

114. No. CIV.A.11265, 1992 Del. Ch. LEXIS 252, (Dec. 7, 1992).

Control Premiums

Although many believe that there is little support for adding a premium to values determined through the use of the guideline company method, there are instances in these types of judicial matters for explicit consideration of such premiums. Accordingly, when ascertaining the value of a corporation for the purposes of an appraisal proceeding, a control premium may be applied, as the aim is generally to find the control value of the corporation as a whole or the value of the enterprise.

Rapid American v. Harris is such an example. Since *Rapid American v. Harris*,[115] the Delaware Court of Chancery has consistently applied a control premium where the company was a controlled subsidiary.

Rapid American v. Harris

In 1974, Meshulam Riklis, chairman and CEO of Rapid American Corporation (Rapid), began purchasing Rapid's shares in the open market through his holdings in Kenton Corporation and American Financial Corporation (AFC). Rapid also began repurchasing large blocks of its own shares, effectively increasing Riklis's control.

In 1980, Rapid announced a merger with Kenton. On the eve of the merger, Kenton and AFC controlled 46.5% of Rapid's stock. After the merger, Rapid's shareholders would receive a compensation package worth $28 per share, including $25 principal in a 10% sinking fund subordinated debenture, $3 cash, and an additional $.25, representing settlement consideration for pending derivative suits. Rapid employed an outside group, Standard Research Consultants, to review the fairness of the merger, and an examination concluded that the package was fair to Rapid's shareholders. The valuation technique used considered Rapid on a consolidated basis, based on an analysis of earnings and dividends. It figured each subsidiary's contribution to the parent's operating income for a set period of time.

Harris, a Rapid shareholder, retained Willamette Management Associates (WMA) to evaluate the merger. WMA reasoned that a segmented approach was appropriate because of the difficulty of finding a conglomerate comparable to Rapid, and evaluated each of Rapid's subsidiaries. The trial court ruled that WMA's segmented valuation was more reliable and ruled the fair value to be $51 per share. WMA examined the financial statements of the subsidiaries and the comparable companies to develop certain pricing multiples based on various factors. WMA included a control premium in the evaluation of each subsidiary. The Vice Chancellor rejected this, finding

115. 603 A.2d 796; 1992 Del. LEXIS 30

that the addition of a control premium violated Delaware law, which contravenes the proscription against weighing factors affecting shareholder-level valuation.

Rapid argued that WMA's valuation was incorrect on four counts:

1. The control premium
2. The valuation was based on a liquidation value of the subsidiaries
3. The valuation did not consider the value of the parent
4. WMA treated Rapid's debt at its market value rather than book value

With regard to the valuation at liquidation value, the court found no support for the valuation being similar to a liquidation approach, and WMA explicitly considered Rapid's subsidiaries as going concerns. In addition, the trial court explicitly considered parent-level financials and decided to exclude them.

Harris's cross-appeal claimed that the decision to exclude the control premium was a legal error, maintaining that WMA's valuation compared subsidiaries publicly traded equity value with the individual shares of similar corporations and that the market price of these corporations was discounted already, thereby giving Rapid a windfall at his expense. The appellate court reviewed the record and found that the trial court misinterpreted applicable legal precepts in omitting the control premium.

The appellate court acknowledged that a court is prohibited from adding a control premium at a shareholder level, reasoning that if the control premium arises out of the merger, it is not part of going concern value. In this case, however, the control premium represented a valid adjustment to the valuation at the company level against all assets. The share price that WMA arrived at was a price already at a discount from the control level, and therefore a premium would have to be employed to arrive at the value of a 100% ownership in the corporation.

The trial court's decision practically discounted Rapid's entire value, and the exclusion of the control premium effectively treated the whole corporation as a minority shareholder. The decision was remanded for recalculation of the value with any applicable control premium.

Along with *Rapid American v. Harris*, New Jersey's *Casey v. Brennan*[116] acknowledged the need for an entity-level control premium, in case an embedded or inherent minority discount may exist when valuing shares. In this case, the court rejected discounts and acknowledged the need for a control premium to reflect market realities and arrive at the value of the company as a whole, provided that anticipated future events are not included in that value.

116. 344 N.J. Super. 83; 780 A.2d 553; 2001 N.J. Super. LEXIS 331.

When performing a valuation, it is important for a valuation professional to support the use or nonuse of a control premium through fact and valuation theory. Generally such premiums may be appropriate if a control buyer can extract more cash flow from the enterprise than the company's current owner. For example, when using control cash flows in a discounted cash flow valuation method, a control premium is not warranted. In the Delaware case of *In re Radiology Assocs., Inc.*,[117] no control premium was applied because the DCF method used control cash flows. The application of a control premium to a DCF valuation was expressly rejected in Delaware in *Lane v. Cancer Treatment Centers of America, Inc.*[118] and in *Montgomery Cellular Holding Co., Inc. v. Dobler*.[119]

If the valuation professional uses a guideline public company method, the public multiples may result in a minority-marketable value. Therefore, a control premium may be necessary to derive the value of the enterprise. This was necessary in *Bomarko, Inc. v. International Telecharge, Inc*,[120] where the Court of Chancery supported the application of a control premium when the appraiser used the guideline public company method and the court found that this produced a minority value. The Court of Chancery has been quite consistent in applying a control premium to the results of the guideline public company method. In fact, in *Doft & Co. v. Travelocity.com, Inc.,*[121] the court added a control premium even though neither expert had done so.

Extraordinary Circumstances

The ALI suggests that fair value should be the value of the eligible holder's pro rata share of the enterprise value, without any discount for minority status or, absent extraordinary circumstances, lack of marketability. These so-called extraordinary circumstances require more than just a lack of a public market for shares. Instead, the court usually applies a discount only if merited by the circumstances of the case. The ALI offers the example of a dissenting shareholder withholding approval of a merger in an attempt to exploit the appraisal-triggering transaction in order to divert value to him- or herself at the expense of other shareholders. In that case, the court may make an adjustment.[122]

117. 611 A.2d 485, 498 (Del. Ch. 1991).

118. 2004 WL 1752847 (Del. Ch. 2004).

119. 2004 WL 2271592 (Del. Ch. 2004) and affirmed 2005 WL 1936157 (Del. 2005).

120. 794 a.2d 1161 (Del. Ch. 1999) and affirmed at 766 A.2d 437 (Del. 2000).

121. 2004 WL 1152338 (Del. Ch. 2004)

122. American Law Institute, *Principles of Corporate Governance*, at 325.

Devivo v. Devivo,[123] a Connecticut case, found similar results as *Advanced Communication Design, Inc. v. Follet* in Minnesota. The company would not be able to achieve the liquidity to compensate the departing shareholder, so the court applied a marketability discount in order to be fair to the parties involved.

Extraordinary circumstances are subject to review. In *Lawson Mardon Wheaton v. Smith*,[124] the trial court held that an extraordinary circumstance existed, considering that the dissenters exploited a change that they had previously supported. However, the New Jersey Supreme Court did not find substantial evidence to consider this an extraordinary circumstance. The court stated that the dissenters wanted to sell their stock back to the corporation because they had no confidence in the new management. The court believed that these stockholders were only exercising their right to dissent. The court held that to find extraordinary circumstances in this case would be inconsistent with the purpose of the statute.

The treatment of discounts is largely addressed by each state individually. While some states have adopted the 1999 RMBCA definition of fair value, that prohibits discounts, other states either have unique definitions or adhere to the 1984 RMBCA definition and leave the decision on discounts to the judgment of the courts. However, the statutory definition and precedent set by case law are not set in stone. For example, Georgia's courts set the precedent in 1984 in *Atlantic States Construction v. Beavers*[125] to apply minority discounts but not marketability discounts. In 2000, however, this was overturned by *Blitch v. People's Bank*,[126] where the court rejected the application of minority or marketability discounts at the shareholder level.

Exhibits 3.6 through 3.10 summarize some of the more important state and federal court decisions on the application of discounts. The published opinions that have addressed these issues vary considerably from state to state. Some reject discounts by statute, others by case law. Some apply discounts consistently, others on a case-by-case basis, depending on the specific circumstances of each case. Some states have applied control premiums under certain specific circumstances.

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123. 2001 Conn. Super. LEXIS 1285.

124. 160 N.J. 383, 397, 734 A.2d 738 (1999).

125. 169 Ga. App. 584; 314 S.E.2d 245; 1984 Ga. App. LEXIS 1640.

126. 264 Ga. App. 453, 540 S.E. 2d 667 (2000).

Exhibit 3.6 Cases From States Rejecting Discounts by Statute[a]

Connecticut[b] (2001)	*Devivo v. Devivo*, 30 Conn. L. Rptr. 52, 2001 WL 577072, 2001** (allowed discounts due to extraordinary circumstances, prior to statutory rejection). A minority shareholder in a motor transportation company sought dissolution due to oppression and a deadlock of management. Although a marketability discount would not normally be allowed, this was an extraordinary circumstance because of the corporation's existing debt and market conditions that would limit further growth. The court applied a marketability discount of 35% because of these extraordinary circumstances.
Florida[c] (2006)	*Munshower v. Kolbenheyer*, (1999) 732 So 2d 385, (marketability only). The minority shareholder brought a dissolution proceeding and the corporation elected to purchase the minority shares in lieu of dissolution. The court noted that a discount for lack of marketability is generally necessary because shares of a closely held corporation cannot readily be sold.
Iowa (2002)	*Security State Bank v. Ziegeldorf*, 554 N.W. 2d 884, 889 (Iowa 1996). Refused to allow discounts for minority interest. Quoted *Woodward v. Quigley* that it "in effect would let the majority force the minority out without paying it its fair share of the value of the new corporation." *Sieg Co. v. Kelly*, 568 N.W. 2d 794 (1997). In a shareholder dissent case, the trial court allowed a marketability discount. The Supreme Court found the overall approach to valuation convincing; however, Iowa law was clear that a marketability discount was not permitted.
Maine (2003)	*Re Valuation of Common Stock of McLoon Oil Co.*, 565 A2d 997 (1989). Minority shareholders demanded the fair value of their stock in a closely held family corporation in a dissenter's rights proceeding. Their father sought to merge them into another company where he would have sole voting control. The court held that the shareholder who disapproves of a proposed merger gives up his right of veto in exchange for the right to be bought out, not at market value, but at fair value. Therefore the court stated that as a matter of law, the dissenting shareholders should receive their proportionate share of the corporation without any discounts.
South Dakota (2005)	*First Western Bank of Wall v. Kenneth Olsen, et al.*, 2001 SD 16 (2001). In a dissenting shareholder matter involving a regional bank with branches in four cities, the South Dakota Supreme Court concluded that the proper standard of value in a dissenting shareholder action is fair value. It further concluded that discounts for minority interest and lack of marketability were improper under this standard of value.
Virginia (2005)	*U. S. Inspect, Inc. v. McGreevy*, 57 Va. Cir. (2000). A corporation in which the shareholder held stock proposed to merge into its inactive subsidiary. A minority shareholder dissented. Her stock was valued based on her proportionate interest in the corporation as if the proposed merger had not taken place. The court found that it was not appropriate to apply either a minority or marketability discount to valuation of the shareholder's interest, nor was the shareholder entitled to a control premium.

[a]These cases were decided prior to when the statutes rejecting discounts were instituted. Parentheses represent dates when statutes were instituted. Idaho, Mississippi, and Maine also reject discounts by statute; however, there is currently no case law addressing the topic, whether before or after the insitution of the statutory provision.

[b]Courts in this state have considered the ALI's concept of extraordinary circumstances in their decisions.

[c]Florida adopted statutory changes rejecting discounts in 2006. There does not appear to be any current case law utilizing these new guidelines.

Exhibit 3.7 Cases Rejecting Discounts

Colorado	*Pueblo Bancorporation v. Lindoe, Inc.*, 37 P.3d 492 (2003). A divided Colorado Supreme Court affirmed the Court of Appeals' decision denying a lack of marketability discount when determining fair value under Colorado's dissenters' rights statute. It noted that the trial court must first determine the value of the corporation as a going concern and the pro rata value of each outstanding share. Except for under extraordinary circumstances, discounts should not be applied. *M Life Ins. Co. v. Sapers & Wallack Ins. Agency*, 40 P. 3d 6, 13 (Colo Ct. App. 2001). Minority discount was not applicable as a matter of law.
Delaware	*Cavalier Oil Corp v. Harnett,* Civ. A Nos 7959-60 7967-68, 1988 WL 15816 at *8 (Dl. Ch. Feb. 22, 1988). The court stated that minority and marketability discounts are improper under Delaware law.
Georgia	*Blitch v. People's Bank*, 264 Ga. App. 453, 540 S.E. 2d 667 (2000). In a dissenters' rights proceeding, the appraiser applied both minority and marketability discounts. The court held that the Georgia statutes clearly stated that the discounts were not applicable for fair value determinations.
Kansas	*Katherine B. Arnaud, et al. v. Stockgrowers State Bank of Ashland, Kansas and Stockgrowers Banc Corp.*, 992 P.2d 216 (Kan. 1999). The Kansas Supreme Court ruled that minority and marketability discounts are not appropriate when the purchaser of stock is the corporation or the majority.
Indiana	*Wenzel v. Hopper & Galliher, P.C.*, 779 N.E.2d 30 (2002). A law firm requested the determination of fair value of shares owned by a shareholder who was leaving the company. The value of shares was not discounted, as discounts would unfairly benefit the buyer of the shares. The purchase of shares created a ready-made market for those shares.
Massachusetts	*BNE Mass Corp v. Sims*, 588 N.E.2d 14, 19 (Mass App. Ct. 1992). Although not discussing the applicability of a discount, the court stated that the task assigned to a court by the statute was to determine what a willing buyer would pay for the enterprise as a whole on the valuation date, as opposed to the per share value. That way, the minority stockholders could be assured that controlling shareholders may not purchase the enterprise at a price less than they would receive in the open market. The court cited *Re Valuation of Common Stock of McLoon Oil*, 565 A2d 997 (1989), citing that any rule of law that gives the shareholders less than their proportionate value would produce a transfer of wealth from the minority to the shareholder in control.
Montana	*Hansen v. 75 Ranch Co.*, 1998 MT 77, 957 P.2d 32 (1998). The Supreme Court reversed a lower court's determination of fair value in this dissent action. The minority shareholders dissented from a share exchange. The Supreme Court concluded that the dissenting shareholders were entitled to fair value just prior to the event. It rejected the application of a minority discount as inappropriate when the shares are purchased by the company or an insider.

Exhibit 3.7 Continued

Nebraska	*Rigel Corp. v. Cutchall*, 245 Neb. 118 (1994). A minority shareholder dissented from a merger in order to recover the fair value of his shares. The trial court allowed a discount to the value due to the stockholder's minority position. The appellate court reviewed case law and recent trends and decided that in the event of a merger, neither a minority discount nor a deduction for lack of marketability was allowed in determining the fair value.
Oklahoma	*Woolf v. Universal Fidelity Life Ins. Co.*, 849 P2d 1093 (1992). An insurance company proposed changes to its articles of incorporation. Some shareholders pursued their dissenters' rights. The trial court applied a 12% minority discount to the value of their shares. The appellate court ruled that as the Oklahoma dissenters' rights statute was based on Delaware's, it should apply Delaware's understanding of fair value and disallow the application of discounts.
Oregon	*Hayes v. Olmsted & Associates, Inc.* (2001). 173 Or. App. 259, 21 P.3d 178. A disgruntled shareholder alleged oppression in a food brokerage firm. The firm agreed to purchase his shares. The court found that the minority shareholder was entitled to recover his pro rata interest without regard to discounts applicable in other settings. *Columbia Management Corporation v. Wyss*, 765 P.2d 207, 214 (Or. Ct. App. 1988). The court decided that including a minority discount would penalize the shareholder while allowing the corporation to buy his shares cheaply. It felt that the legislation was not put in place for this purpose and denied application of the discount.
Rhode Island	*Diluglio v. PAB*, 1997 WL 839873, summarily affd 755 A.2d 757 (R.I. 2000). The minority shareholder cited a breach of fiduciary duty and filed for dissolution. The court ordered a buy-out at an undiscounted price. The majority shareholder claimed that a marketability discount could be applied at the entity level instead of the shareholder level. Reviewing prior cases, the court rejected the reasoning based on fact that because the buy-out was under the compulsion of the court, the lack of public market for the shares is irrelevant. *Charland v. Country View Golf Club, Inc.*, 588 A.2d 609, 612 (R.I. 1991). The court adopted a rule that in a buy-out alternative remedy, shares should not be discounted simply due to minority status.
South Carolina	*Morrow v. Martschink*, 922 F. Supp. 1093 (1995). An action was brought for the dissolution of a closely held realty corporation. The parties agreed to allow the court to determine the fair value for the purpose of a buy-out. The court found that discounts were not applicable in intrafamily transfers in closely held company or in a forced sale situation.
Vermont	*Arnold D. Waller v. American International Distribution Corporation, et al.*, 706 A.2d 460 (Vt. 1997). In a shareholder oppression case, oppression was found and the Vermont Supreme Court affirmed the lower court valuation of the company using the discounted future earnings method. It concluded that a minority discount was inapplicable in cases where oppression has been found.

(*continues*)

Exhibit 3.7 Continued

Washington	*Matthew G. Norton Co. v. Smyth*, 51 P.3d 159 (2002). The court noted that fair value did not include shareholder-level discounts under the dissenter's right statute. However, the discount could be applied to the company assets at the corporate level. The court noted that fair value was not intended to mean fair market value. *Robblee v. Robblee*, 841 P.2d 1289, 1295 (Wash. Ct. App. 1992). In this case, the court found no justification to apply a "fair market value minority discount."
Wisconsin	*HMO-W Incorporated v. SSM Health Care System, et al.*, 228 Wis.2d 815 (Ct. App. 1999). In a dissenting shareholder action, the Wisconsin Court of Appeals reversed the lower court's decision to apply a minority discount. The court concluded that dissenting shareholders have the statutory right to receive their pro rata interest in the company's net value, without being discounted for minority status.

Exhibit 3.8 Cases Applying Discounts

Kentucky	*Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553, (1982). (marketability only). The company called a stockholders meeting to approve the sale of the company to a potential buyer. The sale was approved, but dissenting stockholders elected to demand payment of the fair value of their shares. The appellate court upheld a 25% marketability discount applied by the trial court.
Louisiana (Fair Cash Value)	*Shopf v. Marina Del Ray Partnership*, 549 So. 2d 833 (1989). The minority shareholder sought a determination of the sum value of his 12% share in the partnership. Although the book value was negative, the fair market value was to be determined. A minority discount was applied to the fair market value.
New York (marketability discount only)	*In re: Brooklyn Home Dialysis Training Center, Inc.*, 741 N.Y.S.2d 280 (App. Div. 2d Dep't 2002). The court applied a 22.5% marketability discount in a dissolution matter. The appellate court's opinion did not disclose the nature of the company or the reason for the discount, but approved the use of the discount after concluding that the court's reliance on the investment value approach was appropriate. *Blake v. Blake Agency, Inc.*, 486 N.Y.S. 2d 341, 349 (N.Y. App. Div. 1985). The court held that a minority interest in closely held corporate stock should not be discounted solely because it is a minority interest.
Ohio (Fair Cash Value)	*English v. Atromik International, Inc.*, 2000 Ohio App. (both discounts applied). An owner and employee of a corporation refused a monetary offer for his stock and requested a judicial determination of value. The trial court concluded that a straight pro rata valuation of appellant's stock was inappropriate. Instead, the trial court applied the willing buyer–willing seller approach and determined that minority and marketability discounts were appropriate. The appellate court upheld the application of the discounts.

Exhibit 3.9 Discounts Decided by Court's Discretion

Alabama	*Ex parte Baron Services, Inc.*, 874 So. 2d 545 (2003). The corporation organized a stock for stock merger where the minority shareholder would be left with just under the required amount of shares to remain a shareholder in the corporation. The shareholder dissented and demanded the fair value of his shares. The court looked to the 1999 changes in the MBCA and the Georgia case of *Blitch v. People's Bank* as indicative of the trend relating to the application of discounts and overturned the lower court's application of discounts.
Arizona[a]	*Pro Finish USA, Ltd. v. Johnson*, 63 P.3d 288 (2003). In a case involving a nail care business being sold in its entirety to an outside investor, a dissenter claimed his rights to the fair value of his shares. The court looked to the *Principles of Corporate Governance's* concept of extraordinary circumstances and the trend in Delaware for disallowing discounts. It ultimately rejected the application of discounts on the minority's shares.
California	*Gary Thompson, Et al. v. Allen B. Miller, et al.*, No. C037787 (Cal. App. 3 Dist. 2003). The California Court of Appeals, Third District, affirmed a jury's determination that a majority shareholder did not breach his fiduciary duty when he purchased the minority shareholders' stock. The valuation included discounts for lack of marketability and minority interest, and the jury upheld this valuation. The appellate court noted that because there was testimony endorsing the discount for lack of marketability and because the plaintiffs did not request a jury instruction to disregard the discount, consideration of the discount was appropriate. *Brown v. Allied Corrugated Box Co.*, 154 Cal. Rptr. 170, 176 (Ct App. 1979). If minority shares could be discounted, the very misconduct and unfairness that provoked the minority shareholders to file for dissolution would be used to further oppress them.
Illinois	*Jahn v. Kinderman*, 286 Ill. Dec. 466, 814 N.E.2d 116 (2004). The Illinois Court of Appeals, First Division affirmed the lower court's decision denying a discount for lack of marketability in a fair value determination in a buy-out election. The court found that the substantial dividends and employment opportunities presented by stock ownership in the subject company offset any potential impact on marketability presented by a restricted shareholders' agreement. Also, applying discounts is contrary to the current trend seen in the courts.
Minnesota[a]	*Rainforest Café, Inc. v. State of Wisconsin Inv. Bd.*, 677 N.W. 2d 443 (2004). The court stated in this dissenter's rights proceeding that the fair value is the pro rata share of the value of the corporation as a going concern. *Advanced Communication Design, Inc. v. Follett*, 615 N.W.2d 285 (2000). A minority shareholder in a closely held corporation in the communications design business sought dissolution as a counterclaim to the company's suit against him for breach of fiduciary duty. The Minnesota Supreme Court reviewed the statute and noted that it was designed to produce a fair and equitable result, and that the allowance of a marketability discount may allow the corporation to reap the benefits of oppression.

(*continues*)

Exhibit 3.9 Continued

Minnesota[a] (*continued*)	At the same time, the court chose not to apply a bright-line rule barring marketability discounts in all cases as that may not be equitable from case to case. The court noted that the exclusion of a marketability discount in this case yielded a valuation that was in excess of the company's operating cash flow, net income, or net worth. The court employed a marketability discount to yield a more equitable value at which the minority shareholder could be bought out. *MT Props Inc. v. CMC Real Estate Corp.*, 481 N.W. 2d 383, 388 (Minn. Ct. App. 1992) The court held that the aim of the statute was to protect the dissenting shareholder, and therefore, minority discounts must be prohibited.
Missouri	*King v. F. T. J., Inc.*, 765 SW2d 301 (1988). The appellate court upheld the trial court's application of a minority discount. The court noted that the term *fair value* is a flexible standard and that deference is to be given to the trial court's examination of witnesses and evidence. The corporation's experts applied a 15% discount on the total value but the trial court reduced the discount to 7%, calculating that half the company's assets were not marketable.
Nevada	*Steiner v. Benninghoff*, 5F. Supp. 2d 1117, 1129 (1998). In this case, the court utilized a weighted combination of market value of the shares including a marketability discount, an enterprise value of the company as a whole, the premerger net asset value of the company, and any other relevant factors. The market value was weighted 25%, the enterprise value was weighted 75%, and the other factors were given no weight in determining the value of the shares.
New Jersey[a]	*Balsamides v. Protameen Chemicals, Inc.*, 160 N.J. 352, 734 A.2d 721 (1999). A shareholder claimed oppression and brought a dissolution action against his cosmetic chemical company. The court ordered the other shareholder to sell his interest in the company to the petitioner. The court applied a 30% marketability discount to ensure that the oppressing shareholder was not unjustly enriched by the undiscounted value of his shares as the oppressed shareholder would incur the effects of the diminished value if he were ultimately to sell the company to an outside investor. *Lawson Mardon Wheaton Inc. v. Smith*, 160 N.J. 383, 397, 734 A.2d 738 (1999). On the same day as Balsamides, in a dissenter's appraisal case, the court ruled against a marketability discount in determining the dissenter's share value. Although the trial court had considered this an extraordinary circumstance because of the actions of the dissenters, the New Jersey Supreme Court concluded that the stockholders were only exercising their right to dissent, which did not warrant application of a marketability discount.
New Mexico	*McCauley v. Tom McCauley & Son, Inc.*, 104 NM 523, 724 P2d 232 (1986). In a dissolution proceeding, the trial court applied a 25% minority discount in a closely held family corporation. Oppression was found, and the plaintiff argued that had the court ordered liquidation, she would have received her proportionate share of the corporation's assets. The court noted that the trial court was not bound simply to order dissolution but to choose from a variety of available remedies.

Exhibit 3.9 Continued

North Carolina	*Tammy Garlock, et al. v. Southeastern Gas & Power, Inc., et al.*, No. 00-CVS-01018 (N.C. Supr. 2001). The North Carolina Superior Court determined the fair value of a 39% interest in a natural gas marketing company. The court determined that oppression had occurred. The court appointed appraiser used an income approach and applied a high-risk equity premium, a lack of marketability discount, and a key man discount. The court declined to apply a lack of marketability discount, but approved consideration of the key man position as well as the lack of any noncompete agreement. *Royals v. Piedmont Elec. Repair Co.*, No. 97 CVS 7201999, WL 35545516 at *13 (N.C. Super. Ct. Mar. 3, 1999). The court stated that North Carolina law does not favor the application of discounts.
Utah[a]	*Hogle v. Zinetics Medical, Inc.*, 2002 UT 121, 63 P.3d 80. In a dissenter's rights proceeding, the court rejected discounts or control premiums in determining fair value under dissenters' rights statute. It went on to note that the shareholders are entitled to the proportionate share of the value of 100% of the equity without discounting for minority status or, absent extraordinary circumstances, lack of marketability.

[a]Courts in this state have considered the ALI's concept of extraordinary circumstances in their decisions.

Exhibit 3.10 Control Premiums Applied

Delaware	*Robert Michael Lane v. Cancer Treatment Centers of America, Inc.*, No. 12207 (Del. Chan. 2004). The experts disagreed on the future prospects of the company, coming up with different values. The court valued the emerging business using a weighted combination of the discounted cashflow (85%) and the public guideline companies (15%) methods. It included a 20% control premium in the public guideline companies method to account for the inherent minority interest discount, but declined to apply such a discount to account for the use of public company data when calculating the weighted average cost of capital (WACC).
New Jersey	*Casey v. Brennan*, 780 A.2d 553 (2001). The trial court excluded a control premium as a matter of law. Upon review, the Supreme Court ruled that control premiums must be considered and should reflect market realities, as long as the expected synergies of the merger are not included.
Vermont	*In re: 75,629 Shares of Common Stock of Trapp Family Lodge, Inc.*, 169 Vt. 82. (1999). Dissenting shareholders dissented to a merger, and the court upheld the application of a control premium.

A number of states have no published court decisions concerning shareholder-level discounts in dissent or oppression case law.[127]

Although appraisal is a state court remedy, federal cases arise in multijurisdictional matters. They generally follow the law established in the states in their jurisdiction. Exhibit 3.11 shows various jurisdictions and their decisions on the subject of applying discounts. Many of these cases date from the late 1980s and early 1990s when the states applied discounts. Because dissent and oppression cases are based on state law, we would expect the federal courts to follow the most recent state court decisions in their jurisdictions. As a result, practitioners should seek legal guidance concerning the application of minority and marketability discounts in the applicable jurisdiction.

EQUITABLE ADJUSTMENTS

Delaware's Entire Fairness

Delaware does not have a shareholder oppression statute; instead, if a minority shareholder dissents, wrongful conduct by the majority is addressed under the expectation of entire fairness in determining the value of a corporation's shares. The requirement of entire fairness dictates to the Delaware courts whether adjustments or damage claims may be included along with the determination of fair value.

The standards of fair dealing and fair price require that value be determined by independent valuation showing fairness to minority shareholders. To comply with "entire fairness," a company must show consideration in the form of absolute and relative fairness. Absolute fairness addresses whether the consideration received by the shareholder was adequate relative to the value of the interest that was given up. Relative fairness addresses whether the consideration received was fair in comparison with what other stockholders received.[128]

There also must be procedural fairness, in terms of the independence of legal counsel, accountants, and appraisers from the influences of the controlling shareholders. The valuation also should be performed with competence and

127. Alaska, Arkansas, District of Columbia, Hawaii, Idaho, Maryland, Michigan, Mississippi, New Hampshire, North Dakota, Pennsylvania, Puerto Rico, Tennessee, Texas, West Virginia, Wyoming.

128. Shannon P. Pratt, Robert Reilly, and Robert Schweihs, *Valuing a Business*, 4th ed. (New York: McGraw-Hill,(2000), at 792.

Exhibit 3.11 Federal Cases

8th Circuit: Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota	Swope v. Siegel-Robert, Inc., 243 F.3d 486, 492 (8th Cir. 2001): Rejects discounts. (U.S. Supreme Court denied certification.)
5th Circuit: Texas, Mississippi, Louisiana	*Hernando Bank v. Huff*, 609 F. Supp. 1124, 1126 (N.D. Miss. 1985): Applied minority discount reviewing Mississippi law in 1985. Mississippi now rejects discounts by statute.
Eastern District of Missouri	*Hunter v. Mitek Indus.*, 721 F. Supp. 1102, 1106-07 (E.D. Mo. 1989): Following *Dreiseszun v. FLM Indus., Inc.*, 577 S.W.2d 902, 907 (Mo. Ct. App. 1979), refused to apply minority or marketability discounts. The most recent Missouri decision rejected discounts but left that determination to the court's discretion.
Northern District Indiana	*Perlman v. Permonite Mfg. Co.*, 568 F. Supp. 222 (N.D. Ind. 1983): Determined fair market value of a minority interest including discount for minority lack of control. Indiana law now rejects the use of discounts after the decision in *Wenzel v. Hopper* and *Galliher*.
6th Circuit: Northern District Ohio	*Martin v. Martin Bros. Container & Timber Products Corp.*, 241 F. Supp. 2d 815 (2003): Applied discount applying the Ohio standard of fair cash value.
8th Circuit: District of Minnesota	*Foy v. Klapmeier*, 992 F.2d 774, 780-81 (8th Cir. 1993): Applying Minnesota law, the court decided minority discounts should not be applied in dissenter's cases.
7th Circuit: Northern District Illinois	*Laserage Technology Corp. v. Laserage Laboratories, Inc.*, 972 F2d 799 applying Illinois law from *Stanton v. Republic Bank of South Chicago,* 144 Ill. 2d 472, 581 N.E.2d 678, 682, 163 Ill. Dec. 524 (Ill. 1991), that in accordance with Illinois Supreme Court, "the determination of fair value is a matter vested in the sound discretion of the fact finder, and will not be disturbed absent mistake or prejudice." Discounts were rejected.

thoroughness. The board has fiduciary responsibility to the minority shareholders in making recommendations to the company.[129]

Complying with the standard of entire fairness can give proof to the court of the corporation's intention to show due care and consideration to the minority shareholders. A corporation can demonstrate that it is upholding its fiduciary duty by showing due care to shareholders and by doing so may avoid the burden of damages or fees for the mistreatment of the minority shareholder.

There are also consequences for a failure to adhere to these requirements. Lack of entire fairness implies that the directors violated the duty owed to the shareholders. If the shareholders establish that the board has violated the duty of fairness, then the measure of damages may go beyond the basic determination of fair value.[130] If, in a buy-out, the court determines that minority shares have a fair value of $40 million and the corporation offered $10 million, the court may see fit to award the shareholder the $40 million plus damages for expenses and inconvenience. The next two cases, *Seagraves v. Urstadt Property Co, Inc.*[131] and *Bomarko, Inc. v. International Telecharge, Inc.*,[132] deal with decisions based on the corporation's entire fairness to minority shareholders.

Seagraves v. Urstadt Property Co., Inc.

A group of plaintiffs brought a class action suit against Urstadt Property Co. that would ultimately involve many more plaintiffs than those who had asserted their dissenter's rights. The company requested that it pay the amount due under an appraisal remedy to avoid a class action trial. The court denied the request, stating that the company did not seek a fairness opinion at the time of the merger, nor did it establish an independent committee to safeguard the interests of the minority shareholders, and other undisclosed information may have affected the share price.

Bomarko, Inc. v. International Telecharge, Inc.

Here the court found a lack of entire fairness. The board had appointed a special committee, but it did not retain experts to develop opinions of fair value prior to the merger. Some actions were taken without the board's knowl-

129. Id. at 793

130. Id. at 794.

131. 21 Del. J. Corp. L. 1281 (Del. Ch. 1996).

132. 794 A.2d 1161 (Del. Ch. 1999) and affirmed at 766 A.2d 437 (Del. 2000).

edge, and one principal was ordered to return an $8 million payment he had received. The court awarded the plaintiffs $2.34 per share as opposed to the $0.30 they were offered at the merger.[133]

Consideration of Wrongdoing in Calculating Fair Value

In states that have both dissenter's rights and oppression statutes, the definition of fair value is usually stated in connection with the dissenter's rights statute, unless the circumstance or the standard of value in oppression is different. As previously mentioned, California's dissolution statute contains an entirely unique definition of fair value, *fair value in liquidation*, while the state's dissenter's rights statutes use fair market value.

Although many cases consider fair value in dissent and oppression cases to be largely the same concept, the nature of the events leading to the valuation can have an effect on how the court determines what is fair. For example, New Jersey's dissolution statute offers equitable adjustments to fair value in cases of oppression. The text of the statute is:

> The purchase price of any shares so sold shall be their fair value as of the date of the commencement of the action or such earlier or later date deemed equitable by the court, plus or minus any adjustments deemed equitable by the court if the action was brought in whole or in part under paragraph 14A:12-7(1)(c).[134]

The official comment to the 1991 changes to the RMBCA leaves room for the court to consider the circumstances of the case in determining fair value:

> If the court finds that the value of a corporation has been diminished by the wrongful conduct of controlling shareholders, it would be appropriate to include as an element of fair value the petitioner's proportional claim for any corporate injury.[135]

The official comment to the 1999 changes to the RMBCA's definition of fair value asserts that although the new definition denies the application of discounts, fair value in dissenting shareholder matters should be seen as different

133. Fishman, Pratt, and Griffith, "PPC's Guide to Business Valuation," at 1504.4.

134. N.J. Statute 14A:12-7–8(a).

135. Id.

from fair value in dissolution matters because of the differing circumstances of majority conduct in oppression and dissent cases.[136] The comment states:

> Section 14.34 (oppression) does not specify the components of "Fair Value," and the court may find it useful to consider valuation methods that would be relevant to a judicial appraisal of shares under section 13.30 (dissent). The two proceedings are not wholly analogous, however, and the court should consider all relevant facts and circumstances of the particular case in determining fair value. For example, liquidating value may be relevant in cases of deadlock but an inappropriate measure in other cases. If the court finds that the value of the corporation has been diminished by the wrongful conduct of controlling shareholders, it would be appropriate to include as an element of fair value the petitioner's proportional claim for any compensable corporate injury. In cases where there is dissension but no evidence of wrongful conduct, fair value should be determined with reference to what the petitioner would likely receive in a voluntary sale of shares to a third party, taking into account his minority status. If the parties have previously entered into a shareholders' agreement that defines or provides a method for determining the fair value of shares to be sold, the court should look to such definition or method unless the court decides it would be unjust or inequitable to do so in light of the facts and circumstances of the particular case. The valuation date is set as the day before the filing of the petition under section 14.30, although the court may choose an earlier or later date if appropriate under the circumstances of the particular case.

Last, it appears that a well-written buy-sell agreement can be useful concerning the fair value buy-out of minority shareholders. The valuation professional should be cognizant of the provisions outlined in the buy-sell agreement as it pertains to a valuation. Such agreement may even permit the corporate activity that has caused the shareholder to dissent. In that case, the court may not look favorably on the dissenter, as he or she should have been aware of a buy-sell provision.

The comment suggests that in cases of appraisal pursuant to a dissent action, an individual should receive the undiscounted proportionate value of the company as a going concern. In an oppression action, there are many other considerations caused by the degree of oppression and misconduct by the ma-

136. American Bar Association, A Report of the Committee of Corporate Laws, "Changes in the Revised Model Business Corporation Act—Appraisal Rights," *The Business Lawyer* 54(1998), at 209.

jority. In the buy-out remedy, as evidenced by this passage, the company may elect to buy out the shareholder at fair value before a proceeding occurs, or the court can go on with the proceeding. This leaves four scenarios when oppression is alleged:

1. If the company elects the buy-out, fair value is to be paid.
2. If the company does not elect the buy-out option and the court finds that oppression has occurred, the company will ultimately pay fair value, plus any equitable adjustments the court requires.
3. If the court finds no oppression, the shareholder will likely not recover the fair value as a percentage of enterprise value, and the court may look to what the shareholder's share would bring on the open market, considering his or her minority status. This would imply the application of shareholder-level discounts.
4. If the court finds no oppression, there may be no buy-out and the shareholder may be compelled to remain with the corporation.

If there is a chance the corporation will be found to have committed acts of oppression, fraud, mismanagement, abuse; or if the corporation anticipates dissolution being the outcome of the court proceeding; or if the corporation wants to avoid the court proceeding altogether, it may elect to purchase the petitioner's shares at their fair value within the statutory time frame.[137] In this case, the dissolution proceeding will be put on hold (but not terminated) until an equitable settlement has been negotiated. One New York decision stated:

> Once the corporation has elected to buy the petitioning stockholders' shares at fair value, the issue of majority wrongdoing is superfluous.[138]

Electing to buy out may also help the corporation avoid the "equitable adjustments" the court might make in a case where wrongdoing is found, as well as other costs associated with a court proceeding. The unpublished Connecticut case *Johnson v. Johnson*[139] is particularly illuminating with respect to the treatment of fair value when wrongdoing is in question.

137. Douglass Moll, "Shareholder Oppression & Fair Value: of Discounts, Dates, and Dastardly Deeds in the Close Corporation," 54 *Duke Law Journal* 293 (2005), at 369.

138. *In Re Friedman*, 661 N.E. 2d 972, 976 (NY 1985).

139. 2001 Conn. Super. LEXIS 2430 X07CV990060602S.

Johnson v. Johnson

A close family corporation, Johnson Corrugated Products Corporation involved siblings James, Cindy, and Randy Johnson and two unrelated board members. A suit was filed in 1999 by James and Cindy Johnson against their brother Randy for dissolution due to an alleged breach of fiduciary duty.

The corporation manufactured corrugated boxes. It was formed in 1964 by the litigants' father. Cindy and James each owned 7.8 shares, representing a 30.83% equity interest in the corporation. Cindy had been employed by the corporation for several years and took maternity leave in 1994. She tried to resume her employment in 1997, but Randy had blocked her return. Despite her absence, Cindy continued to be paid under a 1992 employment agreement. She believed that her stock ownership entitled her to employment, membership on the board of directors, and a share of the corporate profits.

James was employed at the corporation for 20 years, filling in as a handyman and floater where needed. After suffering a traumatic head injury, he felt that his father promised him he could always work at the company. He also believed that he was entitled to a position on the board of directors as a member of the Johnson family. He also continued to receive wages, although he no longer worked at the corporation.

Randy owned the remaining equity in the corporation, representing a majority share. He also functioned as the chief executive officer, majority shareholder, and chairman of the board of directors. He had substantial knowledge of the production process of the corporation.

Cindy and James asserted that Randy had acted in a manner that was illegal, oppressive, or fraudulent. The corporation elected to purchase the plaintiffs' stock with fair value to be ascertained by the court.

The experts came up with widely different figures, due to various factors, including the money to be saved by the installation of a new corrugator, the extent of excessive compensation, and depreciation.

With respect to the corrugator, minutes of a meeting suggested that the corrugator could save up to $700,000—the figure used by the plaintiffs' expert. Upon review of known and knowable details at the valuation date, the court concluded that this was wishful thinking on the part of the board of directors rather than fact and declared that no prudent investor would rely on that figure.

The excessive compensation was also a factor in the valuation. Although the compensation was not found to be tantamount to corporate waste, it did amount to more than a prudent investor would anticipate paying a competent nonowner CEO and financial officer. The compensation was set at $262,250 for valuation rather than the $333,536 Randy was receiving.

The court went on to determine that the equity value of the corporation was between the values of the two experts. The court stated that the fair value of the plaintiffs' shares cannot be determined by a simple apportionment based on ownership percentage, because the statute allows consideration of fraud, waste, and oppressive conduct as well as the minority status of shares being valued.

The court asserted that if no agreement on fair value could be reached, in a case of dissension where there is no evidence of wrongful conduct, fair value should be determined with reference to the value in a voluntary sale to a third party.

The plaintiffs argued that their apportioned value should be increased due to the defendant's oppressive and wasteful conduct, while the defendant argued that his apportionment should be increased due to the plaintiffs' minority status and the limited marketability of the minority shares.

The court was not persuaded by the defendant's marketability discount argument, as evidence suggests that the corporation enjoyed a niche in the market and the shares would be attractive to outside buyers. In addition, the court suggested that the appraiser should take the projected rate of return that a reasonable investor would require into consideration in assessing the risk factors flowing from the characteristics of the corporation. The court did find, however, that a 20% reduction in value due to minority status was acceptable.

In regard to additional compensation to the plaintiffs because of waste and oppression, the Superior Court of Connecticut looked to the RMBCA for guidance and concluded that if the value of the corporation had been diminished by the wrongful conduct of the controlling shareholders, a proportional claim for corporate injury could be assessed.

The plaintiffs claimed that the failure of the corporation to declare dividends was oppressive, but the corporation had never declared dividends, and this was a company policy since the inception of the corporation. The plaintiffs also claimed that exclusion from the board of directors and employment was oppressive and that they should be compensated for Randy's excess compensation. The court found that these claims did not amount to oppression, considering the circumstances of this case, and that the equity value of the corporation already took into account the compensation when normalizing executive income. The court determined no further adjustments were necessary.

The finding of dissension without oppression caused the court to dissolve the corporation and ascertain fair value based on the third-party sale value—concluding that a minority discount was appropriate while a marketability discount was already accounted for in the projected rate of return. As no wrongdoing had occurred, the court did not find any adjustments necessary to the value of shares in favor of the plaintiffs.

The difference in fair value could be significant, based on the particular fact pattern and the statutes and case law of a specific state. Bearing in mind that

Connecticut follows the 1999 RMBCA definition of fair value and thereby rejects discounts for dissent and oppression matters, it appears that the court could have decided the case in these ways:

- Found oppressive behavior and disallowed minority and marketability discounts and adjusted the value for corporate waste
- Found dissension and no oppression (which it did) and then considered minority and marketability discounts

Discounts Used as an "Equitable Adjustment"

Equitable adjustments are one of the tools the courts can use to achieve what they believe to be an equitable result. The courts have used equitable adjustments in cases where they have perceived dishonorable, fraudulent, oppressive, or illegal behavior. An equitable adjustment may be the award of damages, expert fees, and attorney fees. In other circumstances, the courts may adjust a fair value determination by using discounts and premiums to raise or lower the value of the shares, to achieve what is perceived to be an equitable result. In doing this, the court may or may not strictly adhere to all of the underlying assumptions that valuation professionals commonly associate with fair value.

By virtue of the definition of fair value in the New Jersey dissolution statute,[140] the New Jersey court can make equitable adjustments in the case of illegal, oppressive, or fraudulent conduct. For instance, the court may adjust the valuation date or make inclusions or exclusions of certain elements in the calculation of fair value. An example of this a New Jersey oppression case *Balsamides v. Protameen Chemicals*,[141] in which discounts were used to lessen the value of the shares in the corporation, because the oppressed shareholder would be remaining with the corporation. The very same day, a complementary decision was handed down in a dissent case, *Lawson Mardon Wheaton v. Smith*.[142] In both cases, the court considered the equities of the circumstances before making its decision.

140. N.J. statute 14(A):12-7(8)(a).

141. 160 N.J. 352; 734 A.2d 721; 1999 N.J. LEXIS 836.

142. *Lawson Mardon Wheaton Inc. v. Smith*, 160 N.J. 383; 734 A.2d 738; 1999 N.J. LEXIS 835).

Balsamides v. Protameen Chemicals, Inc.

Emanuel Balsamides and Leonard Perle went into business together over 25 years before the suit was filed. Balsamides had been a purchasing agent for Revlon and acted as the rainmaker for the corporation due to his many contacts. He was also responsible for advertising, marketing, and insurance. Perle, having a chemistry background, was responsible for the technical and administrative portion of the business. By mid-1995, gross sales exceeded $19 million, and each man had an annual income of between $1 and $1.5 million.

In the late 1980s, each brought two sons into the business, expecting eventually to hand over management. Balsamides's sons worked in sales and received commissions, expense accounts, and company cars, as did other Protameen salesmen. Perle's sons started in administrative and office management positions. Perle believed his sons should receive the same compensation as Balsamides's sons, and hostilities ensued.

In the early 1990s, Perle's sons moved into sales. However, the feuding already had gone so far as to cause conditions at the company to deteriorate to the point where the families could no longer conduct business together. In June 1995, Balsamides sought relief as an oppressed minority shareholder. Perle answered by denying the allegations and seeking the sale of Protameen to a third party. The court directed Balsamides to cooperate.

Despite many claims and counterclaims being filed, all but the breach of fiduciary duty by Perle were dismissed. The court found that Balsamides was an oppressed shareholder and was entitled to buy out Perle in lieu of dissolution or sale. The court found both families at fault, but concluded that Perle conducted himself in a way that was harmful to the business of Protameen and his partner.

The fair value that was accepted by the trial court was that of Balsamides's expert, Thomas Hoberman, using an excess earnings method of valuation with a 35% marketability discount. Perle's expert, Robert Ott, valued the company using a combination of market and income approaches without any discount, because the court was creating a market for the shares by ordering the buy-out.

Ott's valuation was specifically rejected by the trial court, as it looked not to determine the value of Protameen in light of a buy-out but to determine the intrinsic value[143] of the business, which does not change simply because the court directed a buy-out.

On appeal, the appellate court was concerned about the trial court's application of the 35% marketability discount in valuing Perle's stock. The ap-

143. It should be noted that although the language the court used is "intrinsic value," it appears that in this instance intrinsic value was used synonymously with fair value.

pellate court stated that the shares were not being sold to the public, nor would they later be sold to the public. Therefore, any discount for marketability would be inappropriate as Balsamides would maintain 100% ownership. In addition, the court recognized that the IRS frowns on the excess earnings method of valuation, and Revenue Ruling 68-609 states that this method should be used to value intangible assets only if there is no better basis available.

Although Hoberman claimed that there was no better basis available, Ott claimed that he was able to use an income approach and verify his results with a market approach. The appellate court found that Hoberman was not given enough information to execute a valuation better than the excess earnings method allowed, and that this was due to Perle's noncooperation. Moreover, the only reason why Ott could calculate the income approach was because Perle provided him with more information than he provided Hoberman.

There was also discussion of the 30% capitalization rate that Hoberman used. This rate was based on the lack of a full-time chemist, the projected decline in the market for the company's animal-and mineral-based chemicals over the coming years, the use of purchasing policies that placed priority on price over quality, the potential cancellation of a big contract, the reliance on six customers who account for 27% of sales, and the generation of nearly half the company's sales by Balsamides. The appellate court suggested that these items could be corrected with the corporation under Balsamides's management and should not contribute to such a high capitalization rate; however, the potential competition from Perle and his sons should be taken into consideration. Although the 30% was deemed high considering the factors offered by Hoberman, the existence of competition could merit the high rate if on remand the trial court decided to uphold its original acceptance of the 30% rate.

When the New Jersey Supreme Court reviewed the lower court's decision, it found that the appellate decision had not abused its discretion on most issues. However, in addressing the marketability discount, the Supreme Court pointed out the distinction between applying a discount at the corporate level versus the shareholder level and stated that the former may be appropriate if generally accepted in the financial community. It further cited the New Jersey dissolution statute, which directs the court to determine the fair value plus or minus any adjustments deemed equitable by the court. This statute gives the court substantial discretion to adjust the buy-out price.

Balsamides claimed that by not applying a discount, if he chose to sell the corporation at a later time, he would have to absorb the full reduction for the lack of marketability of a close corporation. The appellate court thought it would not be fair or equitable for the surviving shareholder to obtain the remaining interest at a discount, dismissing the idea that Balsamides would sell at a later time. Therefore, the market would be Balsamides himself, so no discount should be applied.

The New Jersey Supreme Court, however, called this an erroneous assumption, as there is a reality to the illiquidity of Protameen, and if the marketability discount is not applied at the buy-out, Balsamides would incur the full brunt of the illiquidity if and when he tried to sell the corporation at a later date. In addition, the Supreme Court stated that a consistent rule regarding the determination of fair value and the applicability of discounts should not be made, as the specific facts of the case may have an impact on the decision, and a marketability discount cannot be used unfairly to benefit the controlling or oppressing shareholder at the expense of the minority party.

Lawson Mardon Wheaton v. Smith

Twenty-six shareholders owning approximately 15% of the stock of a corporation dissented from a corporate restructuring, demanding fair value. The corporation offered $41.50 per share, calculated with a 25% marketability discount. The dissenters rejected the offer in April 1992, initiating the appraisal action. In the trial, the court upheld the 25% marketability discount, citing extraordinary circumstances. It believed that the dissenters had exploited a change that they themselves had championed and possibly prevented an initial public offering to the detriment of other shareholders. On appeal, the court found that a discount is generally inapplicable, but found that the record supported the conclusion that the actions constituted an extraordinary circumstance.

The New Jersey Supreme Court, however, did not agree. It did not consider the record to support a finding of extraordinary circumstances, noting that the appraisal statute is designed to provide a remedy to dissenting shareholders and should be liberally construed in their favor. The court believed that the record indicated that the dissenters wished to liquefy their assets because the corporation was now controlled by new management in whom they lacked confidence. The court denied that this was an extraordinary circumstance.

The court also recommended that the record be reopened in order to consider a later acquisition price, $63 per share in 1996. The company's financial statements disclosed that its fair value was greater in 1991 than 1996 and therefore may have had a bearing on the value of the corporation at the time of restructuring.

In its decision, the Supreme Court stated that the nature of the term *fair value* suggested that the courts must take fairness and equity into account in deciding whether to apply a discount to the value of the dissenting shares in an appraisal action, referencing the New Jersey oppression statute's support of equitable adjustments to fair value when the court deems it necessary. The court went on to conclude that there was no reason to believe that fair value should be viewed differently when addressing dissenters and oppressed shareholders.

> The court stated that equitable considerations had led the majority of states to deny the application of discounts in appraisal actions and to award dissenting shareholders a proportional share of the fair market value of the corporation without discounts. It supported the argument that discounts penalize the minority for taking advantage of the protection afforded by the appraisal statute. However, the court left the issue open, stating that there may be situations where equity (and extraordinary circumstance) compels another result. The court also explained its same-day decision in *Balsamides*, applying the same principle of equity to apply a discount in favor of the oppressed shareholder.

Several cases do not support the consideration of improper conduct in the determination of value. In *Cede & Co. v. Technicolor, Inc.*,[144] the court stated that improper conduct should not be considered in an appraisal proceeding.

The appraiser needs to be aware that discounts may be considered by the court because of improper conduct, as in *Balsamides*, or where a damage claim for the loss of a job or other forms of wrongdoing can be brought in conjunction with the judicial appraisal. Accordingly, the appraiser should consult with counsel and obtain direction as to the applicability of discounts in connection with a claim of improper conduct.

Although sometimes employed as punishment, as in situations such as *Balsamides*, discounts are generally a poor calibration of what the actual recompense for damages should be. Some have suggested that there are more appropriate punishments for malfeasance, such as payment of court fees, the award of damages, or the use of injunctions.[145]

Even when a court's decision is not quite as clear as the 1999 decisions in New Jersey, a more favorable result for the dissenting or oppressed party generally will correlate to the court's view that some measure of mistreatment or prejudice by the corporation occurred. A more favorable result for the corporation will usually indicate that the court had the opposite view of what occurred.[146]

In *Weinberger v. UOP, Inc.*,[147] the court acknowledged the chancellor's empowerment to fashion any form of equitable and monetary relief that is ap-

144. 684 A.2d 289, 298 (Del. 1996).

145. Moll, "Shareholder Oppression & 'Fair Value.'"

146. Wertheimer, "Shareholders' Appraisal Remedy."

147. 457 A.2d 701, 713 (Del. 1983).

propriate, including monetary damages based on entire fairness, particularly in cases of fraud, misrepresentation, self-dealing, or deliberate waste. This might have been one of the reasons the court did not find that the Delaware block method was the sole method to be used in valuation.

In the Kansas case of *Arnaud v. Stockgrowers State Bank*,[148] the court held that minority and marketability discounts should not be applied when the fractional share resulted from a reverse stock split intended to eliminate a minority shareholder's interest in the corporation.

Based on an analysis of the official comments to the RMBCA, the ALI's *Principles of Corporate Governance*, and relevant case law, such as the decisions in *Johnson v. Johnson*,[149] *Lawson Mardon Wheaton v. Smith*,[150] and *Balsamides v. Protameen Chemicals*,[151] it appears as if fair value may be calculated in a different manner when oppression is proven as opposed to cases where there is only disagreement or dissension (not dissent) between shareholders.

Damage Claims

The loss of salary can be a significant issue in many oppression cases. Since a characteristic of a closely held business is that its shareholders are often its key employees, those shareholders have the expectation of income from employment (salary and benefits) as well as the benefits associated with ownership. In such a case, behavior by the majority to eliminate that job might be more damaging to the minority shareholder's interest than the elimination of the profits from the ownership. Here we are referring only to the salary that would be termed *replacement compensation* in the calculation of value. The profits in excess of replacement compensation, whether received as salary, perks, or dividends, are capitalized and included in the fair value of the owner's stock. In a damage claim, this amount may be mitigated by any compensation received as part of salary, whether similar to the position given up or not.

For example, consider a situation where a shareholder-employee of a corporation earned a salary of $200,000. A nonshareholder employee with a comparable position at a comparable company would earn a $125,000 salary. The

148. 268 Kan. 163, 992 P.2d 216, 217 (Kan. 1999).

149. 2001 Conn. Super. LEXIS 2430 X07CV990060602S.

150. *Lawson Mardon Wheaton Inc. v. Smith*, 160 N.J. 383; 734 A.2d 738; 1999 N.J. LEXIS 835).

151. 160 N.J. 352; 734 A.2d 721; 1999 N.J. LEXIS 836.

termination of the shareholder employee causes him or her to lose the ability to receive $75,000 in salary. If the fair value of the shareholder's investment included compensation for the loss of a job, she would have to receive $75,000 per year in back pay from the time of termination to the time of the trial. In addition, that $75,000 may continue for a given or specified period of years after the date of trial, depending on the judgment of the court.[152]

The court in *Weinberger v. UOP, Inc*.[153] looked at the case of damages in fair value through the perspective of the statutory requirement of "all relevant factors." It stated: "When the trial court deems it appropriate, fair value also includes any damages, resulting from the taking, which the stockholders sustain as a class. If that was not the case, then the obligation to consider 'all relevant factors' in the valuation process would be eroded."[154]

Several cases have addressed the fact that minority shareholders often rely on their salary as the principal return on their investment.[155] The violation of the shareholder's expectation to continue employment in a close corporation may be sufficient to incur damages, back pay, or other adjustments to the value of his or her shares.[156]

The courts may find it difficult to calculate the value of the damages, as in many cases the fair value of shares is not sufficient to encompass all of the shareholder's loss. The courts may use discounts or court fees or other damage assessments, but it is difficult to ascertain the appropriate value and may largely become a judgment call for the court.[157] The New Jersey Superior Court, for instance, in *Musto v. Vidas*[158] suggested that after the petitioning shareholder's termination, the shareholder should continue to receive the same compensation as the defendants, as provided for in the initial shareholder agreement for a period of two years after the shareholder was frozen out.

In *Johnson v. Johnson*,[159] the court considered the issues of oppression and waste in determining compensation for the minority shareholders. It decided that the corporation's failure to declare dividends was not a sufficient

152. Moll, "Shareholder Oppression & 'Fair Value,' " at n180.

153. 457 A.2d 701, 713 (Del. 1983).

154. 457 A.2d 701; 1983 Del. LEXIS 371. The subsequent enactment of Delaware Code section 102 b(7) allows corporate charter provision to limit or eliminate the personal monetary liability of directors Del Code 102 b(7).

155. *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E. 2d 657, 662 (Mass 1976); *Exadaktilos v. Cinnaminson Realty Co.*, 400 A.2d 554, 561 (N.J. Super. Ct. Law Div. 1979).

156. Mark A. Rothstein, et al. *Employment Law* §9.24, at 593 (1994).

157. Moll, "Shareholder Oppression & 'Fair Value,'" at n185.

158. 281 NJ Super. at 561.

159. 2001 Conn. Super. LEXIS 2430 X07CV990060602S.

condition to merit damages, especially because the company had not historically declared dividends. The court considered whether the level of compensation of the primary executive was oppressive and whether damages should be incurred for corporate waste. The court found that the level of compensation was not tantamount to waste, and although it might be more than a prudent investor would expect to pay, the court found no breach of reasonable expectations in this case and therefore no additional compensation was required.

FAIR VALUE AND THE MINORITY SHAREHOLDER

The bottom line in dissenting shareholder matters and when a shareholder petitions to dissolve a corporation alleging oppression is: What does the minority shareholder receive at the end of the day? In both types of cases, this is going to depend almost entirely on the circumstances of the case. With dissent, the outcome is more straightforward; a minority shareholder either can or cannot dissent based on a triggering event, and the court can look at the circumstances of the case to determine the fair value.

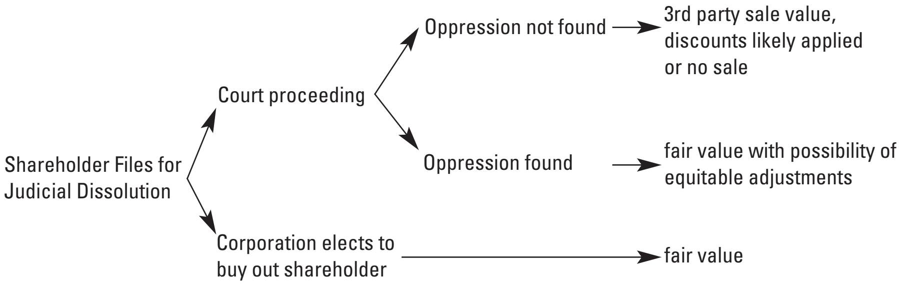
In oppression, the outcomes are a bit more complicated. If the shareholder files suit under the dissolution statute, two situations can occur:

1. The corporation could elect to buy out the petitioner's share at fair value. At that point, any decision regarding wrongdoing is suspended and the court's primary focus is to determine the fair value of the petitioner's shares.
2. The corporation can decide to gamble with a court proceeding, maintaining that its actions were not oppressive. If the court finds the corporation's actions to be oppressive or prejudicial, it will be required to pay the fair value plus any equitable adjustments the court deems necessary. This could include damages, court fees, or the application of discounts to benefit the oppressed shareholder. If oppression or wrongdoing is not found, however, the corporation will not be required to buy the shares, and the shareholder is likely to be forced either to remain a shareholder or to sell the shares at a value that would be received from a third party.

The chart below lays out the scenarios involved in filing for a dissolution action, and in states like Delaware, when entire fairness is an issue considered in an appraisal action.[160]

160. The three scenarios in this chart are taken from the ABA's 2002 RMBCA, section 14.30 (1, 2, 3).

Shareholder Oppression Scenarios



If there is clear wrongdoing, self-dealing, or unfairness, in most states, it is likely that oppression will be found and the shareholder will receive the fair value of his or her shares based on case precedent. In those situations where there was egregious behavior on the part of the oppressor, the court may apply additional equitable adjustments. If shareholders bring a proceeding solely to cash out on an investment without any reasonable complaint, the court may decide that there is no oppression, and the shareholder will likely either receive a share price reflecting the third-party sale value or be compelled to remain as a shareholder.

SUMMARY

We have traced the history and development of fair value back through the nineteenth century when majority rule was instituted in place of unanimity. While fair market value evolved to mean the value arrived upon in a hypothetical transaction between willing participants, fair value was created for the purpose of shareholder dissent and oppression to protect a minority shareholder and to compensate the shareholder for that which has been taken.

The attempt to establish exactly what has been taken is the basis for the controversy over fair value. Based on loose guidelines set by the statutes, a valuation professional receives guidance on valuation date and certain elements to include and exclude from valuation. However, one still must determine exactly what one is valuing and the best methods and techniques to perform the valuation. These concepts have been shaped by legislatures, case law, the influence of the American Bar Association and the American Law Institute, and current valuation theory.

Although dissenters' and oppressed shareholders' rights developed throughout the twentieth century, they did not gain widespread usage until the decision in *Weinberger v. UOP, Inc.*[161] established the use of customary and current valuation techniques in valuing a business under these statutes. That decision, combined with the institution of the buy-out remedy and oppression doctrines, has significantly increased the popularity of cases determining fair value.

Each state has different definitions and treatments of fair value. As we have discussed, most states are now open to current and customary valuation techniques, but we can break the states down into roughly three groups based on the acceptance or rejection of discounts: those states that totally reject discounts, those that consider the facts and circumstances of the case, and those that accept discounts in most all situations.

Recently, the trend endorsed by the ABA and the ALI has directed that the value be set at a pro rata share of the enterprise, without any shareholder-level discounts. Some states have adopted this treatment, while others are content with their own definitions of fair value. This trend, however, should not be seen to affect the need for entity-level adjustments made necessary by the cash flows used in valuation or the current circumstances of a given company. Once a value for the corporation as a whole is established by a proper valuation technique, the precedent-setting case law in each state may determine whether discounts are likely to be applied at the shareholder level.

Finally, and importantly, when a court reviews the facts and circumstances of a case, it attempts to compensate the parties involved equitably. This is the underlying basis for extraordinary circumstances, the award of damages, and any "adjustments" to value that would not normally be applied. Ultimately, a court may not be as concerned with strict adherence to the assumptions underlying fair value, and instead, may simply intend to find a means of fairly compensating the minority shareholder for that which as been taken.

That having been said, the valuation professional should apply current and customary techniques that are generally accepted by the appraisal profession in determining value. Those techniques should be supported by reasonable facts and valuation theory. The final determination of value will be at the court's discretion based on the facts and circumstances of a given case.

161. 457 A.2d 701, 713 (Del. 1983).

4

Standards of Value in Divorce

INTRODUCTION

In this chapter, we address the theory and application of the standards of value used in divorce. As in stockholder oppression and dissent cases, the standards of value in matrimonial matters are state specific and often case specific.

As one commentary has indicated:

> Matrimonial actions are unique types of litigation. While people in litigation are people in conflict, people in matrimonial litigation are involved in conflicts that go to the very root of their existence.[1]

Divorce cases are often acrimonious and adversarial. It is the task of business valuation professionals to sort through these issues and evaluate a business based on the objective application of valuation methodology that is consistent with the laws of a given state.

The application of the standard of value is left to the courts within the individual states. These courts can often inconsistently apply the underlying assumptions of a standard of value, to achieve what they believe to be equitable solutions consistent with the policy expressed in each state's statutes.

When we compare the way valuation issues are viewed in the U.S. Tax Court to the way they are they are viewed in many matrimonial courts, we often

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1. Gary N. Skoloff and Laurence J. Cutler, *New Jersey Family Law Practice*, 10th ed. (New Brunswick, NJ: New Jersey Institute for Continuing Legal Education, 2001), at 1.11.

find significant differences. In the Tax Court, precedents have fashioned a consistent premise, value in exchange, and a consistent standard, fair market value, and have provided guidance to practitioners as to the application of this standard. Because of this consistency, experts can differ in methodology but not on the premise or standard of value. For instance, valuation practitioners can opine on the size of the applicable discount for an interest lacking control, but not, in most instances, on its applicability.

In the same manner, fair value is the standard applied most often in stockholder dissent and oppression matters in most states. Again, the premise of value is a value in exchange, and the standard is fair value. In these matters, the most frequent valuation controversy involves the applicability of lack of control and marketability discounts. As we explained in Chapter 3, legal associations such as the American Law Institute (ALI) and the American Bar Association (ABA) have weighed in on the applicability of lack of control and marketability discounts under this standard of value.

As will be explained further in this chapter, we have found that there has been no consistent application of the premises and standards of value in divorce matters. In fact, even though the ALI has opined on certain valuation issues concerning divorce, its' opinions have not been cited in matrimonial cases as frequently as in dissenters' and oppressed shareholder matters.

In divorce, the standard of value for each state is established by court cases that implement that state's marital dissolution statutes. Each state's legislature sets forth the property distribution policy in the statute. The courts attempt to implement the policy through their individual decisions. Generally, the statutes provide little guidance on valuation; one has to divine it from case law. Therefore, to more clearly understand the standards of value in this context, one needs to understand the definition of property in the particular state statute and the treatment of business and intangible value in that state's case law. In our analysis, we address the implied or stated standard of value as it is expressed in the court opinions regarding the treatment of intangible assets such as enterprise and personal goodwill, the application of lack of control and marketability discounts, and the weight accorded buy-sell agreements.

We begin with a general background and history of the treatment of marital and separate property and then analyze the identification of marital and separate property. We then discuss the premises of value, the standards of value, and their theoretical underpinnings as stated or implied by statute or case law.

Premises of value are assumptions based on the set of actual or hypothetical circumstances applicable in a valuation. Standards of value represent the type of value being sought.[2] In determining a premise of value, one must ask whether the subject company should be valued in a hypothetical exchange between a willing buyer and willing seller, or as a business in the hands of its current management with no consideration of such an exchange.

In our view, standards of value in divorce can be seen to fall under two general basic premises: value in exchange and value to the holder. Value in exchange is the value arrived at in a hypothetical sale, with assumptions ranging from the seller departing immediately and competing with his or her former business, to the seller staying on to help transition management. Underlying value in exchange are two general standards: fair market value, where discounts for lack of control and lack of marketability, also referred to as shareholder-level discounts, are generally considered, and fair value, where the value of a fractional interest is generally seen to be, except under extraordinary circumstances, as its pro rata share of the enterprise without minority or lack of marketability discounts. The value to the holder premise is based on the assumption that the business or business interest will not be sold. Although frequently not articulated, the standard of value most often associated with the value to the holder is investment value, which in this context is also referred to as intrinsic value.

After a general discussion of the assumptions implicit in the two premises and three standards, we discuss the value in exchange premise and how personal and enterprise goodwill, shareholder-level discounts, and buy-sell agreements are viewed. Similarly, in states where these issues are addressed using a value to the holder premise, we discuss such issues as the difference between goodwill and earning capacity, and the inclusion of such marital assets as a professional degree or license, enhanced earning capacity, celebrity status, and the issue of double dipping. We eventually use the premise and standard of value implied by the treatment of personal and enterprise goodwill, lack of control and marketability discounts, and the weight accorded buy-sell agreements to move toward a standard of value classification system.

Using these elements, we build a continuum of value that addresses the way courts view property by their treatment of goodwill, the application of shareholder level discounts, and the adherence to buy-sell agreements, all under a stated or implied standard and premise of value. Note that this continuum is based on our view of the issues implicit in business valuations for the purpose of divorce, and, the lines between these classifications are not always clear.

2. Shannon P. Pratt, Robert Reilly, and Robert Schweihs, *Valuing a Business*, 4th ed. (New York: McGraw-Hill, 2000), at 28.

In some cases, even a state that appears to adhere strictly to one standard may use elements of another to achieve what the court believes to be equitable. Moreover, we are reviewing statutes and cases as valuation practitioners, not lawyers, and applying our suggested classifications to premises and standards of value in ways that are consistent with generally accepted valuation theory but may not have been contemplated by courts, the attorneys, and even many experts.

Marital Property: General Background and History

The varying nature of the divorce laws of the states can be traced back to the turn of the twentieth century, when the National Conference of Commissioners for Uniform State Laws[3] sought to unify divorce laws across the nation. The common sentiment at the time, endorsed by the public, the clergy and even President Theodore Roosevelt, was that the unsettling increase in the divorce rate across the land had to be checked. Thus, in the same way the commissioners later attempted to create uniform triggering events for dissenting shareholders, they proposed certain laws that would create a uniform standard by which a married couple could get divorced. The states, however, wanted autonomy, as several already had more stringent grounds for divorce in place. For example, in New York, adultery was the only grounds for divorce. In South Carolina, divorce was not permitted on any grounds. Accordingly, despite being adopted by five states, the uniform divorce laws were viewed as a massive failure.[4]

It is generally agreed that the law of marital property in the United States has its origins in English common law. However, influenced by their French or Spanish heritage, eight states adopted the continental system of community property. Those original eight community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.[5] Later the total increased to 10, when both Alaska and Wisconsin chose to treat marital property as community property.

3. The National Conference of Commissioners on Uniform state laws was formed in 1892 for the purpose of providing states with non-partisan, well-conceived, and well-drafted legislation that brings clarity and stability to critical areas of the law. http://www.nccusl.org/Update/

4. James J. White, "Symposium: One Hundred Years of Uniform State Laws: Ex Proprio Vigore," 89 *Michigan Law Review* 2096 (August 1991), at 2106.

5. Ira Mark Elman, Paul M. Kurtz, and Catherine T. Bartlett, *Family Law: Cases Text Problems*, 2nd ed. (Charlottesville, VA: Michie Company, 1991).

Initially, most common law states looked exclusively to property law where title dictated ownership. This left the nontitled spouse at a severe disadvantage. In 1973, the Uniform Marriage and Divorce Act set an example for the states by abandoning the traditional treatment of property by common law and moved toward a system that would give the court discretion over how to divide property. Over the next 10 years, this principle was adopted by the remaining 41 common law states in their statutes as equitable distribution. This new standard for distribution divided marital property according to some principle of need or equity, without particular regard to title or ownership as determined by common law rules.[6]

By the early 1990s, all states had enacted statutes that provided for the distribution of property acquired during the marriage in accordance with equitable distribution or the continental system of community property. Equitable distribution states endeavor to divide marital property fairly, but not necessarily equally. Community property states more often seek to divide marital property equally, but in many cases also prefer an equitable arrangement for distribution.[7]

Marriage is now generally considered to be an economic partnership where title is irrelevant and property is acquired and maintained by the marital unit rather than separately by the individuals. In both community property and equitable distribution states, property acquired during the marriage through the time, skill, and labor of either spouse is considered part of the marital estate. Typically, anything acquired by gift or inheritance or acquired before or after the marriage is considered to be the separate property of the owner.

The states that adopted the equitable division method of property distribution now look to equitably distribute assets defined as marital property. As such, all states, whether by equitable distribution or community property, recognize that the noneconomic contribution of the nontitled spouse has value and the state legislatures have enacted statutes that provide for the fair distribution of property acquired during the marriage.

6. Mary Ann Glendon, "Symposium: Family Law: Family Law Reform in the 1980s," 44 *Louisiana Law Review* 1553 (July 1984).

7. California requires an equal division. Idaho and Nevada both require equal division unless compelling reasons exist to divide property differently. Alaska, Arizona, and Washington require equitable division. New Mexico, Texas, and Wisconsin leave the details of division to the court's discretion. Louisiana does not include direction on division in their statues.

Dividing marital property as part of a divorce involves a three-step process:

1. Identify marital assets.
2. Value them.
3. Then distribute them.

There is an interrelationship among the three steps, with the term *value* mostly left undefined by statute. In fact, only the statutes of Arkansas and Louisiana explicitly address the standard of value to be used. Arkansas's statute, for example, only establishes the standard of value for certain assets:

> When stocks, bonds, or other securities issued by a corporation, association, or government entity make up part of the marital property, the court shall designate in its final order or judgment the specific property in securities to which each party is entitled, or after determining the fair market value of the securities, may order and adjudge that the securities be distributed to one (1) party on condition that one-half (1/2) the fair market value of the securities in money or other property be set aside and distributed to the other party in lieu of division and distribution of the securities.[8]

Louisiana requires that the parties to a divorce list their community assets at their fair market value for distribution.[9] No other state statute addresses value with even that much specificity. Some states refer to a particular standard in their case law; others suggest a certain standard by their treatment of certain elements of value. Often a case in a particular state may name one standard of value but attribute to it characteristics more commonly associated with another standard of value.

Identification of Marital Property and Separate Property

In our view, the ambiguity as to the appropriate standard of value in a state often is the result of differing interpretations of what constitutes property in general and marital property in particular. In fact, property is quite often undefined in most statutes. Community property states, typified by the statute in Arizona, define community property as:

8. Arkansas Statute § 9-12-315 (4)
9. Louisiana Statute § 9:2801.

> All property acquired by either husband or wife during the marriage, except that which is acquired by gift, devise or descent is the Community Property of the husband and wife.[10]

Alternatively, an equitable distribution state, such as Pennsylvania, defines marital property as:

> (a) all property acquired by either party during the marriage; (b) including the increase in value, until the day of final separation of non-marital property acquired by gift, bequest, devise or descent; and (c) the increase in value of property owned prior to the marriage or property acquired in exchange for property owned prior to the marriage until the date of final separation.[11]

As can be seen, the definition of *property* is rather ambiguous, regardless of the property distribution scheme. This can lead to controversy with respect to certain assets that can be difficult to identify and value.

This ambiguity is most clearly seen in the treatment of intangible property. Identifying intangible assets can involve the valuation of an expected (or future) income stream, which may not be transferable and/or may require the continued efforts of a spouse after the end of the marriage. The courts in each state decide whether these types of assets may or may not be included as assets to be distributed. Their decisions will rely on their interpretation of the term *marital property*.

The identification of tangible assets acquired during the marriage does not stir the same controversy as the identification of intangible assets. Essentially, tangible assets are physical things—things that may be valued based on use (the value one receives from owning an asset) or in exchange (the value at which it may be sold to a third party). Either way, with these assets, identification is typically not an issue.

Identification issues relating to intangible assets, the most common of which is often labeled goodwill, can be much more difficult. The controversies are manifold, but the main issue in the identification of marital assets becomes whether the intangible asset, if one exists, belongs to the person or the enterprise and whether that intangible asset was developed during the marriage. In order to understand the treatment of these assets in a given state, we must understand the nature of these assets and how they were developed.

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10. Arizona Statute 25-211.

11. Pennsylvania Divorce Code Section 3501.

Ultimately, a valuation professional determines the value of property based on valuation principles and analysis coupled with professional judgment, the guidelines set by the statutes, and the precedents set by the courts interpreting those statutes. From there, the courts will determine what is fair and equitable in distribution. Aside from the states that mandate equal distribution, the final outcome of "who gets what and how much" is left to the judgment of the courts.

Regarding the distribution of assets, a Michigan court stated:

> The only requirement [for an award of marital assets in a divorce action] is that the award result in a fair and equitable distribution of the marital assets.[12]

As sound as these societal principles may be, they offer the valuation expert little guidance as to the application of valuation principles to a particular situation.

The standard of value varies from state to state and may vary even within a state. Some courts do not define and follow any one standard of value consistently. As will be seen, the courts often use the term *fair market value* and attribute to it elements and theory more closely related to investment value. The courts may not understand the implications of the standard that they are applying or even intend to apply a certain standard of value at all. They are identifying and distributing assets in a manner considered to be fair and equitable. As another commentator stated:

> No single standard could possibly encompass the multitude of considerations necessary for equitably dividing marital assets.[13]

In addition to the division of property acquired during the marriage, most states have statutes that address spousal support (alimony) and child support and a body of case law that implements those statutes. There is a relationship between alimony and property distribution, and the combination of these remedies is used by the courts, which, in theory, look to be fair and equitable, without a requirement to adhere strictly to the underlying assumptions of a given standard of value. Courts often have the opportunity to adjust alimony or the percentages of the property distribution to achieve what they view as a fair out-

12. *Hatcher v. Hatcher* (1983), 129 Mich. App. 753; 343 N.W.2d 498; 1983 Mich. App. LEXIS 3397.

13. John McDougal and George Durant, "Business Valuation in Family Court," 13 *South Carolina Lawyer* 14 (September/October 2001), at 2.

come for the parties involved. The judge may start with a certain standard of value in mind, but may end at a completely different standard based on his or her interpretation of the facts and the circumstances of the case. Moreover, the courts generally adhere to their interpretation of the law and the equities in the particular case more rigorously than they adhere to the assumptions inherent in or classification associated with a particular standard of value.

Relationship between Valuation and Identification of Intangible Assets

While one may suspect that a business has intangible assets (goodwill in particular), often there is no way to know that goodwill exists until the business is valued or sold. In matrimonial matters, frequently used methodologies for valuing goodwill can include excess earnings[14] or finding the sale price above the net asset value of a business.[15]

The Washington case of *In re: Hall*,[16] which addressed the valuation of goodwill in a medical practice, provides an example of several methods that the courts may recognize in valuing goodwill. According to the case, three of the methods are: (1) capitalization of excess earnings method; (2) the straight capitalization method; and (3) the IRS variation on capitalization of excess earnings method. The other two methods discussed in the case are: (4) the buy-sell agreement method; and (5) the open market approach.

Simply stated, some form of the capitalization of benefits (the first three methods) can be employed to determine whether an intangible asset exists. From a strictly legal point of view, these methods have been criticized for placing too much importance on future earnings, thereby including the future efforts of the owner.[17] Some experts contest this criticism, contending that the ability of the asset to continue to produce earnings in the future is attributable to the fruits planted during the marriage. Another criticism is that these methods may set high relative values for an unrealized intangible asset for which the titled professional gives up a tangible asset such as real property or cash. This

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14. The "excess earnings" method for valuing intangible assets consists of estimating the value of the tangible assets, estimating a reasonable rate of return on the tangible assets, and, to the extent that total returns of the business or practice exceed the reasonable return of the tangible assets, is the basis for finding the dollar value of the intangible assets. That is accomplished by dividing the excess returns by a rate called a capitalization rate.

15. Mary K Kistjardt, "Professional Goodwill in Marital Dissolution—The State of the Law," in *Valuing Professional Practices and Liscenses,* edited by Ronald L. Brown 2004 supplement.

16. 103 Wn.2d 236, 692 P.2d 175 (1984)

17. Kistjardt, "Professional Goodwill in Marital Dissolution," at 1.04, p. 1–30.

could potentially overcompensate the non-titled spouse by trading liquid assets like cash and property for a relatively illiquid interest in the goodwill of a closely held business.

The fourth method referred to in the case, the utilization of a buy-sell agreement, is addressed later in this chapter. The utilization of a buy-sell agreement is often considered in the valuation of fractional interests in professional partnerships where an arm's length agreement is in place. Courts may rely more heavily on a buy-sell agreement to determine value if transactions have been consummated under the terms of the agreement as partners have entered and exited the partnership. A court probably will not consider an agreement binding if it was signed shortly prior to divorce, or if partners have come and gone without exercising the explicit formula established by the agreement.[18]

The fifth method, the so-called open market approach, tries to establish value upon a hypothetical sale. In a value in exchange context, this is seen by some as the most relevant method for valuing goodwill, as a quantifiable asset that would be realizable upon the sale of the business.

Appreciation on Separate Property

Another central issue in many divorces is the treatment of separate property owned by a spouse prior to the marriage or gifted to, or inherited by the spouse during the marriage. The majority of states do not include separate property as distributable assets.[19] However, special provisions may apply to appreciation on that property that occurs during the marriage. For example, the Pennsylvania statute mentioned earlier, includes the increase in value of separate property over the course of the marriage. Divorce statutes generally include a description as to the circumstances where the appreciation of separate property can be included in distributable assets. The circumstances often relate to the cause of the appreciation during the marriage and the efforts of the spouse who owned

18. Id. at 1.04, p. 1-33.

19. New Hampshire appears to be the only state that includes all property in the consideration for distribution, defining property in this way: § 458:16-a. I. "Property shall include all tangible and intangible property and assets, real or personal, belonging to either or both parties, whether title to the property is held in the name of either or both parties. Intangible property includes, but is not limited to, employment benefits, vested and non-vested pension or other retirement benefits, or savings plans. To the extent permitted by federal law, property shall include military retirement and veterans' disability benefits." However, the statute goes on to direct that the value of premarital or gifted property should be considered in the distribution of the marital estate. Other states may not recognize separate property, but they do not provide that direction by statute.

the separate property. The cause of the appreciation is often classified as active or passive. Active appreciation is that which is caused by the efforts of one or both of the spouses; passive appreciation is that which is caused by external forces such as market fluctuations or the efforts of other partners.

On one extreme, there are state statutes that do not differentiate between active and passive appreciation on separate property, suggesting that neither is to be distributed.[20] For instance, Delaware's marital dissolution statutes state:

> (b). . . For purposes of this chapter only, *"marital property" means all property acquired by either party subsequent to the marriage except*: (1) Property acquired by an individual spouse by bequest, devise or descent or by gift, except gifts between spouses, provided the gifted property is titled and maintained in the sole name of the donee spouse, or a gift tax return is filed reporting the transfer of the gifted property in the sole name of the donee spouse or a notarized document, executed before or contemporaneously with the transfer, is offered demonstrating the nature of the transfer. (2) Property acquired in exchange for property acquired prior to the marriage; (3) Property excluded by valid agreement of the parties; and *(4) The increase in value of property acquired prior to the marriage*.[21] [emphasis added]

On the other extreme, the statutes do not specifically include or exclude a particular type of appreciation. Colorado, for instance, provides for this to be included in the marital pot:

> (4) Subject to the provisions of subsection (7) of this section, *an asset of a spouse acquired prior to the marriage* or in accordance with subsection (2) (a) or (2) (b) of this section shall be considered as marital property, for purposes of this article only, *to the extent that its present value exceeds its value at the time of the marriage* or at the time of acquisition if acquired after the marriage.[22] [emphasis added]

Most states deal with the issue between the extremes. In some states, the appreciation on separate property may be marital if that appreciation was a product of marital efforts (marital efforts being the contribution of either or both spouses to the increased value, not necessarily to the increased value of

20. Illinois also does not include appreciation, but includes a reimbursement provision for the non-owner spouse for his or her efforts contributing to an increase in value. The appreciation is not made marital property but is recognized by reimbursement.

21. 13 Del. C. § 1513.

22. Colorado Statute 14-10-113.

the asset itself, but to the marital partnership in raising children, keeping the home, etc.). This does not include appreciation on premarital property from dividends, interest, or general market conditions that occur without any action by either individual (passive appreciation). North Carolina, for instance, is one of these middle-ground states. The North Carolina statute specifically defines the circumstances that constitute active and passive appreciation:

> *Passive* increases in value, such as those attributable to inflation or to market fluctuations, will be considered as part of the separate property, whereas *active* appreciation in the value of the property, such as that resulting from economic or noneconomic contributions by one or both of the spouses, is to be treated as part of the marital property.[23] [emphasis added]

Additionally, the courts must make decisions on commingled property. *Commingling* refers to the mixing of separate and marital property. In the case of separate property, the issue is whether separate property has been mixed with marital property and whether this mixing causes the separate property to lose its character and become marital property. This is often referred to as transmuted property. Separate property can be transmuted to marital property by commingling. A few states have specific statutory provisions on commingled property. Missouri, for instance, states:

> Property which would otherwise be non-marital property shall not become marital property solely because it may have become commingled with marital property.[24]

The Alabama statute, however, includes property that may be separate but has benefited both spouses during the marriage as marital property:

> . . . the judge may not take into consideration any property acquired prior to the marriage of the parties or by inheritance or gift unless the judge finds from the evidence that *the property, or income produced by the property, has been used regularly for the common benefit of the parties during their marriage.*[25]

23. Cheryl Lynn Daniels, "North Carolina's Equitable Distribution Statute," 64 *North Carolina Law Review* 1395 (August 1986), at 1399.
24. Arkansas Statute 2004 § 452.330 at 4.
25. Code of Alabama 2005 § 30-2-51 (a).

Most states that have addressed commingling have done so in the courts. For instance, Alaska decided that commingling itself does not necessarily establish intent to hold property jointly, and therefore the court should consider the property's source when determining what assets are available for distribution.[26]

Going back to the definition of marital property, if an asset was created during the marriage, these issues are not addressed. However, if an asset preexisted the marriage, an appraiser may have to employ multiple valuation dates[27] and determine the value of the asset at the beginning and the end of the marriage. The issues of active and passive appreciation, transmutation, and commingling arise somewhat independently from the premise or standard of value, but are nonetheless important considerations for the practitioner.

PREMISES AND STANDARDS OF VALUE IN DIVORCE

As mentioned, the identification and valuation of marital assets fall under two basic premises that form the basis of a continuum of value: value in exchange and value to the holder.

Premises of Value

Value in Exchange

States following the value in exchange premise view the identification and valuation of marital assets in the context of a sale. Value in exchange presumes some sort of hypothetical transaction where the business or business interest is exchanged for cash. To the extent that the conclusion of value estimates depend on the continued efforts of one party, that portion of the value is excluded and viewed as separate property or not as property at all. States following a value in exchange premise reject the inclusion of intangible value reliant on an individual for several reasons, including the viewpoint that postmarital efforts are necessary to realize the value, and also that the "property" allegedly created is not capable of being separated from the person.

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26. *Julsen v. Julsen*, 741 P.2d 642 (Alaska 1987).

27. As previously discussed, determining what caused the appreciation in value is an important element of the distribution of the increase in value. The valuation expert should consult with the retaining attorney to determine what, if any, role he or she has to opine on the economic reason for this increase.

Value to the Holder

Value to the holder considers the value of a business or business interest in the hands of its owner, regardless of whether he or she intends to sell the business. It further assumes that the titled spouse will continue to enjoy the benefits generated by a business that was created or appreciated during the marriage, and contemplating a value upon sale would dilute the actual value that both spouses enjoyed during the marriage, as only the titled spouse would continue to benefit from that value after the marriage ends.

Exhibit 4.1 shows the first level of the continuum of value for these two premises, which have different underlying assumptions involving a state's determination of what constitutes property and how it should be valued.

In our view, these two premises form a continuum of value under which businesses or business interests are identified, valued, and eventually distributed in a divorce. In determining a value in exchange, those elements of skill and reputation attributed to the owner spouse that cannot be distinguished from the individual (and would no longer benefit the business if he or she departed) are typically not considered to be marital and should be separated from the value. One values only the assets of the enterprise that could be sold to a hypothetical buyer at the date of a hypothetical sale.

Under value to the holder, these issues typically do not come into play, as the presumption is that no sale will take place, and, therefore, the effect of the owner leaving is not relevant. Standards of value fall under these two premises, from fair market value, which is value in exchange, to investment value, which is value to the holder. Thus, the continuum of value moves from valuing only assets that may be sold to valuing assets that may have limited marketability absent the continued participation of the owner spouse.

The standards of value most often used by courts to value marital assets are fair market value, fair value (more commonly referred to in oppression and dissent cases), and investment value (also called intrinsic value or, colloquially, value to the holder).

In the remainder of this chapter, we explain how we analyze the premises and standards of value and their stated or implied application. We can use value in exchange and value to the holder as a framework to better understand the theory and application of the common standards of value used in divorce cases.

Exhibit 4.1 Continuum of Value: Premises of Value

Premise of Value	**Value in Exchange**	**Value to the Holder**

Standards of Value

Although a court may use the name of a particular standard of value, the assumptions normally associated with that standard of value are often treated inconsistently or not addressed at all. This can be more readily seen in the varying treatment of goodwill, shareholder-level discounts, and the weight accorded to buy-sell agreements. The valuation professional has to be aware of the precedent-setting case law in each state, including the underlying facts and assumptions of each case in addition to the exact words in the decision.

Fair Market Value

Fair market value is widely applied in divorce valuations. Several states have asserted through case law that fair market value is the appropriate standard; others have implied that it is the standard they are using by their treatment of personal goodwill and the applicability of shareholder-level discounts. Fair market value is defined by the Estate Tax Regulations as:

> the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.[28]

Application of a fair market value standard for businesses or business interests in divorce focuses on those elements of the business value that are considered transferable. To a varying extent, the resulting value under this standard does not ordinarily include nontransferable elements such as personal goodwill. The extent to which this assumption applies varies in some states as to the consideration of the seller's participation in the transition. Some states view the application of fair market value as an immediate departure of the owner with an ability and willingness to compete. Other states consider a more orderly transition.

Simply stated, fair market value assumes a value in exchange: The buyer gets the asset and the seller gets cash or a cash equivalent. This value in exchange results in the identification and valuation of those elements that are normally transferable or capable of being transferred with no long-term participation on the part of the seller.

As we discussed in Chapter 2, certain assumptions are inherent in the application of the standard of fair market value. For example, since it falls within

28. Estate Tax Regulation § 20.2031-1.

the value in exchange premise and contemplates a hypothetical sale of the business or business interests, discounts for lack of control and/or marketability are generally considered.

Fair Value

Fair value is defined mainly in connection with dissent and oppression cases in the corporation statutes and cases. Fair value in divorce is generally applied the same way as it is in dissent and oppression cases, in that it is a standard that is largely determined by the court's direction.

Fair value is different from fair market value and investment or intrinsic value. Fair market value assumes a willing buyer and a willing seller. Investment value assumes that the business will not be sold and the owner will continue to receive benefits from the business or business interest (unless a sale is really occurring). In one context, fair value can entail an exchange, but not necessarily from a willing seller. Fair value may also assert that a lack of intention to sell a business prevents its valuation as a value in exchange. As we will show, some fair value cases adhere more to a value in exchange premise; others adhere to a value to the holder premise. Generally, if a valuation takes a pro rata portion of the enterprise value without shareholder-level discounts, we considered it to be fair value.

The 1950 Delaware dissent case, *Tri-Continental v. Battye*,[29] defines fair value in this way:

> The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder's proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger. In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into fixing the value.[30]

In this interpretation, the courts look to fairly compensate the departing party for that which has been unwillingly taken from him or her. To extrapolate this concept to divorce, under fair value, the courts may look to compensate the non-titled spouse for the value generated during the marriage but realized

29. 74 A.2d 71, 72 (Del. 1950).

30. Id.

after the divorce. Most often, courts believe that absent special circumstances, it would be unfair in an oppression case to apply discounts to the value sought by the oppressing party, as the oppressed party has been mistreated and would otherwise be unwilling to sell. This would create an undeserved windfall for the oppressor. Similarly, in divorce (regardless of marital misconduct or fault), a court evaluating discounts may see the application of discounts as an unfair advantage to the party that will continue to enjoy the benefits of the asset.

In this respect, divorce and oppression may be similar in that they can both be seen in terms of the reasonable expectations of those entering into a partnership or contract (business or marital). A shareholder has the expectation of sharing in the benefits of the business for the course of his or her life or the term of the contract. Should those expectations be breached, the court looks to fairly compensate that individual. Marriage is viewed as an economic partnership in which each party has an expectation of sharing the economic benefits generated during the marriage. In this case, the court may view discounts as unfairly benefiting the owner spouse at the expense of the non-owner spouse.

Investment Value

Another widely used standard of value in divorce matters is investment value, which is often also referred to as intrinsic value. This standard commonly falls under the value to the holder premise. Application of this standard contemplates value not to a potential hypothetical buyer but rather to a particular buyer, which in the case of divorce is the current owner, hence, value to the holder. This standard also recognizes that there may or may not be an *intention* to sell or leave the business, and as it continues, the business will enjoy the benefits and the value derived from the owner's continued presence.

In this context, investment value differs from fair market value in that it will provide a going concern value to the current owner, not a hypothetical buyer. Many courts refer to this standard as the value of a going concern to the owner. This standard of value identifies assets that have an inherent or intrinsic worth to the owner, which may not be transferable to another individual. Some argue that the existence of this asset, regardless of its transferability, was created or germinated during the marriage, and this value is partially attributable to the efforts of the nonowner spouse. During the marriage, both spouses benefited from that earning ability. After the marriage, only the owner will continue to benefit. Several states consider these types of assets marital; many do not. California's landmark case *Golden v. Golden*,[31] for example,

31. 270 Cal. App. 2d 401; 75 Cal. Rptr. 735; 1969 Cal. App. LEXIS 1538.

gives the reasoning behind using the characterization of property that leads to the application of an investment value standard:

> . . . in a matrimonial matter, the practice of the sole practitioner husband will continue, with the same intangible value as it had during the marriage. Under the principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during marriage. She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business.[32]

There are various assumptions involved in a determination of investment value. For example, the transferability (and therefore marketability) of personal goodwill is often not at issue, as there is likely no intention to sell. To illustrate, we can look at the example of a law firm in New Jersey, when the clients (goodwill) of the law firm could not be sold to another lawyer.[33] Under a fair market value standard, the goodwill of a law firm in New Jersey at that time would have no value.[34] However, under an investment value standard, the ability to sell is not as important as it is under the fair market value standard in determining the business's ongoing value to its current owner. The use of the investment value standard suggests that the court is attempting to compensate the nontitled spouse for the economic benefits the titled spouse will receive in the future, regardless of whether that spouse can sell those benefits.[35]

Also, when determining the investment value, discounts are typically not taken because investment value does not contemplate an actual or hypothetical sale, but only the value to the current owners.

Exhibit 4.2 presents the continuum of value for the premise of value and standards of value.

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32. Id. at 738.

33. See *Dugan v. Dugan*, 92 N.J. 423; 457 A.2d 1; 1983 N.J. LEXIS 2351 at 21. DR 2-108(A) of the *Disciplinary Rules of the Code of Professional Responsibility*: "A lawyer shall not be a party to or participate in a partnership or employment agreement with another lawyer that restricts the right of a lawyer to practice law after the termination of a relationship created by the agreement, except as may be provided in a bona fide retirement plan and then only to the extent reasonably necessary to protect the plan."

34. Today, the goodwill or client base of a law firm may be sold in New Jersey. This was not always the case.

35. *Dugan v. Dugan*, 92 N.J. 423; 457 A.2d 1; 1983 N.J. LEXIS 2351.

Exhibit 4.2 Continuum of Value: Premises and Standards of Value

Premise of Value	**Value in Exchange**		**Value to the Holder**
Standard of Value	Fair Market Value	Fair Value	Investment Value

Premises of Value Revealed through the Valuation of Insurance Agencies

Two cases involving captive State Farm insurance agencies demonstrate the difference between a value in exchange premise and a value to the holder premise. The Washington case of *In re: Zeigler*[36] presents a value in exchange, whereas the Colorado case of *In re: Graff*[37] reveals a value to the holder.

In re: Zeigler

Mr. Zeigler was the sole stockholder of a captive insurance agency of the State Farm Insurance Company. In his agreement with State Farm, he sold only State Farm–approved products, the names and book of business were owned by State Farm (and therefore Mr. Zeigler could not sell them). Mr. Zeigler controlled the organization and management of the agency. Upon termination of the agreement, Mr. Zeigler's agency could remain, retaining its name, staff, location, and so on, but would be prohibited from soliciting State Farm policyholders for one year, and for this agreement Mr. Zeigler would be paid 20% of the prior year's commissions for five years by State Farm.

Mr. Ziegler's expert testified that the goodwill of the agency was owned by State Farm, and because Mr. Zeigler had no personal interest in State Farm, he did not own any of the goodwill. The expert calculated no excess earnings and therefore no goodwill value to the agency.

Mrs. Zeigler's expert also applied an excess earnings methodology and adjusted Mr. Zeigler's salary to reflect industry averages, yielding a goodwill value of $231,000.

The trial court agreed with the assessment of Mr. Zeigler's expert, that the agency itself had no goodwill and any value to the firm above its assets was in the termination agreement. Additionally, any excess value to the business was associated with Mr. Zeigler's skill, knowledge, and hard work (what the court called earning capacity), rather than the expected public

36. Wash. App. 602, 849 P.2d 695 (Wash. App. Div. 3, 1993).

37. *In re: Marriage of Graff*, 902 P.2d 402 (Colo. App., 1994).

patronage based on business goodwill. Essentially, the business goodwill belonged to State Farm itself, not Mr. Zeigler's agency.

The Appeals Court agreed that because of the captive status of the agency and the agreements in place, any goodwill resides with State Farm, not with Mr. Zeigler or his agency.

In this case, the business was seen as an entity independent from (but still reliant on) the products it sold. If Mr. Zeigler terminated his relationship with State Farm, the agency would have no goodwill value. Because the goodwill belonged to State Farm, Mr. Zeigler did not have any right to sell it, and therefore it had no value to him.

The opposite was seen to be true in the Colorado case *In re: Graff*. Shortly after the Zeigler decision, the Colorado Court of Appeals decided a case involving another State Farm agency, with a similar contract as the agency discussed in Zeigler.

In re: Marriage of Graff

Mr. Graff's expert argued largely the same points as did Mr. Ziegler's expert. He pointed out that the agency could not sell, assign, exchange, or mortgage the value represented by the agency's ability to generate income. Mrs. Graff's expert testified that the agency had value because Mr. Graff acted like the owner of a business. Mr. Graff set his own hours, decided the location of the office, hired and fired his own employees, set their salaries, purchased his own supplies, and characterized his interest in the firm as that of a business on Schedule C of his tax return. The value arrived at by the wife's expert was $131,500, including a value for goodwill.

The trial court looked at the transferability and termination agreements, the same as those in the Washington case, but found that because a transfer or termination was not contemplated, the husband's interest in the firm and the continuing involvement with State Farm constituted value.

The court of appeals agreed with the trial court, stating that:

> the value of goodwill is not necessarily dependent upon what a willing buyer would pay for such goodwill, rather the important consideration is whether the business has a value to the spouse over and above the tangible assets. . . . Goodwill may be valued even though an agreement, as here, prevents the sale of an agency.[38]

38. Id. at [**5].

This statement shows a clear adherence to a value to the holder premise. Although the goodwill can not be sold, it still has value to the owner who continues in place.

In the case of *Seiler v. Seiler*,[39] New Jersey also addressed the value of a captive insurance agency, in this case, an Allstate agency. The court found that there was no goodwill owned by the individual, as the husband was clearly an employee of the firm, rather than a sole proprietor of his individual business. Any goodwill was associated with Allstate, rather than Mr. Seiler. As applied to the valuation of businesses and business interests, it appears that New Jersey is a fair value state,[40] as the courts regularly reject discounts but include the value of goodwill, even in businesses that cannot be sold. However, because Mr. Seiler was an employee of the firm rather than a sole proprietor or a stockholder, the court found that there was no business and no value to goodwill.

As this shows, two states may view the exact same business in very different ways. When approaching a valuation, one of the most important indicia of value is whether the asset in question qualifies as a business or not. As we explain, only in New York[41] is the value of goodwill in the form of a professional degree, license, enhanced earnings capacity, and celebrity status, without the associated business entity, considered divisible marital property.

Concepts of Value under the Two Premises

The continuum of value represented by the two premises value in exchange and value to the holder can be examined by looking at the treatment of goodwill and whether a particular state views this intangible asset as marital or separate property. Let us first look at value in exchange through the prism of two closely related issues: personal and enterprise goodwill and the applicability of a covenant not to compete, or the right to compete.

Compete: An extreme view of value in exchange includes neither the participation of the owner to help transition the business nor the owner's agreement to refrain from competing with the buyer. This scenario would represent the value of the business if the seller were allowed to open up shop next door, participating in exactly the same business as

39. 308 N.J. Super. 474; 706 A.2d 249; 1998 N.J. Super. LEXIS 80.

40. While the above applies to businesses and business interests, it appears that other marital assets are valued at their fair market value.

41. *O'Brien v. O'Brien*, 66 N.Y.2d 576; 489 N.E.2d 712;498 N.Y.S.2d 743; 1985.

he or she just sold. In this case, the income stream purchased will not include any value attributable to the personal goodwill of the seller and the value would have to consider the former owner's effect as a direct competitor. This is termed as the walk-away value.

Cooperate: Another view of the value in exchange standard considers the situation where the seller is willing and therefore cooperates to maximize value. The seller would eventually leave, possibly signing a covenant not to compete to restrict his or her efforts. The seller might also agree to a consulting contract of limited duration, where he or she will help transition the goodwill of the business to the new owners. Generally, under a value in exchange, the value of this covenant, however, would not be included in the value of the business because it is inextricably tied to the owner and his or her future efforts.

These differing assumptions of the seller's post-sale behavior can result in significantly different values for the business. Moreover, in regard to the valuation of professional practices and other types of businesses under value in exchange, this view of the covenant not to compete will form one of the bases of the difference between personal and enterprise goodwill. Under value to the holder, a sale is not necessarily contemplated. Therefore, the owner's participation in the transition is moot.

In the case that an actual sale occurs (at or prior to divorce), the court would have to consider whether the covenant's value was marital property. As the covenant's value affects an individual's behavior, under value in exchange, it would not likely be included in marital property. Under value to the holder, the issue is rarely addressed as there is an assumption that there is no sale.

STANDARDS OF VALUE IN DIVORCE AMONG THE 50 STATES

Lack of Statutory Insight

As we have mentioned, there is a substantial lack of statutory insight as to the standard of value in divorce proceedings. In dissenter's rights and oppressed shareholder suits, there is little doubt that fair value is the generally accepted standard. When it comes to divorce, only two states, Arkansas and Louisiana, provide any statutory guidance as to the standard of value. The Arkansas statute says:

§ 9-12-315. (4)—When stocks, bonds, or other securities issued by a corporation, association, or government entity make up part of the marital property, the court shall designate in its final order or judgment the specific property in securities to which each party is entitled, or after determining the *fair market value* of the securities, may order and adjudge that the securities be distributed to one (1) party on condition that one-half (1/2) the fair market value of the securities in money or other property be set aside and distributed to the other party in lieu of division and distribution of the securities. [emphasis added]

The Louisiana statute more generally applies the fair market value standard:

§ 9:2801—(1) (a) Within forty-five days of service of a motion by either party, each party shall file a sworn detailed descriptive list of all community property, the *fair market value* and location of each asset, and all community liabilities. [Emphasis added]

Further, Louisiana's statute prevents the valuation of personal goodwill in the distribution of community assets:

§ 9:2801.2—In a proceeding to partition the community, the court may include, in the valuation of any community-owned corporate, commercial, or professional business, the goodwill of the business. However, *that portion of the goodwill attributable to any personal quality of the spouse awarded the business shall not be included in the valuation of a business*. [Emphasis added]

Most states do not recommend or require any particular standard with which to value assets upon the dissolution of marriage. For example, New Jersey's equitable distribution provision states:

§ 2A:34-23 h. In all actions where a judgment of divorce or divorce from bed and board is entered the court may make such award or awards to the parties, in addition to alimony and maintenance, to effectuate an Equitable Distribution of the *property*, both real and personal, which was legally and beneficially acquired by them or either of them during the marriage. However, all such *property*, real, personal or otherwise, legally or beneficially acquired during the marriage by either party by way of gift, devise, or intestate succession shall not be subject to Equitable Distribution, except that inter-spousal gifts shall be subject to Equitable Distribution." [Emphasis added.]

Although the Arkansas statute is specific regarding the applicable standard of value in divorce, the New Jersey statute, along with the majority of others, states that property is to be distributed but does not state how the property is to be valued or the standard of value to be used in the process.

Revealing Standard of Value through Case Law

Many states appear to view the valuation of marital property based on the circumstances of the case or the precedents previously set by the courts with respect to certain elements of value. Because of this, clarity about the applicable standard of value suffers from the valuation practitioner's point of view. We can begin to look at the decisions made by each state as a means of suggesting which standard or combination of standards may apply. Later we will further discuss the continuum of value as it applies to these decisions and the actual classification of states into standard and premise of value categories.

While, with few exceptions, state statutes do not address the standard of value, a review of relevant case law can provide further insight as to the application of a standard of value in a particular state. A few states, including Hawaii, Florida, and Missouri, more clearly apply fair market value as the standard of value in their case decisions. For example, Hawaii's statute does not provide guidance on the standard of value:

> § 580-47—Upon granting a divorce, or thereafter if, in addition to the powers granted in subsections (c) and (d), jurisdiction of those matters is reserved under the decree by agreement of both parties or by order of court after finding that good cause exists, the court may make any further orders as shall appear just and equitable (1) compelling the parties or either of them to provide for the support, maintenance, and education of the children of the parties; (2) compelling either party to provide for the support and maintenance of the other party; (3) finally dividing and distributing the estate of the parties, real, personal, or mixed, whether community, joint, or separate; and (4) allocating, as between the parties, the responsibility for the payment of the debts of the parties whether community, joint, or separate, and the attorney's fees, costs, and expenses incurred by each party by reason of the divorce. In making these further orders, the court shall take into consideration: the respective merits of the parties, the relative abilities of the parties, the condition in which each party will be left by the divorce, the burdens imposed upon either party for the benefit of the children of the parties, and all other circumstances of the case.

Accordingly, the statute provides only a general outline for the dissolution of the marital estate. However, in the 1988 Hawaii case *Antolik v. Harvey*,[42] the court clearly applies fair market value as the standard with which to value businesses.

Antolik v. Harvey

The husband was a licensed chiropractor and a sole proprietor of his business. As the business was premarital, the parties agreed that the wife was entitled to half of the increase in value of the practice from the date of marriage to the date of contemplation of divorce. The family court found the values at $8,000 and $48,000 respectively as of these dates, and the husband was ordered to pay the wife $20,000.

The husband's expert valued the practice based on an adjusted book value, arriving at a value of $8,000 at the start of the marriage in 1984, assuming a business loan for $18,675.99 was used for personal expenditures and excluding it from the valuation. He used a similar method to determine that the value of the husband's practice was $48,000 at the time of divorce in 1986, but included the remaining balance on the business loan previously discussed.

The wife's expert determined that the practice had gross receipts of $85,445 in 1985, $147,151.05 in 1986, and would generate $175,000 in 1987. The earnings of the practice in 1987 were estimated to be $105,000. Using a reasonable compensation figure of $54,000, the expert concluded that the earnings of the business would be $51,000, and by using a 20% future earnings rate, valued the business at $255,000, plus the replacement value of its intangible assets, less liabilities.

The wife contended that the $48,000 value arrived at in the family court did not include a goodwill value. The appellate court discussed the nature of goodwill and determined it to be an attribute of a business in which there is a recognized value above the tangible assets of such entity. The court stated:

> When dividing and distributing the value of the property of the parties in a divorce case, the relevant value is, as a general rule, the fair market value (FMV) of the parties' interest therein on the relevant date. We define the FMV as being the amount at which an item would change hands from a willing seller to a willing buyer, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

42. 7 Haw. App. 313; 761 P.2d 305; 1988.

The court rejected the contention that the value of the sole proprietorship was the value to the professional operating it, as other assets are valued at their fair market value.

In determining the value of the practice at the date of marriage, the court concluded that the debt must be considered, and therefore the adjusted net book value of the business was $8,136.96.

The date of divorce valuation ($48,000 in 1986), the family court put a value of $2,310.00 on the patient charts as the hypothetical value if the husband had died. The appellate court's review stated that the sale of the business including goodwill would be contingent upon the owner's cooperation and continued presence to transfer the existing patient base to a similarly productive chiropractor. Should the husband leave immediately, the goodwill could not be transferred. The family court did not contemplate the lack of a binding agreement that would prevent the husband from competing upon sale. However, the husband did not appeal the inclusion of the value of the book of business, so the appellate court affirmed the family court's 1986 valuation.

No state specifically uses the terms *investment value* or *fair value* as the standard of value in their statute, but various case decisions in a state might provide the insight so as to generally establish a given standard of value. New Jersey's *Brown v. Brown*[43] (discussed in detail later) uses the language of fair value and refers to New Jersey dissent and oppression cases to determine fair value.

California's *Golden v. Golden*,[44] although never specifically mentioning investment value, clearly lays out what appears to be a value to the holder treatment of assets that embodies most of the elements found in investment value.

Golden v. Golden

After a seven-year marriage, the parties involved were divorced. The husband was a doctor, 31 years old, and the wife was 29 and a housewife who had previously worked as a teacher. In the distribution of community assets, the court included an allocation of $32,500 for the goodwill of the husband's medical practice.

On appeal, the husband argued that the trial court erred in finding goodwill to be a community asset, citing a previous California decision holding that upon the dissolution of law practices, no allowance could be made

43. 348 N.J. Super. 466; 792 A.2d 463; 2002 N.J. Super. LEXIS 105.

44. 270 Cal. App. 2d 401; 75 Cal. Rptr. 735; 1969 Cal. App. LEXIS 1538.

for goodwill because the reputation of the firm depends on the skill of each member. Additionally, tax cases held that goodwill was only connected with a going business.

Other cases, however, had found that salable goodwill exists in a professional business even if founded on personal skill and reputation, and upon the dissolution of the community, a professional's practice must be taken into account for evaluating the community estate. The court established what it called a better rule, as follows:

> We believe the better rule is that, in a divorce case, the good will of the husband's professional practice as a sole practitioner should be taken into consideration in determining the award to the wife. Where, as in *Lyon*, the firm is being dissolved, it is understandable that a court cannot determine what, if any, of the good will of the firm will go to either partner. But, in a matrimonial matter, the practice of the sole practitioner husband will continue, with the same intangible value as it had during the marriage. Under the principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during marriage. She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business.

The valuation therefore stood with the inclusion of goodwill in the calculation of value.

As Exhibit 4.3 shows, we begin with two premises of value and place the standards of value under the applicable premises. Fair market value is a value in exchange, and investment value is a value to the holder. Fair value may fall under either premise in that it may contain elements of both. The three cases we have mentioned in terms of the standard of value used are placed on the continuum as examples.

Exhibit 4.3 Continuum of Value: Standards of Value with Case Examples

<table>
<tr><td>Premise of Value</td><td colspan="2">Value in Exchange</td><td colspan="2">Value to the Holder</td></tr>
<tr><td>Standard of Value</td><td>Fair Market Value</td><td colspan="2">Fair Value</td><td>Investment Value</td></tr>
<tr><td>Case Example</td><td>Antolik v. Antolik</td><td colspan="2">Brown v. Brown</td><td>Golden v. Golden</td></tr>
</table>

Toward a Standard of Value Classification System

To perform this analysis, we first looked to the statutes of all 50 states and the District of Columbia for guidance on the standard of value applied in each jurisdiction. We found that only Arkansas and Louisiana provide direction in their statutes. We then moved to the case law in each jurisdiction, and through this review, we found clearer guidance in 10 additional states. Including Arkansas and Louisiana, 11 states direct the use of fair market value in their case law, and 1 state, Minnesota, uses the term *market value*, which we consider fair market value by the context of the usage.

The standard of value in the remaining 39 jurisdictions must be inferred from the use and application of certain concepts. In these jurisdictions, we examined the treatment of personal versus enterprise goodwill, shareholder-level minority and lack of marketability discounts, and the weight accorded buy-sell agreements. In value in exchange states, we looked at the language of cases and the use of discounts to determine whether a fair market value standard or a fair value standard was being followed. Additionally, by reviewing the language of the case and the treatment of goodwill and covenants not to compete, we have tried to determine whether a state followed a walk-away fair market standard or a more traditional fair market value standard.

In some states, the standard of value is less clear and the body of case law does not imply adherence to any particular standard or valuation principle, perhaps to intentionally allow the court a higher degree of flexibility to pass judgment based on the facts, circumstances, and equities of a given case.

Although the standard of value in each state is often not an absolute, for analytical purposes it is helpful to categorize states based on our earlier assumptions. Although this should not be seen as a hard and fast determination of the application of a specific standard of value, this classification system should provide a reasonable starting point from which to analyze how value is viewed in a particular state. As always, the valuator must be conscious of the nuances in any given case or state that may affect how value is determined.

We begin with the manner in which states view intangible value, specifically goodwill. The treatment of goodwill can be an indicator of how a court views marital property, the premise of value, and the standard of value. Just as the fair market value standard implies the exclusion of personal goodwill (because it cannot be transferred upon sale), prior case law demonstrating the consistent exclusion of personal goodwill implies that the state follows a value in exchange premise and the use of a fair market value standard.

The listed states, either through statute or specific language contained in case law, specifically mention the standard of value that should be used in a divorce valuation. Following this concept, we cite specific cases where the standard of value is specifically mentioned.

State	Standard	Source
Arkansas	Fair market value	Statute;[45] *Tortorich v. Tortorich*[46]
Connecticut	Fair market value	*Dahill v. Dahill*[47]
Florida	Fair market value	*Christians v. Christians*[48]
Hawaii	Fair market value	*Antolik v. Harvey*[49]
Kansas	Fair market value	*Bohl v. Bohl*[50]
Louisiana	Fair market value	Statute[51]
Minnesota	Market value	*Bateman v. Bateman*[52]
Missouri	Fair market value	*Hanson v. Hanson*[53]
Nebraska	Fair market value	*Taylor v. Taylor*[54]
New York	Fair market value	*Beckerman v. Beckerman*[55]
South Carolina	Fair market value	*Hickum v. Hickum*[56]
Wisconsin	Fair market value	*Sommerfeld v. Sommerfeld*[57]

For the remaining unclassified states, we can look at the manner in which certain issues are treated to reveal the standard of value. Additionally, we can look at the way the states that use specific language treat certain issues in their case law to make a more specific assessment of their standard of value.

45. Arkansas Statute § 9-12-315 (4)
46. 902 S.W.2d 247 (Ark. App. 1995).
47. 1998 Conn. Super. LEXIS 846 (Conn. Super. Ct. Mar. 30 1998).
48. 732 So. 2d 47; 1999 Fla. App. LEXIS 6687; 24 Fla. L. Weekly D 1218.
49. 7 Haw. App. 313; 761 P.2d 305; 1988.
50. 232 Kan. 557; 657 P.2d 1106; 1983 Kan. LEXIS 236.
51. La. R.S. 9:2801.
52. 382 N.W.2d 240; 1986 Minn. App. LEXIS 4017.
53. 738 S.W.2d 429 (Mo. 1987).
54. 386 N.W.2d 851 (Neb. 1986).
55. 126 A.D.2d 591; 511 N.Y.S.2d 33; 1987 N.Y. App. Div. LEXIS 41733. New York also follows an investment value standard of value, as evidenced by *O'Brien v. O'Brien*, 66 N.Y.2d 576; 489 N.E.2d 712; 498 N.Y.S.2d 743; 1985; and *Moll v. Moll*, 187 Misc. 2d 770, 722 N.Y.S.2d 732 (2001).
56. 463 S.E.2d 321 (S.C. Ct. App. 1995).
57. 454 N.W.2d 55 (Wis. Ct. App. 1990).

First, we can look at whether a state chooses to follow a value in exchange or value to the holder premise by its treatment of goodwill. If nonmarketable or personal goodwill is excluded, the state falls under a value in exchange premise. If a state does not distinguish enterprise and personal goodwill in its case law (or specifically includes personal goodwill), we categorize it under a value to the holder premise.

Under this classification system, a value in exchange state may be either fair market value or fair value based on its consideration of goodwill, discounts, buy-sell agreements, and case-specific language.

In terms of case-specific language, some cases use concepts that imply fair value rather than fair market value, such as an unwilling buyer, unwilling seller, fairness, or instruction to take a pro rata share of the enterprise. Other cases use language of how much a willing buyer would pay or how much a willing seller would accept, indicating a fair market value standard. Courts seeking to determine a value to the holder often use language indicating that a sale is unlikely or the value of a business or business interest should be its value to its current holder.

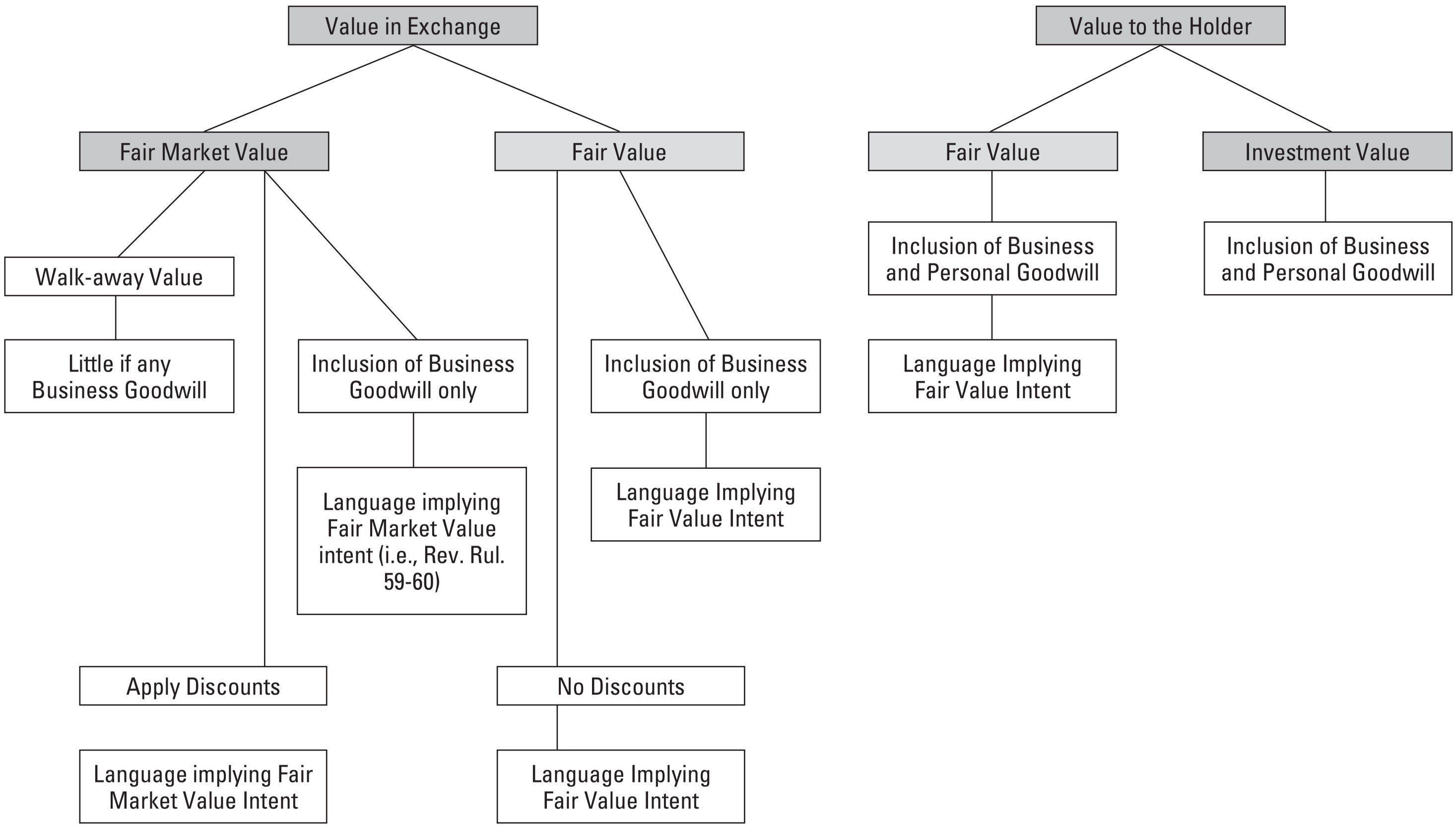
Under the value in exchange premise, following a fair market value standard of value, the language used may further delineate fair market value into a so-called walk-away standard where very little, if any, goodwill is considered a marital asset. Similarly, a value to the holder state will reveal either fair value or investment value based on the same principles of language.

The application of discounts may also reveal the standard of value. If shareholder-level discounts are applied, the case generally falls under fair market value. Under a value in exchange, if discounts are rejected, the case generally falls under fair value. Under value to the holder, discounts are generally not contemplated. However, some cases include goodwill without distinguishing personal and enterprise goodwill and reject the application of discounts. This also suggests a fair value standard.

The analysis of the weight accorded buy-sell agreements depends more on the context and language in the decision. If the language in the decision indicates that great weight should be accorded the buy-sell agreement because it is the amount that the individual will actually receive, that would be a strong indication of value in exchange. If the language in the decision measures the weight associated with the buy-sell agreement in terms of its fairness, it indicates that the continuum is moving from value in exchange to value to the holder. If the language in the decision indicates that little or no weight should be accorded to the buy-sell agreement because there will be no sale, then that indicates a value to the holder standard.

Exhibit 4.4 presents these principles graphically.

Exhibit 4.4 Value in Exchange, Value to the Holder Flow Chart



Additionally, certain states contain elements that belong to both value in exchange and value to the holder. We consider these to be hybrid states. For example, New York looks to apply fair market value in some cases,[58] while in other instances also having cases that clearly fall under of value to the holder.[59] In other states, we have not found any decisions that would suggest they fall under any particular standard. The list that follows classifies states according to our analysis of their treatment of goodwill, shareholder level discounts, and the weight accorded buy-sell agreements.

VALUE TO THE HOLDER

FAIR MARKET VALUE

State	Source
Alaska	*Richmond v. Richmond*[60]
Arkansas	*Tortorich v. Tortorich*[61]
Connecticut	*Dahill v. Dahill*[62]
District of Columbia	*McDiarmid v. McDiarmid*[63]
Delaware	*E.E.C. v. E.J.C.*[64]
Florida	*Williams v. Williams*[65]
Hawaii	*Antolik v. Harvey*[66]
Idaho	*Chandler v. Chandler*[67]
Illinois	*In re: Marriage of Zells*[68]
Iowa	*In re: Marriage of Hoak*[69]

58. *Beckerman v. Beckerman* (1987, 2d Dept) 126 AD2d 591,511 NYS2d 33.
59. *O'Brien v. O'Brien*, 66 N.Y.2d 576; 489 N.E.2d 712;498 N.Y.S.2d 743; 1985.
60. 779P.2d 1211.
61. 902 S.W.2d 247 (Ark. App. 1995).
62. 1998 Conn. Super. LEXIS 846 (Conn. Super. Ct. Mar. 30 1998).
63. App. D.C., 649 A.2d 810 (1994).
64. 457 A.2d 688 (Del. 1983).
65. 667 So.2d 915 (Fla. Dist. Ct. App. 1996).
66. 7 Haw. App. 313; 761 P.2d 305; 1988.
67. 136 Idaho 246; 32 P.3d 140; 2001 Ida. LEXIS 87.
68. 572 N.E.2d 944 (Ill. 1991).
69. 364 N.W.2d 185 (Iowa 1985).

State	**Source**
Kansas	*Powell v. Powell*[70]
Maryland	*Prahinski v. Prahinski*[71]
Massachusetts	*Goldman v. Goldman*[72]
Minnesota	*Bateman v. Bateman*[73]
Mississippi	*Singley v. Singley*[74]
Missouri	*Hanson v. Hanson*[75]
Nebraska	*Taylor v. Taylor*[76]
New Hampshire	*In re: Watterworth*[77]
North Dakota	*Sommers v. Sommers*[78]
Oklahoma	*Ford v. Ford*[79]
Oregon	*Marriage of Maxwell*[80]
Pennsylvania	*Butler v. Butler*[81]
Rhode Island	*Moretti v. Moretti*[82]
South Carolina	*Hickum v. Hickum*[83]
Tennessee	*Alsup v. Alsup*[84]
Texas	*Nail v. Nail*[85]
Utah	*Sorenson v. Sorenson*[86]

70. 648 P.2d 218 (Kan. 1982).
71. 582 A.2d 784 (Md. Ct. Spec. App. 1990).
72. 554 N.E.2d 860 (Mass. App. 1990).
73. 382 N.W.2d 240 (Minn. Ct. App. 1986).
74. 2003 Miss. LEXIS 283.
75. 738 S.W.2d 429 (Mo. banc. 1987)
76. 386 N.W.2d 851 (Neb. 1986).
77. 821 A.2d 1107 (N.H. 2003).
78. 2003 ND 77, 660 N.W.2d 586 (2003).
79. 840 P.2d 36 (Okla. Ct. App. 1992).
80. 876 P.2d 811 (Or. App. 1994).
81. 663 A.2d 148 (Pa. 1995).
82. 766 A.2d 925 (R.I. 2002).
83. 463 S.E.2d 321 (S.C. Ct. App. 1995).
84. No. 01A01-9509-CH-00404, 1996 WL 411640 (Tenn. Ct. App. July 24, 1996).
85. 486 S.W.2d 761; 1972 Tex. LEXIS 244; 16 Tex. Sup. J. 67; 52 A.L.R.3d 1338.
86. 839 P.2d 774, 775-776 (Utah 1992).

State	Source
Vermont	*Goodrich v. Goodrich*[87]
West Virginia	*May v. May*[88]
Wisconsin	*Sommerfeld v. Sommerfeld*[89]

VALUE IN EXCHANGE

Fair Value	Source
Indiana	*Bobrow v. Bobrow*[90]/*Yoon v. Yoon*[91]
Louisiana	*Ellington v. Ellington*[92]
Virginia	*Howell v. Howell*[93]
Wyoming	*Neuman v. Neuman*[94]

VALUE TO THE HOLDER

INVESTMENT VALUE

State	Source
Arizona	*Mitchell v. Mitchell*[95]
California	*Golden v. Golden*[96]
Colorado	*In re: Marriage of Huff*[97]
Kentucky	*Clark v. Clark*[98]

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87. (1992) 158 Vt. 587, 613 A.2d 203.
88. 214 W. Va. 394; 589 S.E.2d 536; 2003 W. Va. LEXIS 118.
89. 454 N.W.2d 55 (Wis. Ct. App. 1990).
90. 711 N.E.2d 1265; 1999.
91. Id.
92. 842 So. 2d 1160; 2003 La. App. LEXIS 675. While Louisiana's community property distribution statute excludes personal goodwill, the decision in *Ellington* uses language that suggests fair value.
93. 31 Va. App. 332, 523 S.E.2d 514 (2000).
94. 842 P.2d 575 (Wyo. 1992).
95. 152 Ariz. 317, 732 P.2d 208 (1987).
96. 75 Cal. Rptr. 735 (Cal. Ct. App. 1969).
97. 834 P.2d 244.
98. 782 S.W.2d 56, 1990 Ky. App. LEXIS 3 (Ky. Ct. App. 1990).

State	Source
Michigan	*Kowalesky v. Kowalesky*[99]
Montana	*In re: Marriage of Hull*[100]
Nevada	*Ford v. Ford*[101]
New Mexico	*Mitchell v. Mitchell*[102]
North Carolina	*Poore v. Poore*[103]
Washington	*Matter of Marriage of* Fleege[104]

HYBRID STATES

State	Standard	Source
New Jersey[105]	Fair value	*Brown v. Brown*[106]
	Investment value	*Dugan v. Dugan*[107]
New York	Investment value	*Moll v. Moll*[108]
	Fair market value	*Beckerman v. Beckerman*[109]
Ohio	Fair market value	*Goswami v. Goswami*[110]
	Investment value	*Kahn v. Kahn*[111]

States with No Definitive Decisions

Alabama, Georgia, Maine, South Dakota

99. 148 Mich. App. 151; 384 N.W.2d 112; 1986 Mich. App. LEXIS 2380.
100. 219 M 480, 712 P2d 1317, 43 St. Rep. 107 (1986).
101. 782 P.2d 1304 (Nev. 1989).
102. 719 P.2d 432 (N.M. Ct. App. 1986).
103. 75 N.C. App. 414, 331 S.E.2d 266, cert. denied, 314 N.C. 543, 335 S.E.2d 316 (1985).
104. 588 P2d 1136 (1979).
105. The Brown case used concepts of fair value in rejecting the application of discounts in a valuation, and the court based that decision upon cases dealing with fair value in shareholder oppression and dissent. Dugan and Piscopo can be considered to adhere to an investment value standard with regard to personal goodwill. Moreover, an area of controversy in New Jersey is the weight to be afforded a buy sell agreement, especially in a professional practice, in light of the New Jersey Supreme Court case Stern v. Stern.
106. 348 N.J. Super. 466; 792 A.2d 463
107. 92 N.J. 423; 457 A.2d 1; 1983 N.J. LEXIS 2351.
108. 187 Misc. 2d 770, 722 N.Y.S.2d 732 (2001).
109. (1987, 2d Dept) 126 AD2d 591, 511 NYS2d 33.
110. 152 Ohio App. 3d 151, 2003 Ohio 803, 787 N.E.2d 26 (Ohio App. 7th Dist. 2003).
111. 42 Ohio App. 3d 61, 536 N.E.2d 678 (Ohio App. 2d Dist. 1987).

As with dissenter's rights and oppression proceedings, we can look to the law associations for guidance on the standard of value. The ALI's *Principles of the Law of Family Dissolution*[112] espouses a value in exchange premise, because it advocates excluding nonsalable goodwill attributable to the individual for assets subject to equitable distribution. The reasoning separates enterprise goodwill and personal goodwill from any value associated with an increased earning capacity. The ALI's *Principles of the Law of Family Dissolution* state:

> (1) Spousal earning capacity, spousal skills, and earnings from post-dissolution spousal labor, are not marital property.
>
> (2) Occupational licenses and educational degrees are not marital property.
>
> (3) Business goodwill and professional goodwill earned during marriage are marital property to the extent they have value apart from the value of spousal earning capacity, spousal skills, or post-dissolution spousal labor.

In the explanation to this passage, the ALI endorses a market treatment for goodwill, indicating that it exists if and only if the market value of the practice exceeds the asset value.[113]

Although the *Principles of Corporate Governance* are cited continually in case law and legal scholarship with regard to fair value in dissenter's rights and shareholder oppression matters, the *Principles of the Law of Family Dissolution* are not often cited in marital dissolution matters. The states are generally more concerned with the case law precedents of their own or other states with respect to goodwill, discounts, earning capacity, and the like than with the suggestions of law associations.

To demonstrate how we arrived at the classification system, we can start by looking at Tennessee's *Alsup v. Alsup*[114] as an example of why Tennessee is categorized as a fair market value state. In this case, the court decided that goodwill in a professional practice or sole proprietorship was not a marital asset for equitable distribution purposes, which suggests that the court in Tennessee is likely to follow a fair market value standard.

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112. American Law Institute. "Principles of the Law of Family Dissolution" 2002.

113. American Law Institute, "Principles of the Law of Family Dissolution: Analysis and Recommendations" Philadelphia: Matthew Bender, 2002 at §.4.07.

114. *Alsup v. Alsup*, No. 01A01-9509-CH00404, 1996 WL 411640 (Tenn Ct. App. July 24, 1996).

California's *Golden v. Golden*, however, established that goodwill in a medical practice exists, and the individual practitioner's inability to sell it should not affect its consideration as an asset because the nontitled spouse contributed to its existence. This implies an investment value standard.

New Jersey's *Brown v. Brown* is a matrimonial case where there are continuing references to the fair value standard as used in dissenting and oppressed shareholder matters. Accordingly, fractional interests in businesses seem to be viewed the same way in matrimonial matters as in dissent and oppression matters in New Jersey.

New York is an example of a hybrid state. While seeming to base the valuation of businesses on the IRS's Revenue Ruling 59-60 including the application of shareholder-level discounts where appropriate (an indicia of fair market value). The state seems to fall closer to investment value with regard to other types of marital property. In fact, New York has gone so far as to assign a value to a license, professional degree, and enhanced earning capacity.

We next address the key issues and cases that lead to the aforementioned characterizations. We begin with the treatment of goodwill, especially enterprise and personal goodwill, by the individual states.

VALUE IN EXCHANGE

As discussed, value in exchange assumes a hypothetical sale and looks to the value of the asset based on what would be realizable upon that sale at the valuation date. Several issues stem from the assumption of a hypothetical sale. We begin by looking at the differences in enterprise and personal goodwill, as a value in exchange would be concerned only with the elements of value that could be transferred to another owner, as opposed to those that reside solely with the current owner.

Goodwill

Enterprise Goodwill

Enterprise goodwill is the goodwill of the business. Therefore, it generally is a transferable asset, and it almost always is included in the valuation of the enterprise, even in those states that adhere to the narrowest interpretation of fair market value.[115] Upon selling a business, one has the ability to transfer

115. Enterprise goodwill in a professional practice may be treated differently because of the reliance on a particular owner.

enterprise goodwill to the buyer. Enterprise goodwill is defined by *Black's Law Dictionary* as "favorable consideration shown by the purchasing public to goods or services known to emanate from a particular source."[116] The existence of enterprise goodwill is based on the fact that customers return to an enterprise, based on its location, staff, telephone number, facilities, and the reputation of the overall entity.[117] Enterprise goodwill is found when there is an expectancy of repeat patronage attributable to the entity as distinguished from the individual. An elegant description is found in the nineteenth-century English case *Cruttwell v. Lye*:[118]

> The good-will, which has been the subject of sale, is nothing more than the probability, that the old customers will resort to the old place.

An early twentieth-century New York commercial case makes a broader statement about goodwill, extending it not only to a particular place, but to a particular advantage that may be sold to another:

> Men will pay for any privilege that gives a reasonable expectancy of preference in the race of competition.[119]

These privileges might include a business's name, its phone number, its logo, or any facet of the business that might give it a continuing competitive advantage. Enterprise goodwill is the goodwill adhering to an entity regardless of the input of any specific individual.

Personal Goodwill

Personal goodwill is goodwill that adheres to an individual. It consists of personal attributes of a practitioner including personal relationships, skill, personal reputation, and various other factors. It is usually not transferable, and therefore, states with a value to the holder premise usually do not require it be distinguished from enterprise goodwill. Justice Joseph Story, Associate Justice of the Supreme Court serving from 1812 to 1845, builds on the idea of good-

116. Bryan A. Garner, *Black's Law Dictionary*, 8th ed. (St. Paul, MN: Thompson West., 2004), at 694.

117. Jay Fishman, "Personal Goodwill v. Enterprise Goodwill," 2004 AICPA National Business Valuation Conference, Session 5. Orlando, FL. November 7, 2004.

118. 34 Eng. Rep. 129, 134 (1810).

119. *In re: Brown*, 150 N.E. 581, 583 (N.Y. 1926).

will adhering not only to a location, but to the reputation or celebrity of the establishment that causes customers to resort to a particular behavior.

> Goodwill may be properly enough described to be the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.[120]

The basic question surrounding the issue of personal goodwill comes from whether certain abilities, relationships, qualities, and attributes of individuals that generate income (including their reputation) can or should be distributed as marital property. Additionally, are these personal assets transferable within some reasonable time frame to the entity through an individual's cooperation?

A useful working definition of personal goodwill is "[the] part of increased earning capacity that results from the reputation, knowledge and skills of individual people, and is nontransferable and unmarketable."[121] Simply, personal goodwill is that which would make a doctor's patients follow him even if he changed his location, staff, and phone number.

California's *In re: Marriage of Lopez*[122] is an example of an early case where the court suggested a list of factors to be considered in valuing goodwill. Those five factors are:

1. The age and health of the professional
2. The professional's demonstrated earning power
3. The professional's reputation in the community for judgment, skill, and knowledge
4. The professional's comparative professional success
5. The nature and duration of the professional's practice, either as a sole proprietor or as a contributing member of a partnership or professional corporation

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120. Joseph Story, "Commentaries on the Law of Partnerships" § 99, at 170 (6th ed. 1868).

121. Helga White, "Professional Goodwill: Is It a Settled Question or Is There 'Value' in Discussing It?" 15 *Journal of the American Academy of Matrimonial Lawyers* 495 (1998) at 499.

122. 113 Cal. Rptr. 58, 38 Cal. App.3d 1044 (1974).

Upon careful review, it is clear that at least four of the five factors deal with personal attributes. Typically, the age and health of the professional is of little concern to the buyer, unless they have impacted the historical performance of the practice or are used as a negotiating ploy. The reliance on these factors implies that California falls under a value to the holder premise, as there appears to be no explicit attention drawn to the difference between the professional and the practice. In a value in exchange state, most of the five factors would be used to determine how much goodwill is dependent on the individual and should therefore be excluded from value.

Owner's Compensation

There is often an interrelationship between enterprise goodwill, personal goodwill, and the amount paid to the owner employee. One characteristic of a closely held business is that typically its owners are also its key employees. As a result, there is a merging of a return on labor (wages) and return on capital (profits/dividends). The valuation professional is tasked with the responsibility of separating these two returns into wages paid to the employee on an arm's length basis and the profits generated by the business. This is a difficult task under ordinary circumstances; it becomes even harder when the enterprise is indistinguishable from the individual. The separation of these two returns is necessary under both a value in exchange and a value to the holder premise. Assuming one can estimate compensation for the replacement proxy, it is important to understand whether the resulting profits, if any, are attributable to the enterprise and therefore part of the business or merely the earning capacity of the individual.

The case of *Dugan v. Dugan*[123] laid out several factors that should be considered in an assessment of reasonable compensation, including age, experience, education, expertise, effort, and locale. In a value in exchange state, to the extent these excess profits are generated by some unique inchoate attribute, the profits in excess of the reasonable compensation, if any, are considered personal goodwill and not includable as a marital asset. In a value to the holder state, typically, the individual attributes are not explicitly excluded but are considered in the selection of reasonable compensation and in the capitalization rates used in the valuation methodology.[124]

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123. 92 N.J. 423; 457 A.2d 1; 1983 N.J. LEXIS 2351.

124. There is much debate on the methodologies to be used to determine reasonable compensation; however, that is beyond the scope of this book. For such a study, see *Dugan v. Dugan*, 92 N.J. 423; 457 A.2d 1; 1983 N.J. LEXIS 2351, or Jay E. Fishman, Shannon P. Pratt, and J. Clifford Griffith, "PPC's Guide to Business Valuation," Thompson PPC 2004, at 11-12.

Goodwill versus Going Concern

The Pennsylvania case *Gaydos v. Gaydos*[125] may further illuminate the character of personal goodwill. The husband, a sole-proprietor dentist, argued that the difference between the fire sale value and the court's value (found using the average income method) was personal goodwill. The trial court said that this was simply the going concern value of the business and, therefore, was marital property. On appeal, the Superior Court decided that the husband, not the practice, was responsible for the net income of the business, and that going concern value was contingent upon his continued participation, not that of another dentist at the same practice in place of him. (The appellate court was saying that the value was personal to the practitioner.)

Going concern value, as indicated by the *Gaydos* court, is not the same as goodwill. Going concern value is the intangible value attached to the assemblage of assets of the business, including the business's fixtures, equipment, and its assembled workforce. Business goodwill is not concerned with physical assets; instead, it can be viewed as the excess earnings the business produces due to (among other things) its reputation and skill.[126] Personal goodwill concerns the excess earnings reliant on the practitioner's personal attributes.

Exhibit 4.5 builds on the Continuum of Value with an additional layer showing the types of intangible value and where they fall over the full continuum. In the next section, we address the intangible values included in marital property under value in exchange, and how those are differentiated from value to the holder intangibles. Later, we will address the most inclusive intangibles under our analysis of value to the holder concepts.

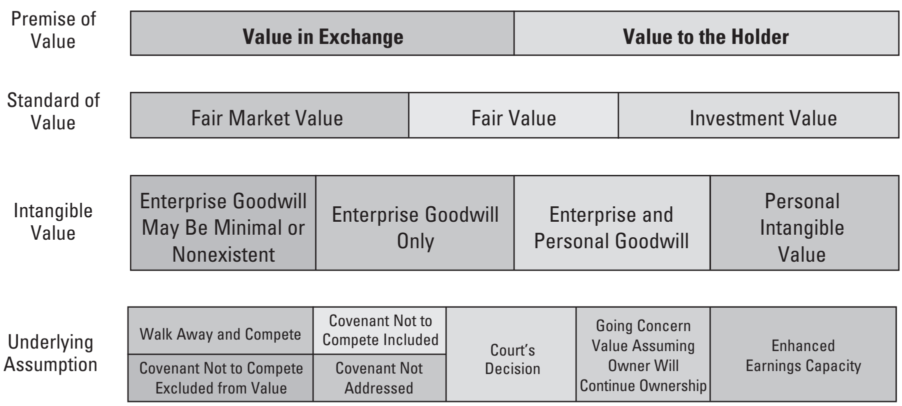
Distinguishing Personal and Enterprise Goodwill

Typically, commercial goodwill that has been institutionalized is considered marital property. It is when there is a question as to whether the goodwill adheres to an individual or a business that identification and valuation of goodwill can be problematic. The requirement to distinguish between personal and enterprise goodwill often can be used as a litmus test to establish how that particular state views value. In those states where a value to the holder premise is employed, the issue is almost never explicitly addressed, as there is no requirement to distinguish between transferable enterprise goodwill and nontransferable personal goodwill. Generally enterprise goodwill, the institutionalized

125. 693 A.2d (Pa. Super. Ct. 1993).

126. Kathryn J. Murphy, "Business Valuations in Divorce," Dallas Chapter Texas Society of Certified Public Accountants, 1998 Divorce Conference, September 22, 1998, at 19.

Exhibit 4.5 Continuum of Value: Intangible Assets



expectancy of repeat patronage, is considered marketable. Personal goodwill, the goodwill associated with the person, generally is not marketable without the continued postmarital participation of that person.[127]

In a value in exchange state, transferable enterprise goodwill must be separated from nontransferable personal goodwill but this is not always an easy distinction. The line between an individual's contribution to the success of a business and the success of the business itself is not necessarily clear. However, any state using fair market value or some other variation of a value in exchange premise requires the valuation practitioner to distinguish between the two concepts.

The seminal Florida case of *Thompson v. Thompson*[128] provides insight as to how that state views the distinction between personal and enterprise goodwill, in this case, in a professional practice.

Thompson v. Thompson

The Thompsons were married for 23 years. During that time, Mr. Thompson finished college, attended law school, and became an attorney specializing in personal injury and medical malpractice while Mrs. Thompson maintained the home and raised their children.

127. Alica Brokers Kelly, "Sharing a Piece of the Future Post-Divorce: Toward a More Equitable Distribution of Professional Goodwill," 51 *Rutgers Law Review* 569 (Spring 1999), at 588.

128. 576 So. 2d 267; 1991.

> The trial court awarded Mrs. Thompson permanent periodic alimony, lump-sum alimony paid over 10 years, child support, and other real and personal property which to some extent represented a credit for the goodwill of Mr. Thompson's sole shareholder interest in a professional association. On appeal, Mr. Thompson argued that the trial court improperly included goodwill of the professional practice distributable marital property. The court stated that, typically, a nonprofessional spouse's efforts during the marriage increase the professional spouse's earning power and that this should be compensated with higher alimony. The court then acknowledged that if indeed professional goodwill exists and was developed during the marriage, it should be included in the marital estate upon dissolution.
>
> The court had defined goodwill as the advantage or benefit a business has beyond the value of its property and capital. The court then reviewed the treatment of professional goodwill in various states, finally settling in agreement with the Missouri case, *Hanson v. Hanson*,[129] which stated that professional goodwill is property that attaches to and is dependent upon an existing business entity. Any personal component, including a person's reputation and skill, however, are not components of goodwill in a professional practice and therefore are not subject to equitable distribution.
>
> The Missouri court went on to define goodwill as the value of the practice that exceeds tangible assets that is dependent on clients returning to the business irrespective of the participation of the individual practitioner. If goodwill depends on the practitioner, it is not marketable, and represents probable future earning capacity, which may be relevant to determining alimony but not property distribution.
>
> The *Thompson* court directed that fair market value was the clearest method by which to value a business, and directed that it should be the exclusive method of measuring the goodwill in a professional association.

Unfortunately, *Thompson* refers to fair market value as a method of value and not a standard of value. While approaches and methods can be used to establish fair market value, the term *fair market value* is a standard under which various approaches and methods are employed.

In some practices, the viability of the practice may be dependent on the continued participation of an individual practitioner, making it difficult to distinguish between enterprise goodwill and the individual practitioner's reputation. Courts that look for a transactional value have in some cases excluded the consideration of goodwill in a professional practice altogether because of either its lack of marketability or its reliance on a particular individual. Other courts have acknowledged that goodwill in a professional practice may have

129. 738 S.W.2d 429, 434 (Mo. 1987).

elements of both personal and enterprise goodwill, suggesting that there would be a value to the enterprise in the sale of the business to another individual. At the other end of the continuum, courts in states that favor a value to the holder premise will likely not differentiate between personal and enterprise goodwill as no transaction is contemplated and therefore the transferability issue is not as relevant.

Because of the service aspect of their operations, professional practices and other service businesses are where the personal/enterprise goodwill issue is most evident. A group or partnership type of professional practice might have less reliance on personal goodwill, as it may involve several individuals providing the service and transferability in the form of partners buying in or out of a practice. Other commercial enterprises, including manufacturing, retailing, and wholesaling, may not be as reliant on an individual; therefore, personal goodwill may be less prevalent, depending on the nature of the firm and its management structure. Of course, these are all flexible concepts that will vary based on the circumstances of any given enterprise.

Either the stated or implied standard of value in a given state probably will have the largest effect on the elements of goodwill of a professional practice that are identified as marital property. Indiana's *Yoon v. Yoon*[130] is a case where a court attempted to distinguish personal and enterprise goodwill in a professional corporation.

Yoon v. Yoon

Upon dissolution of marriage, the court ordered Dr. Yoon to pay child support to his wife and divided the marital estate 55% to his spouse. The value of the estate included Yoon's medical practice. Former Indiana case law had established that the goodwill of a professional practice could be included in the marital estate. Dr. Yoon appealed the valuation of this goodwill, as he asserted it represented his future earning capacity that had already been used as a reason to unequally divide property (55% versus 45%) for the benefit of his wife.

The court established that goodwill in a professional practice may be attributable to the business by virtue of arrangements with suppliers, customers, or others and its anticipated future customer base. However, it may also be attributable to the owner's personal skill, training, or reputation. The court recognized that case law from other jurisdictions has recognized enterprise goodwill as a divisible asset. However, reviewing previous Indiana case law, the court viewed personal goodwill as indivisible future earning

130. 711 N.E.2d 1265; 1999.

capacity. In order to determine if goodwill should be included in the estate, the court must determine what portion of it is attributable to the individual and exclude that value.

As to the valuation, the wife's expert used an "intrinsic value" in determining the value "to the physician." The court determined that this value was the physician's future earning capacity. In its decision, the court explained that enterprise goodwill was subject to equitable distribution, whereas personal goodwill could affect only the relative distribution of property, stating the following:

> ". . . before including the goodwill of a self-employed business or professional practice in a marital estate, a court must determine that the goodwill is attributable to the business as opposed to the owner as an individual. If attributable to the individual, it is not a divisible asset and is properly considered only as future earning capacity that may affect the relative property division. In this respect, the future earning capacity of a self-employed person (or an owner of a business primarily dependent on the owner's services) is to be treated the same as the future earning capability and reputation of an employee."

The court considered whether any value was actually attributed to the value of the practice rather than Yoon's reputation and remanded the valuation to the lower court to remove the value of personal goodwill. On remand, the case was settled before the lower court issued an opinion.

Following Yoon, the case of *Bobrow v. Bobrow*[131] discussed the enterprise goodwill of the accounting firm Ernst & Young. In this business, the facts of the case established that no individual owner had any personal goodwill in the entity and therefore only enterprise goodwill existed.

Bobrow v. Bobrow

In a divorce action, the husband had a partnership interest in a division of the big four accounting firm Ernst & Young (E&Y). Although there was a partnership agreement limiting the owner's interest to the value of the capital account thereby excluding goodwill, the partner, Mr. Bobrow, conceded that the agreement applied only to a transaction of his partnership interest (resignation, retirement, or death).

Based on the finding in *Yoon*, the court recognized that the assets of E&Y were not personal to the partner but belonged to the institution of which each partner had a share. These institutional assets included such intangible

131. State of Indiana, Hamilton Superior Court Cause No. 29D01-0003-DR-166.

assets as E&Y's trade name. Specifically, E&Y, the entity, has a favorable business reputation and name recognition. E&Y owns the methods and tools that provide value to the firm. E&Y has relationships with suppliers. All these items were transferable to an outside purchaser. This case contrasts with the case of *Yoon*, where all these assets were associated with the doctor himself rather than the entity and the court found that they could not be transferred to another individual.

Ultimately, because of the Indiana law as interpreted by *Yoon*, the court included the value of enterprise goodwill in valuing E&Y and awarded Mrs. Bobrow a share of the value of Mr. Bobrow's partnership interest in E&Y based on his pro rata share of the value of the enterprise.

Because of its conclusion of value as the pro rata share of the enterprise value, *Bobrow* may be construed as a fair value case under value in exchange premise. Despite a buy-sell agreement that specified only payment of what was in the capital account, the court valued Mr. Bobrow's ownership at his pro rata share of the enterprise, similar to the way it would be treated under a fair value standard in a dissenting or oppressed shareholders' case. The asset can be sold, enterprise goodwill may be valued, and no personal goodwill is involved. However, were this to be viewed under the fair market value standard, typically discounts would be considered for both lack of control and lack of marketability. We discuss this distinction later on in the chapter.

There has also been substantial debate as to whether the value of goodwill in a sole proprietorship should be treated in the same manner as an interest in a partnership or a closely held corporation. In a sole proprietorship, the value of the business is inherently more dependent on the proprietor rather than it would be for a business owned and managed by several operators working together. The Pennsylvania case *Beasley v. Beasley*[132] noted this difference by stating:

> A sole proprietor can be distinguished from a partnership, or a professional corporation, to which an ascertainable value can be ascribed for the purpose of buying into or withdrawing from the relationship: but it is the association, or some share of it, that is valued and not the individual partner upon which the value is placed. . . . When a sole proprietor terminates his activity, the lights go out, the value of the sole proprietorship is extinguished and is non-transferable.

A number of states follow Pennsylvania's *Beasley* in recognizing that goodwill exists in a professional practice, but typically not in a sole proprietor-

132. 518 A.2d 545 (Pa. Super. Ct., 1986).

ship. These include Alaska,[133] Connecticut,[134] Maryland,[135] Nebraska,[136] Oklahoma,[137] Minnesota,[138] Louisiana,[139] Ohio,[140] and Tennessee[141] and Utah.[142]

Nebraska's *Taylor v. Taylor*[143] commented on the dependence of goodwill on the continued efforts of a particular individual. This comment was later cited in Florida's *Thompson v. Thompson*[144] in determining whether personal goodwill should be included in the value of a professional practice. The *Taylor* court indicated that:

> If goodwill depends on the continued presence of a particular individual, such goodwill, by definition, is not a marketable asset distinct from the individual. Any value which attaches to the entity solely as a result of personal goodwill represents nothing more than probable future earning capacity, which, although relevant in determining alimony, is not a proper consideration in dividing marital property in a dissolution proceeding.[145]

Walk-Away Value

In the recent Florida case *Held v. Held*,[146] the trial court relied on the opinion of one expert who claimed that a nonsolicitation agreement was part of enterprise goodwill. On appeal, the court ruled that the lower court impermissibly valued personal goodwill in the nonsolicitation agreement and remanded, directing the trial court to use only the adjusted book value in determining the fair market value of the business. Similarly, as discussed earlier, the court in

133. *Moffat v. Moffat*, 813 P.2d 674 (Alaska 1991).

134. *Cardillo v. Cardillo*, 1992 WL 139248 (Conn. Super. Ct 1992).

135. *Prahinski v. Prahinski*, 540 A.2d 833 (Md. Spec. App. 1988).

136. *Taylor v. Taylor*, 386 N.W.2d 851 (Neb. 1986).

137. *Travis v. Travis*, 795 P.2d 96 (Okla. 1990).

138. *Roth v. Roth*, 406 N.W.2d 77 (Minn. App. 1987).

139. *Depner v. Depner*, 478 So. 2d 532 (La. App. 1985).

140. *Burma v. Burma*, No. 65062 (Ohio App. 8 Dist. Sept. 29, 1994).

141. *Smith v. Smith*, 709 S.W.2d 588 (Tenn. App. 1985).

142. *Sorenson v. Sorenson* (769 P.2d 820 (Utah App. 1989), aff'd 839 P2d 774 (Utah 1992).

143. *Taylor v. Taylor*, 386 N.W.2d 851 (Neb. 1986).

144. 576 So. 2d 267; 1991 Fla. LEXIS 69; 16 Fla. L. Weekly S 7.

145. Id.

146. 2005 Fla. App. LEXIS 14138 (September 7, 2005).

Hawaii's *Antolik v. Harvey*[147] criticized the lower court for not considering that the chiropractor would compete upon the sale of his business.

Under this fairly narrow view of fair market value, the assumption is that the seller could and would compete with the buyer, thereby taking nearly all of the otherwise transferable goodwill. In these instances, the business's value would most likely be close to the net tangible assets of the business. Under a more conventional interpretation of fair market value, the seller would cooperate, to some extent with the buyer. For this reason, some refer to states that apply the more narrow view of fair market value in this fashion as walk-away value states.

The following states have cases that use language implying the walk-away standard.

State	Source
Delaware	*S.S. v. C.S.*[148]
Florida	*Williams v. Williams*[149]
Hawaii	*Antolik v. Harvey*[150]
Kansas	*Powell v. Powell*[151]
Mississippi	*Singley v. Singley*[152]
Missouri	*Taylor v. Taylor*[153]
South Carolina	*Hickum v. Hickum*[154]

Merging of Personal and Practice Goodwill

There may also be a time when the value of the personal goodwill merges with the enterprise goodwill. This normally results from the professional's choice to grow the practice and surround him- or herself with capable people and institutionalize the personal goodwill. As an example of institutionalization, the Mayo Clinic is a business whose personal goodwill has merged with its practice goodwill. It is fairly obvious that no one goes to the Mayo Clinic

147. 7 Haw. App. 313; 761 P.2d 305; 1988.

148. A.2d (Del. Fam. Ct. Aug. 22, 2003).

149. 667 So.2d 915 (Fla. Dist. Ct. App. 1996).

150. 7 Haw. App. 313; 761 P.2d 305; 1988.

151. 648 P.2d 218 (Kan. 1982).

152. 2003 Miss. LEXIS 283.

153. 736 S.W.2d 388 (Mo. 1987).

154. 463 S.E.2d 321 (S.C. Ct. App. 1995).

to be treated by someone named Mayo, but the reputation of the practice is such that people will travel from around the country to be treated there.[155] The enterprise goodwill could (and normally does) exceed the value of the personal goodwill when the personal goodwill has been institutionalized.

Covenant Not to Compete

The lack of transferability of personal goodwill is part of the reason why many courts will exclude it as marital property. However, some elements of personal goodwill may be transferred over time by an individual who will participate in the transition by, at a minimum, signing a covenant not to compete.[156]

> Neither an editor nor lawyer, nor a physician, can transfer to another his style, his learning, or his manners. Either however, can add to the chances of success and profit of another who embarks in the same business in the same field, by withdrawing as a competitor. So that the one sells and the other buys something valuable . . . the one sells his prospective patronage, and the other buys the right to compete with all others for it, and to be protected against competition from his vendor.[157]

By paying for the restriction of the former owner's ability to practice, the buyer effectively purchases some of the personal goodwill that would otherwise take away clients.[158]The transition may also include a consulting contract, whereby the seller is compensated for remaining at the corporation to help transition the company to the buyer, thereby transferring a portion of his or her personal goodwill to the corporation.

The existence of a covenant not to compete may transfer some of an individual's goodwill to the enterprise. Interestingly, the necessity of a covenant indicates two important points. The first is that the buyer perceives that eventually the goodwill can be transferred and, second, that at the valuation date, some or all of the goodwill still belongs to the seller. Since personal goodwill, by its very nature, is inextricably tied to the individual, most states consider a covenant not to compete as separate property.

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155. Fishman, "Personal Goodwill v. Enterprise Goodwill."

156. Fishman, Pratt, and Griffith, "PPC's Guide to Business Valuation," at 1202.19. Reference to Minnesota case, Sweere v. Gilbert-Sweere 534 N.W.2d 294 (Minn. Ct. App. 1995)

157. *Mcfadden v. Jenkins*, 40 N.D. 422, 442, 169 N.W. 151, 155-56 (1918) (quoting Cowan v. Fairbrother, 118 N.C. 406, 411-12, 24 S.E. 212, 213 (1896)).

158. John Dwight Ingram, "Covenants Not to Compete," 36 *Akron Law Review* 49 (2002), at 51.

In other words, jurisdictions in which the value in exchange premise is used most often consider a covenant not to compete as proof that some goodwill is indeed personal and therefore excludable from the marital estate, and therefore any proceeds from such covenant would be separate property. In a value to the holder state, however, the issue is typically not addressed because a sale is not necessarily contemplated.

The Florida case *Williams v. Williams*[159] considers the effect of a covenant not to compete. In this case, the Court of Appeals elaborated on the decision in *Thompson v. Thompson*, where the fair market value standard was decided to be the determining factor in valuing goodwill.

Williams v. Williams

Mr. Williams sought review of the lower court's valuation of property, which determined his accounting practice had distributable goodwill. The court acknowledged that under Florida law, the goodwill of a professional practice may be distributed if indeed it exists and was developed during the marriage. However, relying on the decision of the *Thompson* court, it must exist separately from the reputation of an individual.

Mrs. Williams's expert discussed the sales of other accounting practices, but the court found little similarity between those businesses and that of Mr. Williams. Mr. Williams's expert testified that no one would buy his practice without a covenant not to compete. Essentially, without that covenant, there is reason to believe that Mr. Williams's clients would follow him to his new practice, and his old practice would have little if any value above the net assets.

The court decided that the existence of goodwill in the practice was not established, as Mr. Williams was the only accountant, performing all the work and dealing with the clients himself.

The South Carolina case *Ellerbie v. Ellerbie*[160] is an example where a court decided that the value of an actual covenant not to compete should not be included as distributable property. In this case, there was an actual transaction with a sale agreement entitled "Merger Asset Acquisition Agreement and Covenant Not to Compete." This agreement indicated that $422,000 was paid for the assets of the business and $1,200,000 was paid for a covenant not to compete. The court decided that in this case, the value of the covenant not to compete was separate property and therefore should not be included in the

159. 667 So. 2d 915.

160. 323 S.C. 283; 473 S.E.2d 881; 1996 S.C. App. LEXIS 113.

value of the business. It should be mentioned that in these examples, it is assumed that the covenants were to prevent sellers who were capable of competing not to compete and not just an alternate way of structuring a sale.

The Minnesota case *Sweere v. Gilbert Sweere*[161] also addressed the value of a covenant not to compete. In this case, the court had to decide whether $200,000 from a noncompete agreement should be included in the divorce settlement as marital property. The court found that the portion of the money paid that compensates the spouse for restricting postmarital personal service was separate property. However, any of the payments made to secure transfer of corporate assets was marital property. Ultimately, the court concluded that the purpose of the agreement may have been to prevent Mr. Sweere from interfering with the transfer of goodwill. To this extent, the noncompete was representative of marital goodwill, not postmarital labor and was included in the marital property.[162]

As we have discussed, value in exchange states assume that there will be a hypothetical sale and seek to value the asset based on what would be realizable in a such a sale between a willing buyer and a willing seller at or near a specifically delineated valuation date. These states choose to exclude personal goodwill.

Exhibit 4.6 shows the value in exchange portion of the continuum of value and case examples of the differing treatments of the covenants not to compete fall under the associated standards, premises, and treatments of intangible value.

At the leftmost end of the continuum of value are the states in which the title holder is viewed as if he or she would not sign a covenant and would compete immediately with anyone who would buy the business. Assuming that the business's goodwill was personal, typically, in this case, there will be very little value to the business above the tangible assets, if the practice has not merged the personal goodwill into enterprise goodwill. As one moves to the right on the continuum, the longer the transition between the sale and the departure of the seller.

Before moving on to the treatment of intangible assets under value to the holder and the standard of investment value, we need to address shareholder level discounts and the weight afforded buy-sell agreements as viewed under value in exchange.

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161. 534 N.W.2d 294; 1995 Minn. App. Lexis 912.

162. Fishman, Pratt, and Griffith, "PPC's Guide to Business Valuation."

Exhibit 4.6 Continuum of Value: Intangible Assets under Value in Exchange with Case Examples

<table>
<tr><td>Premise of Value</td><td colspan="3">Value in Exchange</td></tr>
<tr><td>Standard of Value</td><td colspan="2">Fair Market Value</td><td>Fair Value</td></tr>
<tr><td>Intangible Value</td><td>Enterprise Goodwill May Be Minimal or Nonexistent</td><td colspan="2">Enterprise Goodwill Only</td></tr>
<tr><td>Case Example</td><td>Williams v. Williams</td><td colspan="2">Thompson v. Thompson/Sweere v. Gilbert-Sweere</td></tr>
<tr><td rowspan="2">Underlying Assumption</td><td>Walk Away and Compete</td><td>Covenant Not to Compete Included</td><td rowspan="2">Court's Discretion</td></tr>
<tr><td>Covenant Not to Compete Excluded from Value</td><td>Covenant Not Addressed</td></tr>
</table>

Lack of Control and Marketability Discounts under Value in Exchange

Lack of control and marketability discounts are also issues that merit discussion in the context of value in exchange as compared to value to the holder. A state's treatment of these discounts can be another indicium of the premise and standard of value under which courts in that state view valuation in divorce matters. Theoretically, those standards of value that fall under the value in exchange premise typically require the explicit consideration of lack of control and marketability discounts (commonly referred to as shareholder-level discounts), to the value of the owner's shares in recognition of what a willing buyer would pay for the owner's shares upon a hypothetical sale. Alternatively, a standard of value falling under a value to the holder premise does not require explicit consideration of these discounts, as they would be applicable only upon sale, and a sale is not contemplated under this standard. Some states do not fit neatly into either category. Additionally, some states apply a standard more closely akin to fair value as used in dissenting shareholder matters, as buyers or sellers may not be willing, as required by fair market value. These states generally do not apply shareholder-level discounts.

In the U.S. Tax Court, discounts for lack of control and of marketability are generally considered and, when appropriate, applied in the determination of fair market value. The application of these type of shareholder-level discounts in matters of dissenting and oppressed shareholders and the divorce context can be more problematic. As we discussed in Chapter 3, in dissenting and oppressed shareholder matters, absent special circumstances, the courts and the law associations have been trending toward the elimination of shareholder-level discounts. The reasoning for this trend is that, since neither buyer nor seller are willing participants, the moving party should be compensated for what was taken—either the pro rata share of a going concern or what the owner would have reasonably expected to receive from continuing involvement with the enterprise.

In our view, the treatment of shareholder-level discounts can provide additional insight into separating states into value in exchange, value to the holder, or hybrid states. Typically, value in exchange states that use the fair market value standard require consideration of shareholder-level discounts; value to the holder states using some version of investment value do not. Hybrid states use a combination of standards and may also use fair value as a standard.

Does intention to sell matter in the application of discounts? Typically, under the fair market value standard, the intention to sell may only have an impact on the size of the discounts. Since fair market value assumes a hypothetical sale of the business or business interest, normally shareholder-level discounts such as a discount for lack of control or marketability are considered and, where appropriate, applied. However, in some instances there is a question of whether shareholder-level discounts should be applied at all, given the facts and circumstances of the case. The fair market value standard mandates *consideration* of shareholder-level discounts, not the automatic application of them.

To some courts, the intention to sell is an important factor in determining what stream of income the individual can expect to receive and whether shareholder-level discounts should be applied. The Oregon case *Tofte v. Tofte*[163] directly addresses this point.

Tofte v. Tofte

At the dissolution of marriage, the husband worked at and had a minority interest in his family's amusement park business. He had various responsibilities including supervision of maintenance and designing and creating attractions for the park.

Both appraisers used the capitalization of net earnings method of valuation, agreeing on a multiple of nine times net earnings. Their valuations differed on the application of discounts. The trial court relied on the husband's

163. 134 Ore. App. 449; 895 P.2d 1387; 1995 Ore. App. LEXIS 772.

> expert's testimony that to arrive at fair market value, the shares should be discounted 35% for the shares being a minority interest and lacking marketability.
>
> The wife's expert argued that the yearly bonus awarded to the husband would be attractive enough to entice a willing buyer to pay full price. However, the husband's expert testified that the bonuses bore no relation to the shares held. The bonus was not seen as a return on the shares of stock.
>
> Additionally, the wife argued that discounts should not be included in the calculation of husband's stock value as he had no intention to sell his share of the company. The court found that intention to sell did not matter in the determination of value of a close family corporation, and discounts should therefore be applied.

Using consideration and, if appropriate, the application of shareholder-level discounts as criteria to determine the applicable standard of value, these states can be categorized as fair market value states: Alaska, Arkansas, Connecticut, Iowa, New Hampshire, New York, Oregon, Vermont, West Virginia, and Wisconsin.

When one uses the treatment of goodwill along with the application of shareholder-level discounts as two criteria for determining the standard of value, one may find that a state's treatment of each issue is not consistent with just one standard of value. For example, a state may not require the distinguishing of personal from enterprise goodwill, which suggests a value to the holder premise, but the state may also require consideration of shareholder-level discounts. Minnesota appears to fall into this category. In this state, the treatment of goodwill suggests that the standard of value is more akin to the value to the holder premise, yet in some instances shareholder-level discounts have been applied, suggesting a value in exchange premise.

Fair Value

As mentioned previously, fair value is not the same as fair market value. While fair market value considers a willing buyer and a willing seller, generally when fair value is at issue, one of the parties is not willing. Therefore, in order to compensate that party fairly, special considerations are made.

In dissenter's rights and oppressed stockholder cases, in many states, these special considerations consist of disallowing discounts or applying them only in extraordinary circumstances. Upon divorce, the court may also decide that it would be unfair to apply discounts to the value of shares, regardless of how it treats personal goodwill. In those instances, courts have used a spouse's pro-rata share of enterprise value, which is language normally associated with fair value.

The outcome of the Virginia case of *Howell v. Howell*,[164] represents value in exchange without discounts. This case addresses the applicability of discounts while excluding any personal goodwill present by virtue of an individual's reputation. This case is often referred to as a fair value case.

Howell v. Howell

Mr. Howell, the defendant, had a partnership interest in Hunton & Williams, a law firm he joined during the marriage. Virginia case law indicates that transferable enterprise goodwill may be marital, but personal reputation and future earning capacity are not. Virginia law also prohibits the sale of the goodwill of a law firm. Additionally, the Hunton & Williams partnership agreement provides that when a partner withdraws from the firm, he may receive the balance of his capital account with his share of the firm's net income through the date of withdrawal. The court looked at whether any goodwill should be included in distributable assets, and if so, how to calculate it.

Citing a previous Virginia case,[165] the court acknowledged that the trial court's duty is to determine the value that represents the property's intrinsic worth to the parties and that although a restrictive agreement may exist, it should not control value. The court reviewed various other decisions in Virginia's courts as well as others from other states, and the commissioner determined that the evidence demonstrated that the partnership had goodwill regardless of the provisions of the partnership agreement.

The experts disagreed on the appropriate discount to be applied to value the shares. The defendant's expert applied a 40% lack of marketability discount, and the plaintiff's expert applied a 6.9% discount. The commissioner found that the lack of control was not an issue worth discounting, as no one partner had a controlling interest in the firm. The court similarly found that a discount for lack of marketability was inappropriate, as the highest and best use for the defendant's share was to remain with the corporation. The appellate court found that the commissioner's determination of value had been appropriate.

In this case, the court used the concept of highest and best use, reasoning that highest value that would be realized was that which would be achieved through the owner's continued presence, not upon sale, and therefore discounts should not be applied. While Virginia requires one to distinguish personal and enterprise goodwill, thereby implying a titled spouse's departure, the court in

164. 46 Va. Cir. 339; 1998 Va. Cir. LEXIS 256.

165. *Bosserman v. Bosserman*, 9 Va. App. 1, 5, 384 S.E.2d 104 (1989).

this case considered that the highest and best use was the title holder's continued presence. This case appears to have elements of both fair market value and investment value. We have categorized it as fair value because it calculates the value as a pro-rata share of the enterprise value.

The New Jersey case *Brown v. Brown*[166] addresses the valuation of a wholesale flower distributor in a marital dissolution case in terms resembling those normally found in fair value in oppression and dissenter's rights matters. In this case, no distinction was made as to personal or enterprise goodwill, and the issue at hand between the valuation experts was whether the lack of intention to sell the business should control whether discounts should be applied or not.

Brown v. Brown

James Brown was an officer of and had a 47.5% interest in a florist supply company. Mr. Brown had a reported W-2 income of $75,000, 1099 income of $75,000, and interest income of $7,131. The trial court had accepted the wife's expert's valuation of Mr. Brown's interest in the company at $561,925, excluding any discount for marketability or lack of control.

The wife's expert valued the business as a whole as of the date of complaint and then took a percentage to establish the husband's proportionate interest. He assumed that the pro-rata value of that interest should be included in equitable distribution. The husband's expert valued the same interest but applied a 25% discount for lack of marketability and a 15% discount for lack of control.

The court found no previous decisions in New Jersey addressing the applicability of discounts for the purposes of equitable distribution. After reviewing the assumptions and elements of both valuations, the court was more persuaded by the testimony of the wife's expert. As the corporation in question was a close corporation, any liquidity issues were not of consequence as there was no intention to sell the business, and therefore the fair value should be assessed. The court referred to the fair value determination made in *Balsamides v. Protameen Chemicals, Inc.*[167] (an oppression case) and *Lawson Mardon Wheaton, Inc. v. Smith*[168] (a dissenter's rights case).

The court found that there were no extraordinary circumstances warranting any discounts and that because divorce was not a trigger for the sale of shares, the application of discounts was inappropriate in this case.

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166. 348 N.J. Super. 466; 792 A.2d 463.

167. 160 N.J. 352, 368, 734 A.2d 721 (1999) (*Balsamides*).

168. 160 N.J. 383, 397, 734 A.2d 738 (1999) (*Lawson*).

Brown has elements of fair value, with its rejection of discounts, and investment value, in the consideration that the business is not likely to be sold. The case states that the husband will receive the benefits of ownership by continuing to hold the asset. North Dakota also has two decisions where the court looks to determine fair value. One of these cases[169] looks at a situation where the only way the wife could recover her interest would be to file as an oppressed shareholder; therefore, in the divorce proceeding, the court awarded her the fair value of her interest without discounts for lack of marketability and lack of control. In another case,[170] the court upheld the judgment of the trial court that a small discount for lack of control status would be equitable. In these cases, it appears that the courts may have been looking for an equitable solution and not strictly applying a particular standard of value.

In summary, four states appear to regularly follow a fair value standard under a value in exchange premise: Indiana, North Dakota, Virginia, and Wyoming. Exhibit 4.7 shows the continuum of value with respect to the treatment of shareholder level discounts.

Buy-Sell Agreements under Value in Exchange

Many times, when valuing a business, especially a professional practice, there are agreements in place between shareholders or partners that provide for the treatment of a shareholder or partner upon death, retirement, or other manner of withdrawal.

The existence of a partnership or shareholder agreement may have an impact on value because many such agreements serve to delineate the amount participants would receive upon certain circumstances. In a divorce proceeding, many view such agreements as indicia of value but not necessarily as presumptive of value. Still other states view the existence of such an agreement, if timely, arm's length, and acted upon, as the sole indicator of value.

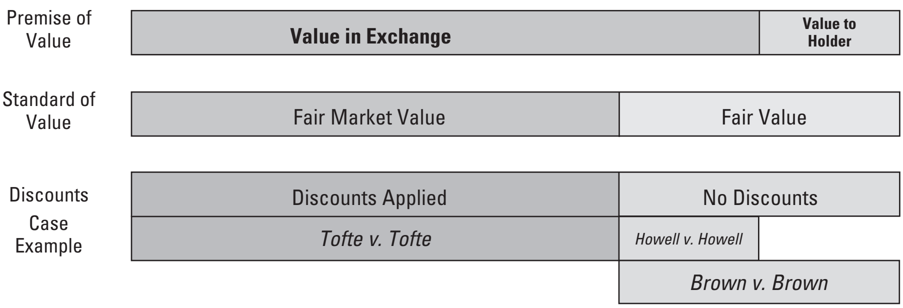
Logically, states that more closely adhere to a fair market value standard may be inclined to rely more heavily on such an agreement if it meets the above-mentioned criteria. However, if a buy-sell agreement exists but has never actually been used, it would have far less impact than a buy-sell agreement that is regularly updated and enforced.[171] Moreover, states that more

169. *Fisher v. Fisher*, 1997 ND 176; 568 N.W.2d 728; 1997 N.D. LEXIS 195.

170. *Kaiser v. Kaiser*, 555 N.W.2d 585; 1996 N.D. LEXIS 253.

171. Frank Louis "Economic Realism: A Proposed Standard," New Jersey Institute of Continuing Legal Education 2005 Family Law Symposium.

Exhibit 4.7 Continuum of Value: Discounts under Fair Market Value and Fair Value



closely adhere to an investment value standard may assign little, if any, weight to these agreements, because there is no sale. It has been our experience that under any standard of value, the weight accorded a buy-sell agreement is fact sensitive.

Under the value in exchange premise, buy-sell agreements are usually viewed in two ways. First, the agreement may be considered presumptive because upon selling his or her shares, the amount stated in the agreement is all a shareholder would likely receive. Conversely, a court looking to apply a fair market value standard might afford the value of the buy-sell agreement little weight, as it does not represent what a hypothetical willing buyer would pay a hypothetical willing seller in an open market.

Many courts have taken the value set forth in buy-sell agreements under consideration, but few have considered such agreements consistently controlling for the purposes of divorce. For example, Pennsylvania's *Buckl v. Buckl*[172] stated that a buy-sell agreement or other such agreement should be considered as a factor in valuing a business. It does not establish, however, that the value established by that agreement must be controlling.

The Connecticut case of *Dahill v. Dahill*[173] discussed this matter, as well, adhering more closely to the hypothetical nature of fair market value.

172. 373 Pa. Super. 521; 542 A.2d 65; 1988 Pa. Super. LEXIS 1048.

173. 1998 Conn. Super. LEXIS 846 (Conn. Super. Ct. Mar. 30 1998).

Dahill v. Dahill

Mr. Dahill had an interest in a family business. As Mr. Dahill was ill, he entered into a shareholder's agreement with the other shareholder. The agreement offered a right of first refusal for Mr. Dahill's shares to his son and established a purchase price upon death. Upon termination, however, Mr. Dahill had the right to sell his shares on the open market.

Mrs. Dahill's expert valued the shares at 1.5 times book value, or $1,100,000—the value from the agreement that controlled upon Mr. Dahill's death. The expert conceded that this was not the fair market value of the shares but Mr. Dahill's value in hand. Mr. Dahill testified that his shares were worth $350,000 based on an expert's valuation from 1992. However, the court felt that this date was too far past to be controlling.

The court appointed an expert who assessed the fair market value of Mr. Dahill's interest in the company at $490,000, after applying discounts for illiquidity. The court decided on a $500,000 value for Mr. Dahill's interest. The court stated that because none of the triggering events in the shareholder agreement had occurred, it was incorrect to base the value on that set forth in the agreement. In addition, the court stated that it was its duty to find the fair market value rather than the book value or "in hand value."

The New Jersey case of *Stern v. Stern*[174] represents a value in exchange concept in which the buy-sell agreement was relied upon as the primary indicator of value.

Stern v. Stern

Mr. Stern was a partner in a highly respected law firm, and while conceding that his partnership interest was marital property, he objected to the trial court's determination of the valuation of the partnership. The trial court also had valued his earning capacity.

Beginning with the issue of earning capacity, the appellate court agreed that even if the earning capacity has been enhanced by the other spouse, it should not be recognized as an item of marital property, but it may be considered in determining what distribution of property would be equitable as well as being relevant in the calculation of alimony.

As for the value of the partnership interest, the appellate court looked to the terms of a partnership agreement. The agreement reflected elements of the partnership worth that were in excess of the capital account. This excess value was revised on a quarterly basis. Although within the agreement

174. 66 N.J. 340; 331 A.2d 257; 1975.

> there were several values contingent upon differing situations, the court recognized the value upon the death of the partner as the value that should hold in the case of divorce.
>
> While the value set forth by the agreement constitutes the presumptive value of the partnership (and therefore may be challenged), the court established that as far as the books of the firm are well kept and the value of the partners' interests are periodically and carefully reviewed, then the presumption of value should be subject to effective attack only if there is clear and convincing proof that the value is more or less than represented by the partnership agreement figure.

This case continues to cause a great deal of controversy in New Jersey, with arguments being made that the agreement should control because it is all the stockholder will ever receive. Furthermore, some practitioners argue that the terms of the agreement become more important as the stockholder ages and comes closer to the time when he will receive his buy-out. This follows a value in exchange premise. Other practitioners argue that the investment value principles of *Dugan* and the fair value principles of *Brown* supersede this case. Based on the facts and circumstances of the case, ultimately the court is the arbiter of which argument will prevail.

The buy-sell agreements enhance our analysis of our chart as shown in Exhibit 4.8.

A review of the case law in Arkansas seems to indicate little reliance on the provisions of a buy-sell agreement as it does not adhere to a strict inter-

Exhibit 4.8 Continuum of Value: Buy-Sell Agreements under Value in Exchange

Premise of Value	**Value in Exchange**
Standard of Value	Fair Market Value
Buy-Sell	Accepted as Economic Reality: The most a seller will ever actually receive
	Rejected as Economic Reality: Court looks to hypothetical willing buyer and willing seller
Case Example	*Stern v. Stern*
	Dahill v. Dahill

pretation of fair market value. As mentioned in the *Dahill* case, some Connecticut cases place little emphasis on the provisions of a buy-sell agreement, but others seem to place more weight on such agreements. In Alaska, Washington, DC, Indiana, Oklahoma, and Oregon, courts have reached a value based on buy-sell agreements. Illinois, Minnesota, Missouri, Ohio, Pennsylvania, Utah, West Virginia, and Wisconsin have all considered the buy-sell agreement to be case sensitive and that it may be considered in the calculation of value, but not necessarily presumptive of value.

Exhibit 4.9 presents the continuum of value under the value in exchange premise including the fair market value and fair value standards as have been discussed up to this point.

Exhibit 4.9 Continuum of Value: Value in Exchange

Premise of Value	**Value in Exchange**		
Standard of Value	Fair Market Value		Fair Value
	Antolik v. Harvey		*Bobrow v. Bobrow*
Intangible Value	Enterprise Goodwill May Be Minimal or Nonexistent	Enterprise Goodwill Only	
	Williams v. Williams	*Thompson v. Thompson/Sweere v. Gilbert-Sweere*	
Underlying Assumption	Walk Away and Compete	Covenant Not to Compete Included	Court's Discretion
	Covenant Not to Compete Excluded	Covenant Not Addressed	
Discounts	Discounts Applied		No Discounts
	Tofte v. Tofte		*Howell v. Howell*
Buy-Sell	Accepted as Economic Reality: The most a seller will ever actually receive		
	Rejected as Economic Reality: Court looks to hypothetical willing buyer and willing seller		
	Stern v. Stern		
	Dahill v. Dahill		

In summary, based on our analysis, 34 states fall under a value in exchange premise:

Arkansas	Missouri
Alaska	Nebraska
Connecticut	New Hampshire
District of Columbia	North Dakota
Delaware	Oklahoma
Florida	Oregon
Hawaii	Pennsylvania
Idaho	Rhode Island
Illinois	South Carolina
Indiana	Tennessee
Iowa	Texas
Kansas	Utah
Louisiana	Vermont
Maryland	Virginia
Massachusetts	West Virginia
Minnesota	Wisconsin
Mississippi	Wyoming

VALUE TO THE HOLDER

Value to the holder states are generally those that look to identify and value the asset or assets created during the marriage as the result of the joint efforts of both spouses regardless of whether a marketable asset was created or not. States that favor the value to the holder premise consider the cash flows received by the title-holding spouse regardless of the asset's transferability.

Goodwill

This definition describes goodwill in a manner that largely represents an investment value, in that it includes certain personal attributes in the value:

> The economic benefits that a going concern may enjoy as compared to a new firm, from (1) established relations with all the markets—both output and

input, (2) established relations with government departments and other non-commercial bodies, and (3) personal relationships.[175]

States that follow an investment value standard seem to apply the notion that although a business may not be immediately salable and may not have value beyond its net tangible assets without the owner/key employee in place, the business has an ongoing value to the owner and therefore to the marital estate. In value to holder states, the view of property is broad and recognizes that the title holder will continue to function as an owner benefiting from the asset already in place.

Dugan v. Dugan,[176] one of New Jersey's early cases with respect to the treatment goodwill, shows the court's reasoning for including elements of personal goodwill as marital property.

Dugan v. Dugan

After a 20-year marriage, the Dugans separated. Mr. Dugan was a member of the New Jersey Bar, and continued to practice in a professional corporation.

Mr. Dugan appealed the lower court's judgment regarding property distribution, and the New Jersey Supreme Court had to determine whether the goodwill of Mr. Dugan's law practice was an asset subject of equitable distribution, and, if so, how it should be evaluated. At the time of the case (1983), New Jersey lawyers were not permitted to sell their goodwill.

The New Jersey Supreme court distinguished intangible assets from tangible ones, in that intangible assets have no intrinsic value, but do have a value related to ownership and possession of tangible assets. Intangibles such as trademarks and patents are identifiable intangible assets, while goodwill is based on reputation that will probably generate future business.

The court then noted that goodwill is a legally protected interest, as evidenced by the ability to prevent a seller's competition with a covenant not to compete. In addition, New Jersey inheritance tax requires consideration of goodwill. It has also been recognized as an element of value in liquidation.

Goodwill can be translated into prospective earnings and, from an accounting standpoint, can be defined as the future estimated earnings that exceed the normal return on an investment. The court distinguished goodwill and earning capacity by stating that goodwill reflects not only a possibility of future earnings, but a probability based on existing circumstances, and after

175. Allen Parkman, "The Treatment of Professional Goodwill in Divorce Proceedings," 18 *Family Law Quarterly* 213 (1984).

176. 92 N.J. 423; 457 A.2d 1; 1983 N.J.

divorce, the law practice will continue to benefit from goodwill as it had during the marriage. For the purposes of distribution, it would be inequitable to ignore the other spouse's contribution to the development of a valuable economic resource.

The court also acknowledged that limitations exist on the ability to sell a law practice with its goodwill; however, the goodwill itself has significant value irrespective of any limitations.

The court found several problems with the valuation, including the method of determining reasonable compensation. The court felt that the method used determined the firm's efficiency rather than the plaintiff's reasonable compensation. Instead, the court noted that age, experience, education, expertise, effort, and locale should be elements considered in determining reasonable compensation. In addition, the valuator added back too many expenses to the income stream used in the valuation and compared the attorney's compensation to an average from around the country rather than a specific area. The court also took issue with an unsubstantiated capitalization rate.

The important concept established by this case is that goodwill has value, if only to the holder, regardless of its marketability.

Celebrity Goodwill

Currently, New Jersey is the only state that has considered celebrity goodwill as marital property, recognizing that the development of celebrity, like that of personal goodwill in a business, is created by virtue of the noncelebrity spouse's contributions to the marital partnership.[177] New York has a similar concept but characterizes it as celebrity status, not celebrity goodwill.

In the case of *Piscopo v. Piscopo*,[178] the value of comedian Joe Piscopo's celebrity status was divided by the court upon the dissolution of his marriage.

Piscopo v. Piscopo

The New Jersey Superior Court addressed the topic of celebrity goodwill in the case of *Piscopo v. Piscopo* in 1989. The trial court[179] held that the marital property included Joe Piscopo's celebrity goodwill.

The court's expert found that Piscopo's income flowed through Piscopo Productions, Inc., and that Piscopo's compensation was determined at the

177. Robin P. Rosen, "A Critical Analysis of Celebrity Careers as Property upon Dissolution of Marriage," 61 *George Washington Law Review* 522 (January 1993).

178. 232 N.J. Super. 559; 557 A.2d 1040; 1989.

179. *Piscopo v. Piscopo*, 231 N.J. Super. 576, 580–581 (Ch. Div. 1988).

end of each year as in any corporation. The expert valued that business as he would any other professional corporation, taking into account Piscopo's goodwill.

In valuing Piscopo's celebrity, the expert took 25% of his average gross earnings over a three-year period, calculating goodwill at $158,863. Citing *Dugan v. Dugan*[180] the trial court accepted that goodwill was a distributable asset representing the reputation that will probably generate future business.

Piscopo claimed that this situation was distinguishable from *Dugan* because a professional has a reliable future income while show business is volatile. The court did not agree, citing that *Dugan* measured goodwill by past earning capacity and the probability that it will continue.

The appellate court also agreed with the opinion of the trial court judge, who stated that it would not be acceptable if the Court of Chancery protected a celebrity's person and business from another's "unjust enrichment by the theft of [his] goodwill," *Ali v. Playgirl, Inc.*, 447 *F.Supp.* 723, 729 (S.D.N.Y.1978), while another branch deprived the spouse from sharing in the same protectible interest.[181]

The court also cited the New York case of *Golub v. Golub*, 139 *Misc.*2d 440, 527 *N.Y.S.*2d 946 (Sup.Ct.1988), where a celebrity's earning capacity was recognized as an asset because of the increase in that earning capacity due to the efforts of the other spouse.

The appellate court agreed with the trial court in that there was a value to Piscopo's celebrity and that it should be distributed upon dissolution of the marriage.

California recently handed down its first reported decision on celebrity goodwill in a case involving movie director John McTiernan. The trial court held that his celebrity had value in and of itself above his assets based on the fact that his earning capacity far exceeded that which a typical director was able to earn. The judge found his profession analogous to that of an attorney, physician, dentist, architect, or any other professional, and that in that profession, the husband had developed an earning capacity that exceeded that of a typical director. When the appellate court reviewed the decision, however, it decided that goodwill must adhere to a business, even if it is the business of a sole proprietor or professional practice.[182] The director's career in this case

180. *Dugan v. Dugan*, 92 N.J. 423 (1983).

181. *Piscopo v. Piscopo*, 231 N.J. Super. at 579 (slip opinion at 4).

182. *McTiernan v. Dobrow*, 133 Cal. App. 4th 1090; 35 Cal. Rptr. 3d 287; 2005 Cal. App. LEXIS 1692.

was not considered a business. The case was appealed; however, the California Supreme Court declined to hear it.[183]

New York has had several cases involving the goodwill of a celebrity, but these cases dealt with the enhanced earning capacity of a spouse over the course of a marriage and called this celebrity status. In *Golub v. Golub*,[184] for example, the court decided that a celebrity's status and concomitant enhanced earning capacity could be included because the noncelebrity spouse contributed to its formation and appreciation during the marriage. More recently in New York, the court followed the same basic principles in *Mann v. Mann*,[185] where the performer's career had already been established before the marriage, and the court decided that goodwill was not attributable to marital efforts and was therefore not includable in the division of property.

Personal Goodwill versus Earning Capacity

In attempting to distinguish personal goodwill as an inherently separate property, some have made the argument that personal goodwill and earning capacity (not distributable) are indistinguishable. Wisconsin's *Holbrook v. Holbrook*,[186] for example, stated: "*The concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity*." The court conceded that a professional's business reputation has value, but claimed that that value is not a separate property interest, as it only assured the continuation of earnings in the future. The exclusion of goodwill was based on several factors, including the difficulty in valuation, the extent employment status is determinative of goodwill's existence, the concern that goodwill is really earning capacity, the concern for double counting (which we call double dipping), and the need to exchange a tangible asset (cash or its equivalent) for an intangible (the goodwill of the business) upon divorce. This view has been followed by several decisions, including South Carolina's *Donahue v. Donahue*[187] and *Hickum v. Hickum*.[188]

The Wisconsin court later distinguished itself from *Holbrook* in *Peerenboom v. Peerenboom*,[189] a case that involved the valuation of a dental practice.

183. 2006 Cal. LEXIS 1743

184. 139 Misc. 2d 440, 527 N.Y.S.2d 946 (Sup. Ct. 1988).

185. N.Y.L.J., Jan. 10, 1995, at 26 (Sup. Ct. N.Y. County).

186. 103 Wis. 2d 327, 309 N.W.2d 343, 1981 Wisc. App. LEXIS 3322 (Wis. Ct. App. 1981).

187. S.C. 1989) 299 S.C. 353, 384 S.E.2d 741.

188. 463 S.E.2d 321 (S.C. Ct. App. 1995).

189. 433 N.W.2d 282 (Wis. Ct. App. 1998).

The court reviewed the concept that a lawyer's interest in a law firm (such as that in *Holbrook*) is not salable for ethical reasons. However, no such reasons exist in a medical practice, and, therefore, goodwill that is transferable may be included in value. The court did maintain, however, that goodwill must be separate from the reputation of the individual. *Peerenboom* was later cited for the concept that goodwill as a going concern could be marketable and distributable.[190]

There have been several criticisms of the view that goodwill in a professional practice is indistinguishable from earning capacity, and, because the two cannot be separated, goodwill should not be included as a marital asset. Many have argued that it does not comport with the intent of equitable distribution: that the marriage should be viewed as an economic partnership recognizing contributions of each spouse to specific assets. Second, denying the nontitled spouse a share in an asset because of difficulty in valuation is not equitable. Alternatively, some have argued that goodwill not only reflects future earnings, but also should not be recognized as a product of a marital partnership.[191]

The Colorado court in the case *In re: Bookout*[192] supported the view that goodwill is property or an asset that *supplements* the earning capacity of another asset, business, or a profession, and, therefore, is not the earning capacity itself. The case cites numerous decisions in Washington, California, and New Jersey, all separating goodwill from earning capacity. As expected, all these states seem to view, to some extent, value under a value to the holder premise.

To further illuminate the difference between goodwill and earning capacity, in the Washington case of *In re: Hall*,[193] two spouses had identical educations as doctors. One owned a practice while the other worked as a salaried teacher. The court found that although both doctors may have equal earning capacities, only the practicing doctor had goodwill, as the goodwill needed an entity to adhere to in addition to the person. The concept has been recently affirmed in New Jersey, as well.

Value of a Professional Degree or License and Enhanced Earning Capacity

As the so-called walk-away doctrine is at one extreme of the continuum, the valuation of professional degrees, licenses, and enhanced earning capacity are at the other end of the continuum. Moreover these items of marital property

190. *Sommerfeld v. Sommerfield*, 454 N.W.2d 55 (Wis. Ct. App. 1990)

191. Kistjardt, "Professional Goodwill in Marital Dissolution," at 1.04, p. 1-30.

192. 833 P.2d 800 (Colo. App. 1991), cert. denied, 846 P.2d 189 (Colo. 1993).

193. 103 Wn.2d 236, 692 P.2d 175 (1984).

are valued without the necessity of an underlying business enterprise. *Black's Law Dictionary* defines earning capacity as:

> A person's ability or power to earn money, given the person's talent, skills, training, and experience. Earning capacity is one element considered when measuring damages recoverable in a personal-injury lawsuit. And in family law, earning capacity is considered when awarding child support and spousal maintenance (or alimony) and in dividing property between spouses upon divorce.[194]

Enhanced earning capacity is the enhancement of an individual's ability to earn over and above what would be earned following a so-called normal career path and resulting from joint efforts over the life of the marriage. It is often measured by attempting to quantify the difference between the amounts an individual could earn without the enhancement to the amount that individual was earning at the end of the marriage with the enhancement. This can be the result of the acquisition of a degree or license or the result of some type of training, experience, or perfection of a skill that results in the generation of extraordinary earnings over and above a normal career path. While there is some mention of these concepts in North Carolina and Michigan, to our knowledge, it is only in New York where professional degrees, licenses, and career enhancement are considered marital property.

New Jersey has rejected the inclusion of earning capacity as an asset subject to equitable distribution. While one trial court included earning capacity as a separate "amorphous"[195] asset, the New Jersey Supreme Court rejected the notion, stating:

> Potential earning capacity is doubtless a factor to be considered by a trial judge in determining what distribution will be "equitable" and it is even more obviously relevant upon the issue of alimony. But it should not be deemed property as such within the meaning of the statute.[196]

Normally, earning capacity is a consideration for the determination of spousal support or a factor affecting the division of assets rather than in the determination of marital property. Most states recognize that individuals enter a marriage with a certain amount of intellectual or human capital. They possess

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194. Garner, *Black's Law Dictionary*, at 547.

195. 123 N.J. Super. at 568.

196. *Stern v. Stern*, 66 N.J. 340 at 260.

skills, talents, education, and experience that have resulted in a specific earning capacity. During the marriage, by the attainment of additional education or experience, there may have been an enhancement of this human capital resulting in an extraordinary increase in the degree or license holder's earning capacity to which there was a contribution made, either directly or indirectly, by the other spouse. The rationale for considering these types of assets as marital property seems to be that, by his or her contributions, the dependent spouse should share in the future benefits he or she helped to create. This inclusion is basically the recognition of joint spousal investments in the degree or license holder's career.[197]

The view that enhanced earnings capacity can appreciate during the marriage due, in part, to the efforts and/or sacrifices of the dependent spouse and that this creates marital property appears to result from a conscious decision to treat increased earning capacity developed during the marriage as an asset rather than as income to determine maintenance or support. Initially, the point behind distributing enhanced earning capacity seemed to be that without distribution of their share of this asset, the dependent spouse who contributed to the enhancement may be left without any assets at all.[198] This reasoning can be seen in the New York case *O'Brien v. O'Brien*,[199] which established the treatment of a professional license acquired during the marriage as marital property in New York.

O'Brien v. O'Brien

In this case, during the proceeding for the divorce of a doctor and his wife, the court discussed whether a license to practice medicine had a value distributable as marital property. There were no other assets of consequential value in the marriage. The husband had recently acquired a license to practice medicine. The appellate court held that the plaintiff's license was not marital property, but remitted the case to the trial court for further proceedings. The Court of Appeals of New York disagreed with the lower appellate court, and decided that the license could be considered property under New York Domestic Relations law.

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197. Kelly, "Sharing a Piece of the Future Post-Divorce," at 73.

198. David M. Wildstein and Charles F. Vuotto, "Enhanced Earning Capacity: Is It an Asset Subject to Equitable Distribution under New Jersey Law?" www.vuotto.com/earning capacity.htm.

199. 66 N.Y.2d 576; 489 N.E.2d 712; 498 N.Y.S.2d 743; 1985.

When the couple married, they were both employed as teachers at a private school. The wife had a bachelor's degree and a teaching certificate, but required further education to obtain certification in New York. The court found that she relinquished the opportunity for that permanent certification to allow her husband to pursue his education. Two years into the marriage the parties moved to Mexico, where the husband became a full-time medical student. Returning to New York three years later, the husband completed the last two semesters of medical school and the wife resumed her former teaching position. The husband received his license to practice four years later and shortly thereafter commenced the action for divorce.

During the marriage, both parties had contributed to the education and living expenses, receiving additional help from their families. The court, however, found that during the marriage, the wife had contributed 76% of the marital income while the husband earned his degree. The wife's expert presented the value of the medical license as $472,000 by comparing the average income of a general surgeon and a college graduate between the time when the husband's residency would end and the time he reached age 65. Factoring for inflation, taxes, and interest, that value was capitalized and reduced to present value. The expert also opined that the wife's contribution to the husband's education was $103,390.

The trial court made a distributive award of 40% of the value of the license to be paid in 11 annual installments. The appellate court overturned this, based on a prior case where the value of the license was not deemed to be marital property.

The husband claimed that his license should be excluded because it was not property, either marital or separate, but instead was a representative of a personal attainment of knowledge. The court reviewed the portion of the statute that stated "the court shall consider: . . . (6) any equitable claim to, interest in, or direct or indirect contribution made to the acquisition of such marital property by the party not having title, including joint efforts or expenditures and contributions and services as a spouse, parent, wage earner and homemaker, and *to the career or career potential* of the other party [and] the impossibility or difficulty of evaluating any component asset or any interest in a business, corporation or *profession*" (Domestic Relations Law § 236 [B] [5] [d] [6], [9] [emphasis added]).

The Court of Appeals (New York's highest court) interpreted these words to mean that an interest in a profession or professional career is marital property. The court interpreted the history of the statute as confirming this interpretation, as the traditional common law title system had caused inequity. The purpose of that statute, considering marriage as an economic partnership, was seen to be consistent with the inclusion of the value of the license.

> The Court of Appeals stated that the lack of market value or alienability was irrelevant. Ultimately, the court decided that if it receives evidence of the present value of the license and the working spouse's contribution toward its acquisition, it may make an appropriate distribution of that license as marital property.
>
> In a concurring opinion, Judge J. Titone stated that the provisions of New York's Domestic Relations Law were intended to provide flexibility so that equity could be done.

The *O'Brien* doctrine has been criticized, however, by those who point out that the statutory language on which the doctrine is based focuses on division of property rather than the *definition* thereof. The statute instructs the court to consider "direct or indirect contributions made . . . to the career or career potential of the other party" when distributing marital assets, not while identifying them. The section advises that a spouse's contributions should be accounted for in the distribution of property.[200] Essentially, the contributing spouse should be given a bigger slice of the same pie, as opposed to the pie itself being made bigger.

As personal goodwill may eventually merge with practice goodwill, some have suggested that, eventually, the value of a practitioner's license becomes subsumed in his or her practice. The New York case *McSparron v. McSparron*[201] addresses this issue and asks whether eventually the value of a license is used up by the income that it has produced. The court in this case considered factors such as a change in circumstances and location of a practicing professional and decided that, no matter how far along, the license has a value outside of one's career, concluding that it did not merge.

Several states have addressed the inclusion of a license outside of New York. Michigan has had varying decisions on inclusion of the license. Iowa may include increased earning capacity in distribution but not the license. Maryland has rejected the valuation of a license or degree in property distribution,[202] and although never adopting or rejecting inclusion of a license, Alaska and Minnesota have left the door open to inclusion under compelling circumstances.[203]

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200. Kenneth R. Davis, "The Doctrine of O'Brien v. O'Brien: Critical Analysis," 13 *Pace Law Review* 863 (1994) at 869.

201. 87 N.Y.2d 275; 662 N.E.2d 745; 639 N.Y.S.2d 265; 1995 N.Y. LEXIS 4451.

202. *Archer v. Archer*, 303 Md. 347,493 A.2d 1074 (1985).

203. Davis, "The Doctrine of O'Brien v. O'Brien," at n11.

In the most extreme application of the value to the holder premise that we have found, the New York case of *Hougie v. Hougie*[204] involved the inclusion of the enhanced earning capacity of an investment banker in the property distribution. The facts of the case ultimately revealed that the husband needed and had a license that allowed him to perform his job, but the court stated that the husband's enhanced earning capacity was a distributable asset regardless of whether a license is required.

In February of 2006, New York's Matrimonial Commission report suggested changes to the statute, recommending the elimination of New York's consideration of enhanced earning capacity, professional degree or license, and celebrity status as marital property.[205]

Double Dipping

The value of a business is the present value of expected future benefits that can be received from that business whether determined by the asset based, market, or income approaches. When the value of a business is distributed in a divorce, the non-business-owner spouse receives some type of asset in exchange for their equitable or community share of the business. The share of the business credited to the non-owner spouse is based on the expected future benefits to the owner. Double dipping can arise from the use of the same income stream for both valuation and alimony. This is an increasingly relevant issue when dealing with the interrelationship between the distribution of marital property and the award of alimony.

For example, in using an income or excess earnings method to value a company, the officer's compensation in excess of reasonable compensation is added back to the income stream of the company and capitalized. Essentially, the valuation takes a portion of the owner's compensation and capitalizes it to value the business, while at the same time, considering it all available for alimony and thereby using it twice.[206]

Double-dipping was first addressed in the treatment of pensions as marital property. As applied to business valuation, double dipping was first addressed in the 1963 Wisconsin case *Kronforst v. Kronforst*,[207] where the court

204. 261 A.D.2d 161; 689 N.Y.S.2d 490; 1999 N.Y. App. Div. LEXIS 4588.

205. Hon. Sondra Miller, "Report to the Chief Judge of the State of New York," New York Matrimonial Commission, February 2006.

206. Donald J. Degrazia, "Controversial Valuation Issues in Divorce," presented at the 2003 AICPA National Business Valuation Conference.

207. 21 Wis. 2d 54, 123 NW 2d 528 (1963).

stated that "such an asset cannot be included as a principal asset in making division of the estate and then also an income item to be considered in awarding alimony." However, New Jersey's recent decision in *Steneken v. Steneken*[208] has allowed the use of the same income stream for both alimony and equitable distribution.

Classification of Value to the Holder Typically States by Their Treatment of Goodwill

A state using investment value will typically consider all goodwill in a professional practice and will not attempt to differentiate between personal and enterprise goodwill. California's *Golden v. Golden*[209] is an example of an investment value case where the rationale the court used was based on the nonprofessional spouse's contribution in assisting in the creation of this value.

Interestingly, there are significant differences between the treatment of goodwill as marital property in *Golden v. Golden* and a case like Pennsylvania's *Gaydos v. Gaydos*.[210] The courts in both cases recognized that the practice would continue after the end of the marriage and that there is a value to that continuance. California saw goodwill as a product of the ongoing value of the company that was developed during the marriage and should be shared between the parties, while Pennsylvania excluded that value as being tied too closely to the practitioner and his or her future efforts.

Washington State views personal goodwill in a slightly different manner from California as illustrated by *In re: Lukens*.[211] The Washington court acknowledged that personal goodwill may not be marketable but stated that it is an asset nonetheless. The court viewed goodwill in light of the concept of a recent graduate or an existing practitioner relocating to another state and having to start over. Although the practitioner would have the skills acquired through training and practice, he or she would not have any reputation in a new place, and therefore that reputation has to be affiliated with the practice.

As discussed earlier, New York is the only state to explicitly include professional degrees, licenses, celebrity status, or enhanced earnings capacity that was acquired during the marriage as marital assets or the incremental increase in them. Alternatively, New Jersey does not consider a professional degree or license as marital property but does consider the value of celebrity goodwill.

208. 2005 N.J. LEXIS 57.

209. 270 Cal. App. 2d 401; 75 Cal. Rptr. 735 (1969 Cal. App.).

210. 693 A.2d (Pa. Super. Ct. 1993)

211. 16 Wn. App. 481, 558 P.2d 279 (1976), review denied, 88 Wn.2d 1011 (1977).

Exhibit 4.10 Continuum of Value: Intangible Assets under Value to the Holder with Case Examples

Premise of Value	**Value to the Holder**	
Standard of Value	Fair Value	Investment Value
Intangible Value	Enterprise and Personal Goodwill	Personal Intangible Value
Case Example	*Dugan v. Dugan*	*O'Brien v. O'Brien*
Underlying Assumption	Going Concern Value Assuming Owner Will Continue Ownership	Enhanced Earnings Capacity

Other states have suggested that including the value of a license or degree may be warranted in certain compelling circumstances.

Exhibit 4.10 presents the continuum of value under the value to the holder premise.

Next we move to a discussion of the treatment of shareholder-level discounts and the weight accorded buy-sell agreements in states that fall under the value to the holder premise.

Shareholder Level Discounts under the Value to the Holder Premise

Under the value to the holder premise of value, the business is valued under the assumption that the entity will continue under current ownership. As we have discussed, personal goodwill is includable as a marital asset under this premise, even though it cannot be sold. Therefore, the shareholder-level lack of control and lack of marketability discounts associated with the value in exchange premise would typically not apply.

Montana is an investment value state that has applied discounts in certain divorce valuations, such as that in the case of *In Re: Decosse*,[212] where a 20% lack of control discount was applied. In our view, New York is a hybrid state, which adheres to a fair market value standard in the valuation of businesses while applying the most liberal definition of marital property in the valuation of a professional degree or license and enhanced earning capacity.

212. 282 Mont. 212; 936 P.2d 821; 1997 Mont. LEXIS 66; 54 Mont. St. Rep. 318.

The following states absent special circumstances, do not apply discounts: Arizona, California, Colorado, Kentucky, Michigan, Nevada, New Jersey, New Mexico, and Washington.

Fair Value

Some cases appear to use assumptions more often attributed to an investment value standard while using the language of fair value, which can be either value in exchange or value to the holder. When a case mentions a pro rata share of enterprise value, rejects shareholder level discounts, or mentions the unwillingness of a buyer or seller, the standard of value is usually fair value. Although the New Jersey case of *Brown v. Brown*[213] and Louisiana case of *Ellington v. Ellington*[214] reference investment value concepts like continuing benefits of ownership and employment, the predominant language of these cases involve fair value.

As mentioned previously, the Louisiana case *Ellington v. Ellington*, may be considered a fair value case. While the wife's expert used an excess earnings method and came to a value of $668,000, the husband's expert determined that the fair market value of liabilities outweighed assets by approximately $55,000 and therefore the company had no value. The court rejected the testimony of both experts as each used a fair market value standard, which was not appropriate because *neither party was a willing seller*. Taking this into account, the court came to a value of $293,000. The appellate court affirmed this decision, as the husband would retain ownership and current management would remain in place and the husband would continue to benefit from the asset in place. Subsequently, Louisiana statute was amended to require adherence to a fair market value standard and the specifically excludes personal goodwill.

Exhibit 4.11 shows the continuum of value based on the treatment of discounts in divorce proceedings under investment value and fair value and value to the holder premise.

Buy-Sell Agreements under Value to the Holder

As we have seen in the *Graff* case, Colorado generally favors a value to the holder premise of value. This extends to the treatment of the buy-sell agreement, which can be seen in the case *In re: Huff*.[215]

213. 348 N.J. Super. 466; 792 A.2d 463.

214. 842 So. 2d 1160; 2003 La. App. LEXIS 675.

215. 834 P.2d 244 (Colo. 1992).

Exhibit 4.11 Continuum of Value: Discounts under Fair Value and Investment Value

Premise of Value	**Value to the Holder**	
Standard of Value	Fair Value	Investment Value
Discounts	No Discounts	Not Applicable
Case Example	*Brown v. Brown*	Not Applicable

In re: Huff

In this case, the husband was a partner in a large, well-established law firm with 90 partners and 66 associates. The firm had a detailed buy-sell agreement in place for various circumstances including withdrawal and death, setting forth a partner withdrawal formula based on the value of receivables plus a portion of the firm's capital. No goodwill is included. The books and formulas were periodically reviewed and updated. Additionally, partners were not able to freely sell their interest as a restrictive agreement was in place.

The husband's expert offered two valuations, the first involving the partnership agreement formula and arriving at a value of $42,442 and the second using the excess earnings method arriving at a value of $113,000. The wife's expert also used excess earnings and valued the interest at $309,500. The difference came down to the capitalization rates used. The trial court elected the $113,000 valuation as proper, as the capitalization rate of the husband's expert was more realistic than that of the wife's expert.

The husband's expert testified that the partnership agreement was in place to discourage partners from leaving the firm, as it awarded a withdrawing partner 50% of his or her accounts receivable. The wife's expert testified that the excess earnings method represented the value of the partnership to the husband if he remained at the practice.

The court rejected the valuation based on the partnership agreement because the husband intended to stay with the firm. The district court decided that the partnership figure ignored "all the present facts and intentions of the parties" and that the excess earnings valuation should be used. The husband appealed that this determination was in error, as the partnership agreement was binding on him and the partnership.

The district court (trial court) decided that because a partnership agreement was designed to discourage partners from leaving the firm and it appeared that the husband intended to stay with the partnership, the court felt

Exhibit 4.12 Continuum of Value: Buy-Sell Agreements under Value in Exchange and Value to the Holder

Premise of Value	**Value in Exchange**		**Value to the Holder**
Standard of Value	Fair Market Value	Fair Value	Investment Value
Buy-Sell	Accepted as Economic Reality: The most a seller will ever actually receive	Generally Rejected	
	Rejected as Economic Reality: Court looks to hypotheical willing buyer and willing seller		
Case Example	*Stern v. Stern*	*In re: Huff*	
	Dahill v. Dahill		

that it was not bound to the terms of that agreement upon divorce. The Colorado Supreme court upheld the decision.[216]

The actual use of a shareholder agreement may determine whether it is relied on by the family court. In the New Jersey case *Stern v. Stern*,[217] the court found that the agreement was updated quarterly, it established an intangible value to the business above the value of a partner's capital account, and was generally used for departing partners. In this case, the court decided that that value should not be disturbed.

Arizona, Colorado, Kentucky, New York, Virginia, and Washington are states that use an investment value to value a certain businesses upon divorce, and all of them have applied the notion that a buy-sell agreement may be considered but should not be binding on value. New Mexico uses a value to the holder premise to value personal goodwill but has also used a buy-sell agreement value for a business upon divorce, which would be a value in exchange premise and a fair value standard. Thus, we would view buy-sell agreements in the manner shown in Exhibit 4.12 under both the value in exchange and value to the holder premises.

216. Id. LEXIS 607; 16 BTR 1304.

217. 66 N.J. 340; 331 A.2d 257; 1975.

In summary, based on our analysis, 10 states fall under some version of a value to the holder premise:[218]

Arizona	Montana
California	Nevada
Colorado	New Mexico
Kentucky	North Carolina
Michigan	Washington

SUMMARY

We have presented the stated or implied premises and standards of value under which each state values commercial enterprises in divorce. The reality is, however, that courts are generally less concerned with the theoretical underpinnings of business valuation than they are with what they perceive to be a fair outcome for the parties involved. One commentator in New Jersey said this regarding the 2003 New Jersey case *Brown v. Brown*:[219]

> Brown emphasized not only the importance of the concept of fairness in a divorce case, but when a conflict existed between policy concerns and appraisal methodology, policy would prevail.[220]

Valuations performed for estate, gift, or income tax purposes are often perceived as different from cases involving people who are dividing an ongoing asset (as in divorce, dissent, or oppression), sometimes unwillingly. In these cases, the courts appear more willing to seek an equitable remedy in order to fairly compensate the individuals involved.

For example, the North Carolina case *Hamby v. Hamby*[221] is one in which a different standard is stated from that which is applied. In the valuation of an

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218. New Jersey also has cases with elements of value to the holder, while having others that appear more closely akin to value in exchange. This is why we consider New Jersey a hybrid state.

219. 348 N.J. Super. 466; 792 A.2d 463.

220. Louis, "Economic Realism."

221. *Hamby v. Hamby*, 143 N.C. App. 635, 547 S.E. 2d 110 (2001).

insurance agency, the court directed the experts to find the fair market value less any encumbrances. The expert whose opinion the court ultimately chose stated that his purpose was to find the fair market value, which he determined was the going concern value to the individual. The expert further stated that even though the business could not be sold, there was a value to the owner above what he received as salary. While setting out to determine net value—that is, fair market value less encumbrances—based on the testimony of the wife's expert, the court arrived at a value to the holder.

In this case, there appears to be an obvious intention to fairly compensate the parties without adhering strictly to the assumptions conventionally underlying a particular standard of value. Although the *Hamby v. Hamby* case may go back and forth between premises and standards of value, other cases have looked not to a standard of value but rather, it seems to us, a fair solution. New York did this in *O'Brien v. O'Brien*,[222] and New Jersey applied equitable principles in *Brown v. Brown*.[223]

To summarize, standards of value in divorce are determined on a state by state basis. We have looked at each state as a means of discerning the premises and standards of value they follow. We began with two distinct premises: value in exchange and value to the holder; and three basic standards of value: fair market value, fair value, and investment value. We then looked at the treatment of goodwill, shareholder level discounts, and the weight accorded buy-sell agreements as indicia of the premise and standard of value applied in each state. Our conclusion is that one could look at a continuum of value as a way to conceptualize the intersection of valuation theory and case law and use this continuum towards a standard of value classification system in divorce. Exhibit 4.13 represents the continuum of value including premises, standards, their indicia, and representative cases. While this construct may be helpful to valuation professionals and appraisal users, we offer a word of caution. While we think that our suggested classification system may be a useful way of interpreting how the standards of value have been used by courts, it is likely that the courts will continue to identify, value, and distribute marital property in ways they deem equitable and not feel constrained by valuation theory.

222. 66 N.Y.2d 576; 489 N.E.2d 712; 498 N.Y.S.2d 743; 1985.

223. 348 N.J. Super. 466; 792 A.2d 463.

Exhibit 4.13 Continuum of Value

Premise of Value		
	Value in Exchange	**Value to the Holder**

Standard of Value			
	Fair Market Value	Fair Value	Investment Value
	Antolik v. Harvey	*Brown v. Brown*	*Golden v. Golden*

Intangible Value				
	Enterprise Goodwill May Be Minimal or Nonexistent	Enterprise Goodwill Only	Enterprise and Personal Goodwill	Personal Intangible Value
	Williams v. Williams	*Thompson v. Thompson/ Sweere v. Gilbert-Sweere*	*Dugan v. Dugan*	*O'Brien v. O'Brien*

Underlying Assumption					
	Walk Away and Compete	Covenant Not to Compete Included	Court's Discretion	Going Concern Value Assuming Owner Will Continue Ownership	Enhanced Earning Capacity
	Covenant Not to Compete Excluded from Value	Covenant Not Addressed			

Discounts				
	Discount Applied	Discounts Not applied		Not Applicable
	Tofte v. Tofte	*Howell v. Howell*	*Brown v. Brown*	Not Applicable

Buy-Sell		
	Accepted as Economic Reality: The most a seller will ever actually receive	Generally Rejected
	Rejected as Economic Reality: Court looks to hypotheical willing buyer and willing seller	
	Stern v. Stern	*In re: Huff*
	Dahill v. Dahill	

5

Fair Value in Financial Reporting

INTRODUCTION

This chapter explores the theory and application of the fair value standard used in the preparation of corporate financial statements. The term is not the same as fair value referred to in dissenter's rights and oppression cases, which is discussed in Chapter 3. The fair value standard in accounting literature refers to the measurement of assets and liabilities in financial statements. The current definition of *fair value* is

> The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.[1]

This chapter explains the fair value standard and discusses the history of fair value in accounting literature, the use of the standard as it applies to valuations for financial reporting purposes, and an interpretation of how fair value differs from other standards of value, such as fair market value. The focus of this chapter is on fair value measurement in business combinations and asset impairment tests, since valuation practitioners frequently encounter valuations for these types of assignments. The chapter also discusses audit issues.

1. SFAS No. 141, *Business Combinations*, Glossary, and FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurement*, Glossary of Terms. Note: This definition will be updated when the Financial Accounting Standards Board (FASB) issues its new standard on fair value measurement sometime in the second half of 2006.

Fair Value in Financial Reporting: What Is It?

Fair value is the standard of value used in valuations performed for accounting purposes. The terminology comes from accounting literature, including generally accepted accounting principles (GAAP) and Securities and Exchange Commission (SEC) regulations. Recent guidance on fair value is contained in the March, 2006 Working Draft (WD) of a proposed new accounting standard, expected to be issued final by the Financial Accounting Standards Board (FASB) by in the second half of 2006. This proposed new accounting standard is on fair value measurement.

The initial exposure draft (ED) on fair value measurement was issued in June 2004. In its background notes to the ED, FASB indicates that prior guidance regarding fair value measurement in the accounting literature was developed piecemeal over time and was contained in a number of different pronouncements, which were not necessarily consistent with one another. FASB indicated a desire to change that by establishing a framework that builds on current practice but also clarifies measurement of fair value in a manner that can be consistently applied to all assets and liabilities.[2]

The WD updates the current definition of fair value found in Statement of Financial Accounting Standards (SFAS) 141 and Statement of Concepts 7. The proposed new definition of fair value is:

> Fair Value is the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date.[3]

The WD applies broadly to financial assets and nonfinancial assets and liabilities that are required by GAAP to be measured at fair value. The WD states that the guidance contained therein is to be used together with generally accepted valuation practices and applicable valuation standards. The WD states that this proposed new accounting standard will become effective for corporations with fiscal years beginning after November 15, 2007.

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2. June, 2004 FASB Exposure Draft, *Proposed Statement of Financial Accounting Standards—Fair Value Measurements,* paragraphs C4 and C11.
3. March 15, 2006 FVM Working Draft, *Statement of Financial Accounting Standards No 15x—Fair Value Measurements* at paragraph 5.

Key concepts embodied in the fair value definition include:

- *Price.* The price used to measure fair value is an exit price considered from the perspective of a market participant (seller) that holds the asset or liability.[4]
- *The Asset or Liability.* Fair value considers the condition and/or location of the asset (or liability). In some cases the asset or liability stands alone; in other cases it might be part of a group of assets or liabilities, for example a business.[5]
- *Transaction.* Fair value assumes an orderly transaction, that allows time for exposure to the market that is usual and customary, and reflects market conditions at the measurement date.[6]
- *Market participants.* Independent (i.e., not related parties), knowledgeable, able and willing (i.e. not forced) buyers and sellers in the principal (i.e. most advantageous) market.[7]
- *Highest and best use.* Fair value refers to the highest and best use of asset from the perspective of market participants.[8]
- *Premise of value.* Refers to an assumption of whether the fair value estimate is based on an "in-use" or "in-exchange" premise, with the appropriate premise being the one that reflects the highest and best use of the asset.[9]

In measuring the fair value of assets and liabilities, emphasis is clearly placed on the concept of market participants, market information, and market inputs. The WD establishes a fair value measurement hierarchy, which relates to a preference for using observable market data in measuring fair value, when market data are available. There are three levels of inputs:

Level 1 inputs are observable market inputs that reflect quoted prices for identical assets or liabilities in active markets the reporting entity has the ability to access at the measurement date.[10]

4. Id. At paragraph 7.
5. Id. At paragraph 6.
6. Id. at paragraph 10.
7. Id. at paragraph 11.
8. Id. at paragraph 12.
9. Id. at paragraph 13.
10. Id at paragraph 24.

Level 2 inputs are observable market inputs for assets that are similar but not identical. Assets that will typically be valued using Level 1 and Level 2 estimates are financial instruments. Examples of financial instruments include investments such as marketable securities.[11]

Level 3 inputs are unobservable market inputs, and may consider assumptions about market participant inputs that are estimated by management of an entity. However, management assumptions should not include factors specific to that entity if such factors do not also reflect the assumptions of market participants.[12] For business combination purposes, the valuation of most nonfinancial assets often uses Level 3 inputs.

Estimates of fair value are determined using one or more of the multiple valuation techniques consistent with the market, income, and cost (asset based) approaches to valuation. Judgment is required in the selection and application of relevant techniques and inputs. When multiple techniques are used, the results of each are to be evaluated, considering the relevance and reliability of the inputs used in each. Above all:

> Valuation techniques . . . shall emphasize market inputs.[13]

Definitions for valuation approaches that constitute *multiple valuation techniques* are provided—for example, the market, income, and cost approaches are summarized in this way:

> The market approach uses observable prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). The measurement is based on the value indicated by those market transactions.
>
> The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The estimate of fair value is based on the value indicated by market expectations about those future amounts. Those valuation techniques include present value techniques; option pricing models, such as the Black-Scholes-Merton formula (a closed form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multi-period excess earnings method, a discounted cash flow method used to measure the fair value of certain intangible assets.

11. Id at paragraph 28.
12. Id at paragraph 30.
13. June, 2004 FASB Exposure Draft, *Proposed Statement of Accounting Standards—Fair Value Measurement*, paragraph 23.

> The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the measurement assumes that the price that would be received for the asset would not exceed the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technical) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).[14]

The *premise of value* concept refers to the location and condition of the asset(s) being valued. The premise of value selected should be the one that maximizes the highest and best use of the asset:

> If the highest and best use of an asset is in-use, fair value shall be measured using an in-use valuation premise (fair value in-use). The highest and best use of an asset is in-use if some market participants would use the asset as it is currently installed or otherwise configured for use and that use of the asset would maximize its fair value. In that case, the asset is not separable or substitutable with other equivalent assets (the hypothetical transaction between market participants to sell or otherwise dispose of the asset at the measurement date involves an asset group that is in-use).
>
> If the highest and best use of an asset is in-exchange, fair value shall be measured using an in-exchange valuation premise (fair value in-exchange). The highest and best use of an asset is in-exchange if some market participants would not use the asset as it is currently installed or otherwise configured for use and the exchange of the asset would maximize its fair value. In that case, the asset is separable or substitutable with other equivalent assets (the hypothetical transaction between market participants to sell or otherwise dispose of the asset at the measurement date involves a standalone asset).[15]

History of Fair Value in U.S. Accounting Literature

Fair value is a term that has long been used in the accounting literature. However, the term was often mentioned without providing either a definition or guidance on how to measure it. Therefore, the theory and application of fair

14. FASB Working Draft, March 15, 2006 paragraph 19.

15. Id. paragraph 13.

value for financial reporting purposes was developed piecemeal over time.[16] Early reference to the term *fair value* dates to 1953 with the issuance of Accounting Research Bulletin 43—Restatement and Revision of Accounting Research Bulletins, ARB 43 is itself a restatement of even earlier accounting statements. Other early accounting pronouncements which reference fair value include Accounting Principles Board Opinions APB 29, *Accounting for Nonmonetary Transactions*, issued in 1973, and FASB 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, issued in 1977.

Accounting statements in the United States are promulgated by the Financial Accounting Standards Board. Prior to a project that resulted in the 2004 issuance of an Exposure Draft on fair value measurement, the FASB had formally addressed the definition and usage of the fair value standard primarily in the context of reporting for financial instruments.[17] Examples of financial instruments include cash and short- and long-term investments. In 1986 the FASB added a project to its agenda on financial instruments and off-balance sheet financing, which ultimately led to the issuance in 1991 of SFAS 107, *Disclosures About Fair Value for Financial Instruments* and the issuance in 1998 of Financial Accounting Standards 133, *Accounting for Derivative Instruments and Hedging Activities*. In developing these statements, the FASB adopted a long-term objective of measuring *all* financial instruments at fair value.[18]

Use of the fair value standard in business combinations dates to APB 16 and APB 17, which were issued in 1970. These rulings were in effect for over 30 years and provided no definition of the term and little guidance on how to measure it. During the 1980s, there was a significant increase in the amount of merger and acquisition activity. At the same time the U.S. economy's shift toward service-oriented and information-oriented businesses continued. With these phenomena, the stock of some public companies began trading at increasingly higher multiples of "book value." Interest increased in how to explain these phenomena as being the result of "intangible" value, either developed internally or purchased in a business combination. Intangible assets included intellectual property such as trademarks, trade names, patented technology, know-how, trade secrets, formulas and recipes, and the value of research and development.

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16. June, 2004 FASB Exposure Draft, *Proposed Statement of Accounting Standards—Fair Value Measurements*, paragraph C4.

17. Id. at paragraph C6.

18. Id. at paragraph C7.

As intangible value became more important to the enterprise value of the corporation, discussions on how to account for intangible value increased. Internally developed intangible assets are not recorded on the balance sheet, but intangible assets purchased in a business combination are. However, lack of sufficient guidance on how to measure the fair value of assets in business combinations led to diversity of practice and the potential for different results in the measurement of comparable assets across a spectrum of corporations. For example, some companies combined their intangible assets, purchased in a business combination, together with goodwill, whereas other companies did not.

In some cases abuses were alleged, for example, in the valuation and write-offs of large amounts of in-process research and development (IPR&D) for business combinations in the technology sector in the mid- to late 1990s. In a 1998 letter from the SEC to the American Institute of Certified Public Accountants (AICPA), then chief accountant of the SEC Lynn Turner

> challenged the AICPA to take a larger leadership role, by developing detailed, broad-based guidance on valuation models and methodologies used (a) to measure fair value, under the oversight of the FASB, and (b) in auditing fair value estimates.[19]

The AICPA responded by forming a task force of accountants and valuation professionals to study the issue. In 2001 the AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (IPR&D Practice Aid) was issued. The introduction to the IPR&D Practice Aid cites that its purpose was:

> to bring together a task force to determine best practices in the valuation of IPR&D for financial reporting in business combinations.[20]

Meanwhile, the SEC continued to voice its opinion by also offering comments on the application on the fair value of assets in financial reporting to a variety of other topics, including segregation of identifiable intangible assets

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19. Jackson M. Day, Deputy Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, "Fair Value Accounting—Let's Get Together and Get It Done!" remarks to the 28th Annual National Conference on Current SEC Developments, December 5, 2000.

20. AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices and Pharmaceutical Industries*, Introduction.

from goodwill, goodwill impairment charges, customer-related intangible assets, and amortization of finite-lived intangible assets. In a 2000 speech at the Annual Conference on Current SEC Developments, a member of the SEC staff suggested:

> Standard-setters must provide more detailed, how-to accounting, valuation, and auditing guidance.
>
> The profession must work together and with others outside the profession including users and valuation experts.
>
> Preparers, auditors, and users must become better educated about fair value accounting.[21]

Whereas that speech specifically referred to fair value for financial instruments, it's guidance has broader application to all assets that require fair value measurement for financial reporting.

The SEC also commented on valuators' and auditors' responsibilities. In a 2001 speech at a securities conference, Turner said:

> Whether it is in conjunction with the acquisition of a business, the performance of the impairment test, or the evaluation of recorded intangible assets at transition, in almost every instance, companies will be required to obtain the assistance of a competent and knowledgeable professional to assist in the valuation of these intangible assets. Based on the staff's past experiences . . . I have concerns about the results of this process due to the lack of any meaningful guidance on valuation models and methodologies used to measure fair value and the auditing of those measurements.[22]

Accounting organizations and rule-making bodies have responded to these challenges in recent years. As a result the guidance on fair value for financial reporting has increased.

In 2000 the FASB issued FASB Concepts Statement No. 7, *Using Cash Information and Present Value in Accounting Measurements*, which was the result of a project the FASB had added to its agenda in 1988 to consider pre-

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21. Day, "Fair Value Accounting."
22. Lynn E. Turner, Chief Accountant, U.S. Securities and Exchange Commission, "The Times, They are a–Changing," remarks to the 33rd Rocky Mountain Securities Conference, May 18, 2001.
23. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurement*, paragraph 2.

sent value issues in accounting measurements.[23] And, citing increased amounts of merger and acquisition activity as a principal reason, the FASB undertook a new project in 1996 related to accounting for business combinations. This resulted in the issuance in 2001 of SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*. Both of these statements provide more specific guidance on fair value than did APB 16 and 17.

In 2003 the FASB formed the Valuation Resource Group (VRG) made up of preparers, auditors, and valuation specialists, to provide a standing resource to the FASB on fair value measurement issues.[24] Also in 2003, the Auditing Standards Board issued Statement of Auditing Standards (SAS) 101, *Auditing Fair Value Measurements and Disclosures*.

In June 2004 FASB issued an Exposure Draft on fair value measurement. In its background notes to the ED, FASB indicates a desire to establish a framework that clarifies measurement of fair value in a manner that can be consistently applied to all assets and liabilities.[25] After an open comment period and further deliberations by FASB, a working draft of the proposed new accounting standard was issued in October 2005, and another working draft was issued in March, 2006. The final version of this new accounting standard on fair value measurement is expected to be issued in June, 2006 and will become effective for companies with fiscal years beginning after November 15, 2007.

APPLICATION OF THE FAIR VALUE STANDARD TO BUSINESS COMBINATIONS

Use of the fair value standard in business combinations dates to APB 16 and APB 17, which were issued in 1970. APB 16 defines two accounting methods permissible for use in accounting for business combinations: the pooling of interests method and the purchase method. APB 16 compares and contrasts the two methods and delineates the conditions that would trigger the requirement to use one or the other. APB 17 deals with accounting for acquired intangible assets, both identifiable and unidentifiable (i.e., goodwill), which were acquired either singly or in groups, including in business combinations.

In APB 16, fair value is relevant to the purchase method. Fair value is used in connection with the "historical cost" principle as a way to determine

24. June, 2004 FASB Exposure Draft, *Proposed Statement of Accounting Standards—Fair Value Measurements*, paragraph C13.

25. Id. at paragraphs C4 and C11.

the "cost" of the assets acquired.[26] In particular, fair value is the standard prescribed to allocate the "cost" of the acquisition to assets that were acquired as a group. APB 16 states:

> Acquiring assets in groups requires not only ascertaining the cost of the assets as a group but also allocating the cost to the individual assets which comprise the group. . . . A portion of the total cost is then assigned to each individual asset acquired on the basis of its fair value. A difference between the sum of the assigned costs of the tangible and identifiable intangible assets acquired less liabilities assumed and the cost of the group is evidence of unspecified intangible values.[27]

Despite providing guidance on using the fair value standard, APB 16 contained no definition of the term, and made no mention of how fair value is to be measured. APB 16 does indicate that independent appraisals could be used as an aid[28] in measuring fair value.

APB 17 deals with accounting for intangible assets, both identifiable and unidentifiable (the most common unidentifiable intangible asset being goodwill), that have been acquired by a business. APB 17 describes the characteristics of intangible assets as lacking physical qualities, making evidence of their existence elusive. Furthermore APB 17 states that the value of an intangible asset is often difficult to estimate and its useful life may be indeterminable.[29]

The historical cost principle is invoked in APB 17,[30] as it is in APB 16. The treatment of acquired intangible assets is to record them at cost on the date they are acquired. Intangible assets acquired as groups are recorded at cost, and the cost is allocated to each identifiable intangible asset in the group based on its fair value.[31]

26. APB No. 16, *Business Combinations*, paragraph 66. The purchase method was described as "following principles normally applicable under historical-cost accounting to recording acquisitions of assets and issuances of stock and to accounting for assets and liabilities after acquisition."

27. Id. at paragraph 68.

28. Id. at paragraph 87.

29. APB No. 17, *Intangible Assets*, paragraph 2.

30. Id. at paragraph 15.

31. Id. at paragraph 26.

APB 17 treats unidentified intangible assets (i.e., goodwill) differently from identifiable intangible assets. Unidentified intangible assets are accounted for using a residual method:

> The cost of unidentifiable intangible assets is measured by the difference between the cost of the group of assets or enterprise acquired and the sum of the assigned costs of individual tangible and identifiable intangible assets acquired less liabilities assumed.[32]

APB 17, like APB 16, does not define the term *fair value*, and the opinion does not mention how fair value is to be determined. With the lack of a definition for fair value and little guidance in the accounting literature as to how it should be measured, practitioners adapted various methodologies, based on facts and circumstances applicable to particular assignments, including versions of cost, market and income approaches, to the valuation of tangible and intangible assets for financial reporting purposes in business combinations. As a result, a diversity of practice developed among valuators in the application of fair value to business combinations for financial reporting.

SFAS 141 and SFAS 142 superseded APB 16 and APB 17 in 2001. SFAS 141 reduces the acceptable methods for accounting for business combinations from two to one. The pooling of interests method is eliminated, and effective with the adoption of SFAS 141, all business combinations are to be accounted for using the purchase method. SFAS 141 does not fundamentally change the guidance of APB 16 in treating the cost of an acquired entity as its fair value. Absent persuasive evidence to the contrary, the transaction price between buyer and seller is presumed to be the cost of the acquired entity, and hence its fair value. The requirement to allocate cost to the acquired assets based on their fair values remains the same.

Unlike APB 16 and APB 17, SFAS 141 and SFAS 142 contain a definition of fair value. The other key change in SFAS 141 is that it provides additional guidance on the identification of intangible assets that are to be segregated from goodwill and valued separately:

> In contrast to Opinion 16, which required separate recognition of intangible assets that can be identified and named, this Statement requires that they be recognized as assets apart from goodwill if they meet one of two criteria—the contractual-legal criterion or the separability criterion.[33]

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32. Id. at paragraph 26.

33. SFAS No. 141, *Business Combinations*, Summary Introduction.

Appendix A to SFAS 141 provides specific examples of identifiable intangible assets that meet the contractual-legal and/or separability criteria. Furthermore, Appendix B provides a discussion of the nature of goodwill, to provide further clarification of the differences between separately identifiable intangible assets and goodwill. What is lacking in SFAS 141, however, is any specific guidance on acceptable valuation techniques or appropriate methods for measuring fair value. SFAS 141 carries forward the vague guidance of APB 16 in this regard, and it reiterated that

> Among other sources of relevant information, independent appraisals and actuarial or other valuations may be used as an aid in determining the estimated fair values of assets acquired and liabilities assumed.[34]

Guidance on the measurement of fair value is described in FASB Statement of Concepts 7, *Using Cash Flow Information and Present Value in Accounting* (Concepts 7). The introduction and background sections of Concepts 7 state:

> In recent years, the Board has identified fair value as the objective for most measurements at initial recognition and fresh-start measurements.[35]

The Statement adopts fair value as the measurement objective and describes present value as the application of a measurement technique. In fact, Concepts 7 state:

> The only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value.[36]

The definition of fair value in the glossary of Concepts 7 matches the one used in SFAS 141.

The point of Concepts 7 is that present value techniques provide appropriate methods for measuring fair value. Concepts 7 describe two present value techniques in detail, the estimated future cash flow method and the expected cash flow method. A chief difference between them is that the estimated future cash flow method selects a single best estimate of future cash flows to be used in the present value calculation whereas the expected cash flow method

34. Id. at paragraph 36.

35. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurement*, paragraph 7.

36. Id. at paragraph 25.

incorporates multiple forecasts of future cash flow with a probability factor assigned to each. The Statement indicates a preference, but not a requirement, to use the expected future cash flow method in many situations, especially when the timing of future cash flows is uncertain.

Another key point in Concepts 7 is the use of present value techniques to replicate market prices in the absence of observable transactions. A hierarchy of fair value techniques is implied, in which observable market prices are considered a better measurement technique than present value, when observable market prices are available:

> Observable marketplace amounts are generally more reliable and are more efficiently determined than measurements that must employ estimates of future cash flows. When observable amounts are not available, accountants often turn to estimated cash flows to determine the carrying amount of an asset or a liability.[37]
>
> If a price for an asset or liability or an essentially similar asset or liability can be observed in the marketplace, there is no need to use present value measurements.[38]
>
> Present value should attempt to capture the elements that taken together would comprise a market price if one existed, that is, fair value.[39]
>
> [T]he objective is to estimate the price likely to exist in the marketplace, if there were a marketplace.[40]

Many valuators have found that there is scant market evidence for intangible assets, making market approaches difficult to use and thereby making present value techniques an important measurement tool in determining fair values.

In addition to GAAP, interpretation related to the fair value standard used in financial reporting for business combinations can be gleaned from other sources, for example, the AICPA, In 2001 the AICPA issued, as part of its Practice Aid Series, the IPR&D Practice Aid to provide guidance relative to the valuation of in process research and development (IPR&D) for financial reporting in business combinations.

The IPR&D Practice Aid refers to the fair value definition contained in SFAS 141, which had been issued earlier the same year. However, the IPR&D

37. Id. at paragraph 1.

38. Id. at paragraph 17.

39. Id. at paragraph 25.

40. Id. at page 2, "Highlights."

Practice Aid added that the IPR&D Task Force believed the concept of fair value intended in the accounting literature does not have an equal in valuation literature. It provided further interpretation of the concept of fair value to include key specific attributes, namely:

- Methods used to determine fair value should incorporate assumptions of "market participants."[41]
- Market participants would include all potential buyers, including competitors in the same line of business, that appear to have the access and financial wherewithal giving them the ability to acquire the assets being valued.[42]
- Synergistic or strategic benefits in excess of those expected to be realized by market participants would be removed by the valuation practitioner and eliminated from the techniques used to determine fair value of the acquired assets.[43]
- Fair value of an acquired asset should be based on a separate standalone basis, which would be the hypothetical market price for that asset on a piecemeal basis as if that asset were traded on an established market.[44]

Finally, the IPR&D Practice Aid noted that GAAP uses a hierarchy for evidential matter and that in the absence of quoted prices, the valuation technique used to estimate fair value would be the one that best approximates quoted market prices.[45]

APPLICATION OF THE FAIR VALUE STANDARD TO ASSET IMPAIRMENT TESTS

Business combinations deal with the "initial recognition" of assets and liabilities. The ongoing accounting treatment for assets and liabilities after their initial recognition deals with depreciation and amortization for wasting assets

41. AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*, paragraph 1.1.03.
42. Id. at paragraph 1.1.05.
43. Id. at paragraph 1.1.16
44. Id. at paragraph 1.1.09
45. Id. at paragraph 1.1.20.

as well as testing for impairment both long-lived (wasting) assets and assets with an indefinite or indeterminable life.

In 1995 FASB issued SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. SFAS 121 applies to tangible assets, certain identifiable intangible assets, and goodwill related to those assets. Once it has been determined that an impairment loss should be recognized, the measurement of that loss is to be determined by reference to the fair value of the asset. SFAS 121 defines fair value as:

> The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.[46]

Measurement guidance is provided:

> Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances.
>
> The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.[47]

In its discussion of background information and basis for conclusions, the FASB further notes that:

> The Board decided to include an approach for measuring the fair value of an asset that would be broadly applicable to other assets in addition to those covered by this Statement.
>
> The Board believes that fair value is an easily understood notion . . . . The fair value measure is basic to economic theory and is grounded in the reality of the marketplace. . . . Valuation techniques for measuring an asset covered by this Statement should be consistent with the objective of mea-

46. SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of*, paragraph 7.

47. Id. At paragraph 7.

> suring fair value and should incorporate assumptions that market participants would use in their estimates of the asset's fair value.[48]

In 2001 FASB issued SFAS 144, *Accounting for the Impairment of Disposal of Long-Lived Assets*, which superseded SFAS 121. The discussion of fair value in SFAS 144 is similar to SFAS 121, but was updated to be consistent with guidance included in Concepts 7, issued in 2000. The definition of fair value and measurement guidance in SFAS 144 is:

> Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, in many instances, quoted market prices in active markets will not be available for the long-lived assets (asset groups) covered by this Statement. In those instances, the estimate of fair value shall be based on the best information available, including prices for similar assets (groups) and the results of using other valuation techniques.[49]
>
> A present value technique is often the best available valuation technique with which to estimate the fair value of a long-lived asset (asset group) . . . . (Concepts 7) discuss the use of two present value techniques to measure the fair value of an asset (liability). The first is expected present value, in which multiple cash flow scenarios that reflect the range of possible outcomes and a risk-free rate are used to estimate fair value. The second is traditional present value, in which a single set of estimated cash flows and a single interest rate (a rate commensurate with the risk) are used to estimate fair value. Either present value technique can be used for a fair value measurement. However, for long-lived assets (asset groups) that have uncertainties both in timing and amount, an expected present value technique will often be the appropriate technique.[50]

Questions exist as to the applicablility of a risk-free rate in the discounting of expected future cash flows. The 2004 Exposure Draft on fair value measurement updated and provided further clarification to guidance offered in SFAS 144.

In 2001, FASB also issued SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 142 deals with intangible assets with indefinite lives. SFAS 142 and SFAS 144 both deal with the accounting treatment for goodwill, intangible

48. Id. at paragraphs 72–75.

49. SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, paragraph 22.

50. Id. at paragraph 23.

assets, and other long-lived assets after their initial recognition. Whereas FAS 144 deals with definite-lived assets, SFAS 142 deals with indefinite-lived assets.

A key change in SFAS 142 from APB 17 is in the treatment of goodwill and other indefinite-lived intangible assets; they are no longer amortized, but rather are tested at least annually for impairment. The impairment test is a two-step test. Step 1 can be described as the *identification* of potential impairment, and Step 2 can be described as the *measurement* of the amount of impairment loss. The Step 1 test for goodwill is performed at the reporting unit level. SFAS 142 introduces the concept of a reporting unit as being a collection of assets that operate together as a going concern business. A reporting unit can be one level below a reporting segment, and is described as the lowest level at which management captures and analyzes the financial data of a business. Additionally, a reporting unit has its own management and contains unique risk relative to other businesses in the reporting segment.

The Step 1 test entails fair value measurement of the reporting unit and comparison of the fair value of that reporting unit to its carrying value. Carrying value is the amount of assets net of liabilities recorded on the balance sheet of the reporting unit. If the fair value exceeds its carrying value, no further work is required. However, if the fair value of the reporting unit is below its carrying value, the Step 2 test is required. The Step 2 test is akin to a valuation assignment for a deemed purchase price allocation. A deemed purchase price allocation involves identifying and valuing each of the reporting unit's tangible and intangible assets in order to calculate the implied fair value of each reporting unit's goodwill. The amount of goodwill impaired is not necessarily the difference between the fair value and carrying value of the reporting unit, since the fair value of the reporting unit's underlying assets may be more or less than their carrying values. The Step 2 test is required to determine the amount of goodwill impairment.

The fair value definition in SFAS 142 is consistent with the fair value definition in SFAS 141. The guidance on measurement of fair value in SFAS 142 refers back to the guidance in Concepts 7. SFAS 142 also describes the same preference, or hierarchy, of methods for fair value measurement: (1) quoted market prices in active markets are the best evidence of fair value, if available, and (2) in the absence of quoted market prices, estimates of fair value should be based on the best information available, including prices for similar assets and/or present value techniques.[51]

51. SFAS No. 142, *Goodwill and Other Intangible Assets*, paragraph 23.

SFAS 142 also describes a "market" valuation approach as a potentially appropriate measurement technique for valuing a reporting unit:

> In estimating the fair value of a reporting unit, a valuation technique based on multiples of earnings or revenue or a similar performance measure may be used if that technique is consistent with the objective of measuring fair value. Use of multiples of earnings or revenue in determining the fair value of a reporting unit may be appropriate, for example, when the fair value of an entity that has comparable operations and economic characteristics is observable and the relevant multiples of the comparable entity are known. Conversely, use of multiples would not be appropriate in situations in which the operations or activities of an entity for which the multiples are known are not of a comparable nature, scope, or size as the reporting unit for which fair value is being estimated.[52]

Finally, SFAS 142 alludes to the concept of control premium:

> The fair value of a reporting unit refers to the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit. Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization.[53]

In practice, control premiums are sometimes included in a valuation analysis for the reporting unit and other times not, depending on the valuation

52. Id. at paragraph 25.

53. Id. at paragraphs 23 and 24.

method employed and the unique facts, circumstances, and assumptions applicable on a case-by-case basis.

INTERPRETATION OF FAIR VALUE COMPARED TO OTHER STANDARDS OF VALUE

Fair Value in Financial Reporting versus Fair Value in Dissenters' Rights Cases

Fair value as it is used in accounting literature for valuations in financial reporting is not the same as fair value as it applies to valuations in dissenter's rights and oppression cases. Fair value in dissenters' rights and oppression cases is a judicially created concept that appears in state statutes and case law and was utilized as a factor to distinguish valuation concepts in those cases from fair market value.

Fair Value in Financial Reporting versus Investment Value

Fair value in financial reporting differs from investment value, in that:

> Fair value reflects value in the market and is determined based on the assumptions of marketplace participants (willing buyers and sellers). In contrast, investment value reflects value to a particular investor (buyer or seller) and is often considered from the perspective of that investor as a basis for making investment (buy and sell) decisions. Differences between fair value and investment value may be attributable to varying factors (including synergies). Synergies refer generally to the benefits of combining two or more assets or asset groups (for example, operating units) and fall into two broad categories: (a) synergies generally available to all marketplace participants (marketplace synergies) and (b) synergies specific to a particular buyer not generally available to other marketplace participants (buyer-specific synergies).[54]

Fair Value in Financial Reporting versus Fair Market Value

Fair value in financial reporting differs from fair market value in several respects. Fair market value is used in valuations for tax purposes, whereas fair

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54. June, 2004 FASB Exposure Draft, *Proposed Statement of Accounting Standards—Fair Value Measurements*, paragraph B2.

value is used for accounting purposes. The ED on fair value measurement refers to the difference in this way:

> The definition of fair value used for financial reporting purposes often is confused with the similar definitions of fair market value used for valuation purposes. Specifically, Internal Revenue Service Revenue Ruling 59-60 defines fair market value as "the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts." That definition of fair market value represents the legal standard of value in many valuation situations. Because the definitions of fair market value and fair value are similar, both emphasizing the need to consider the actions of marketplace participants (willing buyers and sellers) in the context of a hypothetical exchange transaction, some constituents asked the Board whether, in its view, they are the same or different. The Board believes that the measurement objectives embodied in the definitions are essentially the same. However, the Board observed that the definition of fair market value has a significant body of interpretive case law, developed in the context of the tax regulation. Because such interpretive case law, in the context of financial reporting, may not be relevant, the Board chose not to simply adopt the definition of fair market value, and its interpretive case law, for financial reporting purposes.[55]

Some valuators view the practical application of fair market value as a transaction-based approach whereas fair value is used to value an asset or group of assets within the context of a larger transaction (e.g., assets valued in a post-transaction allocation of purchase price). Fair market value is based on a value-in-exchange premise whereas the fair value of assets valued for post-transaction purchase price allocation, for example, are often based on a premise of value in-use. The Working Draft of the FASB Exposure Draft on fair value measurement indicates that fair value can be based on either premise, in-use or in-exchange, depending on which represents the highest and best use for the asset.

In the context of fair value of assets in business combinations, each asset of an acquired business is valued based on its contribution to the business as a whole, regardless of whether that asset could individually be bought or sold. An example would be a noncontractual customer relationship. This asset is

55. Id. at paragraph C27.

usually not separable by itself from the business and under the definition of fair market value would have limited value in exchange by itself. Under the definition of fair value, the customers can have considerable value in use as these relationships could represent the primary income-earning asset of the business.

In applying SFAS 141, the price paid for the business is assumed to be the fair value of the acquired business, since it is the result of an arm's-length transaction between unrelated parties (willing buyer and willing seller) akin to the fair market value definition. Absent persuasive evidence to the contrary, it is difficult to successfully argue a fair value for an acquired business other than the transaction price. In this circumstance, fair value is determined by the price paid in one transaction.

Another example of fair value is in the derivation of the fair value of a specific asset in the context of purchase accounting. It is common practice to consider the tax benefits that an asset would generate if the asset were sold on a stand-alone basis when an income approach is applied to deriving value. The market approach is assumed to already have the tax benefits embedded in the market-based transaction prices. Debate and diversity of practice exist as to whether the application of a cost approach should include the tax benefit consideration.

A final example of an interpretive difference between fair value and fair market value is in the area of "cheap stock." Cheap stock issues are typically related to private companies that are approaching an initial public offering (IPO). In conjunction with the IPO, financial statements are issued that reflect the historic performance of the subject company for multiple years prior to the offering. A cheap stock expense often requires valuation and is commonly determined based on the difference between the strike price of options issued by the company to its management and others and the fair value of the underlying common equity.

The SEC in its review of the financial statements has sometimes questioned any difference between the IPO price of the shares and the deemed fair value of the shares within six months of the IPO, even though the IPO event is subsequent to the valuation date. Application of marketability and lack of control discounts due to the uncertainty of completion of the IPO are sometimes not accepted. One reason might be the subjective nature surrounding the magnitude of these discounts. Another reason may be a preference to use the subsequent IPO price since it is verifiable (i.e. it is not subjective). Either way, fair value in the context of cheap stock issues may rely heavily on "after-the-fact" events and sometimes a burden of proof is placed on the company to refute the assumption that a subsequent IPO price differs from fair value.

In contrast, subsequent events (i.e., the IPO price) are not given this same importance in the application of the fair market value standard. Further, marketability and lack of control discounts, changes in risk, and changes in business issues are each expected considerations in arriving at a value conclusion.

AUDIT ISSUES

The rise in accounting pronouncements dealing with fair value has created a need for increased guidance to auditors in their auditing of fair value determinations. In the absence of specific audit guidance, different perspectives amongst auditors, managements and valuation specialists created inconsistencies in the auditing of assets and liabilities recorded on the balance sheet at their fair values. In 2003 the Auditing Standards Board (ASB) issued Statement of Auditing Standards 101, *Auditing Fair Value Measurements and Disclosures*.

SAS 101 notes that generally accepted accounting principles require certain items to be measured at fair value. SAS 101 refers to the definition of fair value contained in Concepts 7. SAS 101 notes that GAAP expresses a preference for using observable market prices to make fair value measurements, but notes that other valuation techniques are also acceptable, especially when observable market prices are not available. Key concepts included in SAS 101 include:

- *Management assumptions* used in preparing fair value estimates include assumptions developed by management under direction of the board as well as assumptions developed by a valuation specialist.
- *Market information and marketplace participants.* Valuation methods must incorporate information that marketplace participants would use, whenever market information is available.
- *Reasonable basis.* The auditor must evaluate whether management's assumptions are reasonable and/or not inconsistent with market information.
- *Valuation specialist.* The auditor should evaluate the experience and expertise of those making fair value estimates; management should assess the extent to which an entity employs valuation specialists, and auditors should determine whether to engage a valuation specialist in auditing fair value estimates.

- *Subsequent events.* Events that occur after the balance sheet date but before completion of audit fieldwork may be used to substantiate fair value estimates.

An area of concern expressed by the accounting community is the auditors' ability to determine the reliability and verifiability of fair value estimates in certain circumstances, particularly when the estimate involves management's entity-specific assumptions. In its comment letter to the FASB on the Exposure Draft for fair value measurements, the Accounting Standards Executive Committee of the AICPA raised this as a concern and quoted from a speech given by the Public Company Accounting Oversight Board (PCAOB's) chief auditor:

> When fair value cannot be measured by reference to matters that are directly observable, and if the measure represents little more than the measurer's state of mind, neither the measurement nor the measurement method are verifiable . . . . Resolving this verifiability issue will require the attention and cooperative efforts of accounting and auditing standard setters and regulators. In the meantime, the independent auditor should exercise due care, including the use of heightened professional skepticism, to ensure that measurer bias has not materially affected a fair value measurement based on valuation techniques.[56]

The audit environment today is increasingly focused on fair value measurement in general and the auditor's responsibilities regarding fair value measurements. Many of the largest accounting firms have established departments of valuation specialists working with their audit groups to assist with the auditing of fair value measurements.

SUMMARY

In recent years (especially since the mid-1990s), there has been a marked increase in the accounting literature and GAAP in the use of fair value measurements in corporate financial statements. Prior to the 1990s, the fair value standard for financial reporting was used less frequently, and guidance regarding its definition and measurement was vague and/or inconsistent. From the

56. Letter, dated September 16, 2004, from the Accounting Standards Executive Committee of the AICPA to the FASB, quoting an April 29, 2004 speech at the Baruch College Third Annual Financial Reporting Conference, letter page 2.

work done by FASB on financial instruments in the 1990s, to the issuance of Statement of Concepts 7 in 2000, which contains the fair value definition in use today, to the Exposure Draft on fair value measurement issued in 2004, the use of fair value measurement in financial reporting continues to grow. The FASB has indicated that clearer guidance on fair value in the accounting literature will improve the consistency of its application, thereby improving financial reporting, and the SEC has called for this effort to continue.

However, questions remain. As SAS 101 describes it, fair value measurement, especially when observable market prices are not available, is inherently imprecise.[57] Practical application of the fair value standard will still require the valuator, in some instances, to interpret the accounting literature's intent, and diversity of practice among valuation practitioners may still exist.

Valuation specialists have an opportunity to participate in the growing emphasis on fair value measurement in financial reporting, and the need for valuation specialists in financial reporting will likely increase. However, it is incumbent upon valuation specialists to help the accounting profession determine consistent and appropriate valuation methodologies for financial reporting valuations, which will help the accounting profession achieve its stated goal of improving the reliability and consistency of fair value determinations in accounting statements.

Trends to watch in the continual evolution of fair value measurement in financial reporting include:

- Expansion of fair value measurement guidance, both in the United States and internationally:
  - An ED on SFAS 141R was issued in 2005 that revises some of the accounting guidance in SFAS 141. Implications for valuation practitioners will likely include a increased emphasis on the valuation of contingent assets and liabilities.
  - SFAS 123R was issued in December 2004 and has created renewed interested in the use of binomial or lattice models in the application of fair value measurements for share-based compensation.
  - The FASB continues to work with accounting rulemaking bodies around the world to pursue convergence of U.S. GAAP with international accounting standards. This will increase consistency of U.S. valuation practices with those of other developed nations.

57. SAS No. 101, *Auditing Fair Value Measurements and Disclosures*, paragraph 5.

- □ There have been serious attempts by valuation practitioners to develop consistency in the application of valuation techniques to fair value measurements.
- □ The Appraisal Issues Task Force has been established as an ad hoc committee of valuation practitioners to discuss the expanding issues related to fair value and to build consensus for the development of consistent practices in the performance of valuations for financial reporting purposes.
- □ Development of new practices in the auditing of fair value measurements
- □ Increasing role of valuation specialists in auditing firms, to assist with the auditing of fair value measurements.

APPENDIX: SOURCES OF INFORMATION

Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*

Accounting Principles Board Opinions (APB) No. 16, *Business Combinations*

APB No. 17, *Intangible Assets*

Statement of Financial Accounting Standards (SFAS) No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*

Financial Accounting Standards Board (FASB) Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurement*

SFAS No. 141, *Business Combinations*

SFAS No. 142, *Goodwill and Other Intangible Assets*

SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

FASB Exposure Draft, *Proposed Statement of Accounting Standards—Fair Value Measurements*

FASB Working Draft, *Proposed Statement of Accounting Standards—Fair Value Measurements*

American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*

Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist*

SAS No. 101, *Auditing Fair Value Measurements and Disclosures*

AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*

AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*

AICPA Exposure Draft, *Proposed Statement on Standards for Valuation Services (SSVS)—Valuation of a Business, Business Ownership Interest, Security or Intangible Asset*

Turner, Lynn E., Chief Accountant, U.S. Securities and Exchange Commission, Letter dated September 9, 1998 to Robert Herz, Chair AICPA SEC Regulations Committee.

Day, Jackson M., Deputy Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, "Fair Value Accounting—Let's Work Together and Get It Done!" remarks to the 28th Annual National Conference on Current SEC Developments, December 5, 2000

Turner, Lynn E., Chief Accountant, U.S. Securities and Exchange Commission, "The Times, They Are-a-Changing" remarks to 33rd Rocky Mountain Securities Conference, sponsored by Continuing Legal Education in Colorado, Inc. and the Central Regional Office of the U.S. Securities and Exchange Commission Denver, Colorado, May 18, 2001

Kokenge, Chad A., Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, "Speech by SEC Staff: 2003 Thirty First AICPA National Conference on Current SEC Developments," December 11, 2003

Letter, dated September 16, 2004, from the Accounting Standards Executive Committee to the FASB, commenting on the FASB Exposure Draft on fair value measurement

Appendix A

International Business Valuation Standards

INTRODUCTION

International business valuation standards are in a stage of evolution. Most efforts to develop international business valuation standards beyond North America are within the context of broader valuation standards, that is, standards that include not only business valuation but also valuation of other types of property, such as real estate and personal property.

INTERNATIONAL VALUATION STANDARDS COMMITTEE

By far the oldest and most developed of the international valuation standards movements is the International Valuation Standards Committee (IVSC), a nongovernmental organization (NGO) of the United Nations.

The IVSC has been in existence since 1982. In 2005 it issued the seventh edition of *International Valuation Standards*, a text of 459 pages.

Membership traditionally has been available to one national association per country. However, both the Appraisal Institute of the United States and the Appraisal Institute of Canada, as well as the American Society of Appraisers are full members. At this writing, there are about 46 full members and another 9 observers or correspondents. For about 10 years, the American Society of Appraiser's (ASA's) representative to the IVSC was Greg Gilbert of the United States. As we go to press, the ASA representative is Vern Blair of Canada.

According to Blair, "IVSC has stronger recognition in Europe than in North America."

The IVSC business valuation standards are closely aligned with the Uniform Standards of Professional Appraisal Practice (USPAP), which are promulgated by the Appraisal Foundation of the United States.

Broad Definitions

The IVSC standards define *value* broadly in this way:

> Value is an economic concept referring to the price most likely to be concluded by the buyers and sellers of a good or service that is available for purchase. Value is not a fact, but an estimate of the likely price to be paid for goods and services at a given time in accordance with a particular definition of value. The economic concept of value reflects a market's view of the benefits that accrue to one who owns the goods or receives the services as of the effective date of valuation.
>
> There are many types and associated definitions of value. . . . Some defined values are commonly used in valuations. Others are used in special situations under carefully identified and disclosed circumstances. It is of paramount importance to the use and understanding of valuations that the type and definition of value be clearly disclosed, and that they be appropriate to the particular valuation assignment. A change in the definition of value can have material effect on the values that would be assigned to properties.[1]

The IVSC standards define *market value* as:

> The estimated amount for which property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.[2]

The standards define *investment value*, or *worth*, as:

> The value of property to a particular investor, or a class of investors, for identified investment objectives. This subjective concept relates specific property

1. International Standards Valuation Committee. *International Valuation Standards*, 7th ed. London, United Kingdom. SW1P3AD 2005, at 36–37.

2. Id. at 26.

to a specific investor, group of investors, or entity with identifiable investment objectives and/or criteria. The *investment value*, or *worth*, of a property asset may be higher or lower than the *Market Value* of the property asset. The term *investment value*, or *worth*, should not be confused with the *Market Value* of an investment property.[3]

Approaches to Valuation

According to the IVSC standards, market-based valuation approaches include:

Sales Comparison Approach. This comparative approach considers the sales of similar or substitute properties and related market data, and establishes a value estimate by processes involving comparison. In general, a property being valued (a subject property) is compared with sales of similar properties that have been transacted in the open market. Listings and offerings may also be considered.

Income Capitalization Approach. This comparative approach considers income and expense data relating to the property being valued and estimates value through a capitalization process. Capitalization relates income (usually a net income figure) and a defined value type by converting an income amount into a value estimate. This process may consider direct relationships (known as *capitalization rates*), yield or *discount rates* (reflecting measures of return on investment), or both. In general, the principle of substitution holds that the income stream which produces the highest return commensurate with a given level of risk leads to the most probable value figure.

Cost Approach. This comparative approach considers the possibility that, as a substitute for the purchase of a given property, one could construct another property that is either a replica of the original or one that could furnish equal utility. In a real estate context, one would normally not be justified in paying more for a given property than the cost of acquiring equivalent land and constructing an alternative structure, unless undue time, inconvenience, and risk are involved. In practice, the approach also involves an estimate of *depreciation* for older and/or less functional properties where an estimate of cost new unreasonably exceeds the likely price that would be paid for the appraised property.[4]

3. Id. at 27.
4. Id. at 33–34.

The standards go on to discuss non–market-based valuations in this way:

> Non-market based valuations may apply similar approaches, but typically involve purposes other than establishing Market Value. For example:
>
> An entity may apply a cost approach to compare the cost of other buildings with the cost of a proposed building to the entity, thereby ascertaining the bargain or premium accruing to a particular property at variance with the market at large. This application focuses on a particular property and what may be a non-market cost.
>
> An owner of land may pay a premium price for adjacent property. In applying a sales comparison approach to determine a maximum price that owner is willing to pay for adjacent land, a Valuer arrives at a figure that may well exceed its *Market Value*. In some States, such an estimate is called *Special Purchaser Value*.
>
> An investor may apply a rate of return that is non-market and particular only to that investor. In applying an income capitalization approach to determine the price that investor is willing to pay for a particular investment based on the investor's anticipated rate of return, a Valuer arrives at an estimate of Investment Value or Worth rather than *Market Value*.[5]

Types of Property

The IVSC recognizes "the customary division of property into four discrete categories":

1. Real property
2. Personal property
3. Businesses
4. Financial interests

The distinction between "businesses" and "financial interests" is:

> A *business* is any commercial, industrial, service, or investment entity pursuing an economic activity.[6]
>
> Financial interests in property result from the legal division of ownership interests in businesses and real property (e.g., partnerships, syndica-

5. Id. at 34–35.
6. Id. at 60.

tions, corporations, cotenancies, joint ventures), from the contractual grant of an optional right to buy or sell property (e.g., realty, stocks, or other financial instruments) at a stated price within a specified period, or from the creation of investment instruments secured by pooled real estate assets.[7]

The IVSC standards list three approaches to business valuations:

Valuers commonly reconcile the indications derived from two or more of these approaches and associated methods. (See the Guidance Note on Business Valuation, GN 6, para. 5.14)

A *sales comparison approach* to value compares the subject business to similar businesses, business ownership interests, or securities that have been sold in the open market. The comparable businesses should be in the same industry as the subject and responsive to the same economic variables. Typical sources of data include the acquisition market in which entire businesses are bought and sold, prior transactions in the ownership of the subject business, and public stock markets in which ownership interests of similar businesses are traded.

An *asset-based approach* to value examines a balance sheet for the business that reports all assets, tangible and intangible, and all liabilities at *Market Value*, or an appropriate carrying amount. When an asset-based approach is used in assignments involving operating businesses valued as going concerns, the value estimate obtained should be considered together with the value estimate(s) from (an)other approach(es).

An *income capitalization approach* to value calculates the present value of anticipated income or benefits in view of their expected growth and timing, the associated risk, and the time value of money. Income is converted into an indication of value either by means of direct capitalization of a representative income level, or a discounted cash flow analysis, or dividend method, in which cash receipts estimated for a sequence of future periods are converted to present value by application of a discount rate.[8]

There is discussion but no such listing of approaches to valuing financial interests.

7. Id. at 63.

8. Id. at 62–63.

TORONTO VALUATION ACCORD

The Toronto Valuation Accord (TVA) was born in late 2003 to attempt to bring convergence between the superpowers of accounting policy—the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB)—with respect to valuation for financial reporting.[9]

Signers of the TVA were:

American Society of Farm Managers and Rural Appraisers

The Appraisal Foundation

Appraisal Institute

Appraisal Institute of Canada

Centre for Advanced Property Economics

Royal Institution of Chartered Surveyors—United States

Royal Institution of Chartered Surveyors—Canada

The activities and concerns of the TVA should be of interest, particularly to those involved in providing services which assist financial reporting requirements.

Mission and Objectives

The TVA states its mission and objectives in this way:

> "The issue of valuation for financial reporting (VFR) poses a key emerging topic for the valuation profession. Recent events in the accounting profession and in the business world have brought issues of professional independence, measurement of asset value and transparency of reporting to the forefront. Accounting standards in the United States and Canada are expected to converge to a common global standard with the international accounting community, of which a component will be methodology for the reporting of assets. Under the Basel capital accords, the banking industry must account for assets and liabilities on a market basis, which has implications for the valuation profession.
>
> Accordingly, it is important that each organization representing the valuation profession in the United States and Canada, including real property,

9. The authors are grateful to Lee Hackett, FASA, Executive vice president of American Appraisal Associates, Inc. and one of the The Appraisal Foundations representatives to the Toronto Valuation Accord, for his input to this section.

personal property and business appraisal, participate in a coordinated fashion to ensure a unified response on behalf of valuers and valuation standards. Participation in the Toronto Valuation Accord of October 2003 was a first step in this endeavor. The following is proposed as a plan for continued progress by the organizations and the profession:

1. We recognize that the recent movement of international standards toward convergence and harmonization, and the related emphasis on market (fair) value, increases the responsibilities of valuers in Canada, the United States, and worldwide to participate in the establishment of reporting standards for the benefit of the users of financial reports and the public at large;
2. We agree to work together to develop policies and establish a plan to position the valuation profession as represented by their members, as the professionals of choice in the provision of valuation for financial reporting purposes and related services;
3. We encourage each organization to establish a plan for how that organization will inform and educate its members on valuation for financial reporting issues and will identify a principal contact in each organization who will coordinate with the other organizations to exchange information regarding those issues and the organization's plan.[10]

Definitions

The IASB states current value as being fair value, which the IASB defines as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." The IASB sets forth these criteria for fair value measurement:

1. Quoted market prices in an active market
2. Recent transactions for similar assets
3. Other valuation techniques

FASB defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." That is, other than in a forced, or liquidation, sale. It further states that valuation techniques used to estimate fair value shall emphasize market inputs, including those derived from active markets, regardless of what approach (market, income, cost) is used.

10. Toronto Valuation Accord Mission Statement 2003.

While there is unanimous concurrence on the use of current value financial reporting, within the TVA there is discussion ongoing as to the premise underlying fair value. Some members think that fair value should be abolished and current value should be defined as market value; further, they believe that market value should be premised on in-exchange, reflecting highest and best use. Other members think that fair value as set forth by the accounting superpowers is an acceptable basis (as it has been for years under Accounting Procedures Board 16/17 and currently under FASB 141) and should be based on market value concepts. Market value concepts, as defined and used within TVA, mean that the premise for market value could be expressed as in-exchange, in-use, or liquidation, depending on the facts and circumstances and the owner's or market participants intent.

Fair Value Measurement

Regardless of whether current value accounting is adopted, measurement of fair value of acquired assets is under scrutiny by the IASB and FASB. IASB criteria were listed in the last section.

FASB issued an exposure draft on fair value measurements on June 23, 2004. Subsequently, there have been comment period reports and two public hearings to discuss the proposals which has led to a June 2006 post ballot daft on fair value measurements. FASB favors a hierarchal approach to estimating fair value, which it refers to as "levels":

Level 1. Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2. Quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3. Unobservable inputs for an asset or liability, that is, inputs that reflect the reporting entitys' own assumptions about assumptions market participants would use in pricing the asset or liability.

Obviously, there is a priority for market inputs if available and reliable and comparable; but there is nothing to preclude valuers from their prior practice of using valuation techniques appropriate to the economic availability of data.

FASB identifies two premises of value that could be utilized in estimating fair value: in-use and in-exchange. Value-in-use is based on an installed machine that will be used in income-producing activities of an entity. Value-in-exchange is contrasted as an installed machine that will be sold to another entity. There is an implication that the intent of the buyer will drive the premise of value. However, to do so, it would be necessary to show that any likely buyer would be expected to behave in a similar manner.

FASB goes further and identifies other premises that might be employed. Orderly liquidation could prevail if there was a requirement to dispose of any assets because of regulatory decrees for example. Abandonment basis could also be appropriate if products are to be rebranded or trademarks discontinued.

FASB presented two alternative approaches regarding using present value of future cash flows in accounting measurements. Called the traditional approach, it is acceptable to utilize a single, best estimate of future cash flows and discount same to present value at a discount rate that reflects the risk involved. Another approach, called the expected cash flow approach, utilizes multiple projections of possible outcomes that can be assigned probabilities and then discounted to present value.

Discount rate treatment utilizing an expected cash flow approach may require reflection of market-based risk premiums in one of two ways. The expected cash flow can be reduced for risk and then discounted at a risk-free rate. Alternatively, the expected cash flows are discounted at a risk-adjusted discount rate.

The recent decisions of FASB and the direction FASB is promoting on the enumerated emerging issues provides us a clear signal: FASB has recognized that worldwide financial markets are demanding a unified set of financial reporting standards. No longer will a company have to follow U.S. generally accepting accounting principles (GAAP) to list shares in New York and list the same shares in London based on UK GAAP or international GAAP.

Another signal of convergence is the change in treatment of in-process research and development; it is no longer allowed to be written off, but must be amortized as required under International Accounting Standards (IAS) 36 and 38. Business combination rules under IAS and FASB are likely to become identical with regard to identification of intangibles separable from goodwill.

More signs of convergence abound as IASB has adopted FASB's definition of a business combination: "a transaction or other event in which an acquirer obtains control of one or more businesses." Both groups also have converged on the definition of goodwill: "Goodwill is future economic benefits arising from assets that are not individually identified and separately recognized."[11]

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11. Lee P. Hackett, Executive Vice President of American Appraisal Associates, Inc. "Valuation for financial Reporting" Unpublished Paper. Milwaukee, WI (2005).

Conclusion

The North American professional valuation groups are coming together to promote the ability of professional valuers to meet the valuation needs of the new global financial reporting standards. The accounting and regulatory community and valuers themselves must become aware of the changes to come and must study these changes in order to continue and grow in a professional valuation career.

ROYAL INSTITUTE OF CHARTERED SURVEYORS

The Royal Institute of Chartered Surveyors (RICS), based in the United Kingdom, is comprised primarily of real estate appraisers. RICS published its first set of valuation standards in 1974; the standards have evolved to the RICS *Appraisal and Valuation Standards*, last revised in January 2005.[12]

RICS defines market value as:

> The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.[13]

It is the stated goal of RICS to narrow as much as possible the differences between the RICS standard and the *International Valuation Standards*.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

The International Financial Reporting Standards were previously known as International Accounting Standards (IAS) and are set by the International Accounting Standards Board (IASB). This board works closely with the Financial Accounting Standards Board in the United States. To draw a parallel, the IASB is to the FASB as the International Valuation Standards Committee is to USPAP.

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12. *RICS Appraisal and Valuation Standards*, revised RICS Business Services Limited, a wholly owned subsidiary of the Royal Institute of Chartered Surveyors. Coventry, United Kingdom January 2005.

13. Id. at glossary at 2.

Appendix B

Fair Value in Dissent and Oppression Chart

STATE	ALABAMA	ALASKA	ARIZONA
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Court's discretion		Court's discretion
Most Recent Case	*Offenbecher v. Baron Services*—2003: No discounts applied		*Pro Finish USA v. Johnson*—2003: No discounts applied
Definition of Valuation Term	§ 10-2B-13.01: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 10.06.580: In fixing the fair value of the shares, the court shall consider the nature of the transaction giving rise to the right to dissent under AS 10.06.576, its effects on the corporation and its shareholders, the concepts and methods customary in the relevant securities and financial markets for determining the fair value of shares of a corporation engaging in a similar transaction under comparable circumstances, and other relevant factors.	§ 10-1301: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable
Dissent/Appraisal Valuation Date	§ 10-2B-13.01: Immediately before the effectuation of the corporate action to which the dissenter objects	§ 10.06.580: The close of business on the day before the date on which the vote was taken approving the proposed corporate action	§ 10-1301: Immediately before the effectuation of the corporate action to which the dissenter objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 10-2B-14.30(2)(ii)	Yes*—§ 10.06.628 (4)	Yes—§ 10-1430 (B)(2)
Buy-out election in lieu of dissolution?	Yes—§ 10-2B-14.34	Yes—§ 10.06.630	Yes—§ 10-1434
Dissolution Valuation Date	§ 10-2B-14.34: The day before the date the petition was filed		§ 10-1434: The day before the date the petition was filed
Definition Following RMBCA	Yes—1984		Yes—1984

*"Oppression" not used as term in statute.

STATE	ARKANSAS	CALIFORNIA	COLORADO
Valuation Term	Fair Value	Dissent: Fair Market Value Dissolution: Fair Value	Fair Value
Case Precedent in Allowing Discounts		Court's discretion	Rejects discounts
Most Recent Case		*Mart v. Severson—2002: No discounts applied.* Thompson v. Miller—2003: Discounts applied.	*Pueblo Bancorporation v. Lindoe*—2003: No discounts
Definition of Valuation Term	§ 4-27-1301: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 1300: The fair market value shall be determined excluding any appreciation or depreciation in consequence of the proposed action, but adjusted for any stock split, reverse stock split, or share dividend which becomes effective thereafter.	§ 7-113-101: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable
Dissent/Appraisal Valuation Date	§ 4-27-1301: Immediately before the effectuation of the corporate action to which the dissenter objects	§ 1300: The day before the first announcement of the terms of the proposed reorganization	§ 7-113-101: Iimmediately before the effective date of corporate action
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 4-27-1430(2)(ii)	Yes*—§ 1800(b)(4)	Yes—§ 7-113-301-304
Buy-out election in lieu of dissolution?	No	Yes—§ 2000	No
Dissolution Valuation Date		*Trahan v. Trahan*—2002: Valuation date is the date the dissolution proceeding was initiated.	
Definition Following RMBCA	Yes—1984		Yes—1984

*"Oppression" not used as term in statute.

(*continues*)

STATE	CONNECTICUT	DELAWARE	FLORIDA
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Rejects discounts by statute	Rejects discounts by law, applies control premium	Rejects discounts by statute
Most Recent Case	*Devivo v. Devivo*—2001: Ext. Circ.: Discounts applied	*Robert Michael Lane v. Cancer Treatment Centers of America, Inc.*—2004: Control premium applied	*Munshower v. Kolbenheyer*—1999: Marketability discount allowed
Definition of Valuation Term	§ 33-855: Value of the shares immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation	§ 262: Value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest including all other relevant factors	§ 607.1301: Using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable to the corporation and its remaining shareholders.For a corporation with 10 or fewer shareholders, without discounting for lack of marketability or minority status.
Dissent/Appraisal Valuation Date	§ 33-855: Immediately before the effectuation of corporate action	§ 262: Date at the point before the effective date of the corporate action	§ 607.1301: Immediately before the effectuation of the corporate action to which the shareholder objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 33-896 (1)	No—§ 275: Majority of shareholders only	Yes*—§ 607.1430(3)(b)
Buy-out election in lieu of dissolution?	Yes—§ 33-900	No	Yes—§ 607.1436
Dissolution Valuation Date	§ 33-900: The day before the date on which the petition was filed or as of such other date as the court deems appropriate under the circumstances		§ 607.1436: The day before the date the petition was filed
Definition Following RMBCA	Yes—1999		Yes—1999

*"Oppression" not used as term in statute.

STATE	GEORGIA	HAWAII	IDAHO
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Rejects discounts		Rejects discounts by statute
Most Recent Case	*Blitch v. People's Bank*—2000: No discounts applied		
Definition of Valuation Term	§ 14-2-1301: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action	§ 414-341: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 30-1-1301: Immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal and without discounting for lack of marketability or minority status except for amendments to 30-1-1302(1)(e)
Dissent/Appraisal Valuation Date	§ 14-2-1301: Immediately before the effectuation of corporate action	§ 414-341: Immediately before the effectuation of corporate action	§ 30-1-1301: Immediately before the effectuation of the corporate action
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes*—§ 14-2-1430 (2)(B)	Yes—§ 414-411(2)(B)	Yes—§ 30-1-1430(2)(b)
Buy-out election in lieu of dissolution?	Yes—under articles of a close corporation—§ 14-2-942	Yes—§ 414-415	Yes—§ 30-1-1434
Dissolution Valuation Date		§ 414-415: The day before the date the petition was filed	§ 30-1-1434: The day before the date the petition was filed
Definition Following RMBCA		Yes—1984	Yes—1999

*"Oppression" not used as term in statute.

(*continues*)

STATE	ILLINOIS	INDIANA	IOWA
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Court's Discretion	Rejects discounts	Rejects discounts by statute
Most Recent Case	*Jahn v. Kinderman*—2004: Discounts Not Applied	*Wenzel v. Hopper Galliher*—2002: No discounts applied	*Seig v. Kelly*—1997: Discounts not applied
Definition of Valuation Term	§ 805 ILCS 5/11.70: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 23-1-44-3: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 490.1301: Immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal and without discounting for lack of marketability or minority status except for amendments to 490.1302(1)(e)
Dissent/Appraisal Valuation Date	§ 805 ILCS 5/11.70: Immediately before the consumation of the corporate action	§ 23-1-44-3: Immediately before the effectuation of the corporate action	§ 490.1301: Immediately before the effectuation of the corporate action to which the shareholder objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—805 ILCS 5/12.55 : (2)	No—§ 23-1-47-1-4: Only in deadlock	Yes—§ 490.1430 (2)b
Buy-out election in lieu of dissolution?	Yes § 805 ILCS 5/12.55	No	Yes—§ 490.1434
Dissolution Valuation Date	§ 805 ILCS 5/12.55: Such date as the court finds equitable		§ 490.1434: The day before the date the petition was filed
Definition Following RMBCA	Yes—1984	Yes—1984	Yes—1999

*"Oppression" not used as term in statute.

STATE	KANSAS	KENTUCKY	LOUISIANA
Valuation Term	Value	Fair Value	Fair Cash Value
Case Precedent in Allowing Discounts	Court's discretion	Generally allows discounts	Generally allows discounts
Most Recent Case	*Arnaud v. Stock Grower's Bank*—1999: No discounts applied	*Ford v. Courier-Journal Job Printing*—1982: Marketability discount allowed	*Shopf v. Marina Del Ray*—1989: Minority discount allowed
Definition of Valuation Term	§ 17-6712: The value of the stockholder's stock on the effective date of the merger or consolidation, exclusive of any element of value arising from the expectation or accomplishment of the merger or consolidation	§ 271B.13-010: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 140.2: A value not less than the highest price paid per share by the acquiring person in the control share acquisition
Dissent/Appraisal Valuation Date	§ 17-6712: The effective date of the merger or consolidation	§ 271B.13-010: Immediately before the effectuation of corporate action	§ 134: If voted upon, the latter of the date prior to the date of the shareholders vote or the day 20 days prior to the consummation of the business combination, otherwise the date of the action
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	No—§ 17-6804: Voluntary only; § 17-6812: Abuse, misuse, or non-use of corporate powers	Yes*—§ 271B.14-300 (2)(b)	No—§ 12:141-146: Voluntary, or deadlock, deadlock only if shareholders or corporation are suffering irreparable damage, or if the corporation has been guity of ultra vires acts
Buy-out election in lieu of dissolution?	No	No	No
Dissolution Valuation Date			
Definition Following RMBCA		Yes—1984	

*"Oppression" not used as term in statute.

(*continues*)

STATE	MAINE	MARYLAND	MASSACHUSETTS
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Rejects discounts by statute		Rejects discounts
Most Recent Case	*In re the Valuation of Mcloon Oil Co.*—1989: No discounts applied		*BNE Massachusetts Corp. v. Sims*—1992: No discounts applied
Definition of Valuation Term	§ 1301: Immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal and without discounting for lack of marketability or minority status	§ 3-202(b): On the date of stockholder vote, free of any appreciation or depreciation which directly or indirectly results from the transaction objected to or from its proposal	§ 13.01: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable
Dissent/Appraisal Valuation Date	§ 1301: Immediately before the effectuation of the corporate action	§ 3-202(b)(1): On the day notice of a merger is given or the date of a stockholder vote for other transactions	§ 13.01: Day immediately before the effective date of the corporate action to which the shareholder demanding appraisal objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 1430 (2)B	Yes—§ 3-413(b)(2)	No—§ 14.30-.34: Deadlock
Buy-out election in lieu of dissolution?	Yes—§ 1434	Yes—under articles of a close corporation—§ 4-603	No
Dissolution Valuation Date		§ 4-603: As of the close of business on the day on which the petition for dissolution was filed	
Definition Following RMBCA	Yes—1999		

*"Oppression" not used as term in statute.

STATE	MICHIGAN	MINNESOTA	MISSISSIPPI
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts		Court's discretion	Rejects discounts by statute
Most Recent Case		*ACD v. Follet*—2000: Ext. Circ.: Marketability discount applied	*Missala Marine Services v. Jenny Kay Odom*—2003: Discounts allowed—dissolution/damage claim
Definition of Valuation Term	§ 450.1761: "Fair value," with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.	302A.473: Value of the shares of a corporation immediately before the effective date of the corporate action	§ 79-4-13.01: Immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal and without discounting for lack of marketability or minority status
Dissent/Appraisal Valuation Date	§ 450.1779: The latter of the day prior to the date of the vote and 20 days before the business combination, or the date of the business combination if there is no vote	§ 302A.473 (c): Value of the shares of a corporation immediately before the effective date of the corporate action	§ 79-4-13.01: Immediately before the effectuation of the corporate action to which the shareholder objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 450.1489	Yes*—§ 302A.751(b)(3)	Yes—§ 79-4-14.30(2)(ii)
Buy-out election in lieu of dissolution?	Yes—§ 450.1489(e)	Yes—§ 302A.751	Yes—§ 79-4-14.34
Dissolution Valuation Date		§ 302A.751: The date of the commencement of the action or as of another date found equitable by the court	§ 79-4-14.34: The day before the date the petition was filed
Definition Following RMBCA	Yes—1984	Yes—1984	Yes—1999

*"Oppression" not used as term in statute.

(*continues*)

STATE	MISSOURI	MONTANA	NEBRASKA
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Court's discretion	Rejects discounts	Rejects discounts
Most Recent Case	*King v. FTJ*—1988: Discounts applied	*Hansen v. 75 Ranch Co.*—1998: Discounts not applied	*Rigel v. Cutchall*—1998: No discounts applied
Definition of Valuation Term	§ 351.870: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 35-1-826: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 21-20,137: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable
Dissent/Appraisal Valuation Date	§ 351.455(1): As of the day prior to the date on which the vote was taken	§ 35-1-826: Immediately before the effectuation of the corporate action to which the shareholder objects	§ 21-20,137: Immediately before the effectuation of the corporate action to which the shareholder objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 351.494(2)(b)	Yes—§ 35-1-938(2)(b)	Yes—§ 21-20,162(2)(a)(ii)
Buy-out election in lieu of dissolution?	Yes—under articles of a close corporation—§ 351.790	Yes—§ 35-1-939	Yes—§ 21-20,166
Dissolution Valuation Date			§ 21-20,166: The day before the date on which the petition was filed or as of such other date as the court deems appropriate under the circumstances
Definition Following RMBCA	Yes—1984	Yes—1984	Yes—1984

*"Oppression" not used as term in statute.

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STATE	NEVADA	NEW HAMPSHIRE	NEW JERSEY
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Court's discretion		Court's discretion
Most Recent Case	*Steiner v. Benninghoff*—1998: Discount applied, but only 25% weight given to that factor		*Wheaton*—1999: No discounts; Balsamides—1999: Marketability discount applied; Casey v. Brennan—2001: No discounts, control premium applied
Definition of Valuation Term	§ 92A.320: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 293-A:13.01: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 14A:11-3: As of the day prior to the day of the meeting of the shareholders at which the action was approved…excluding any appreciation or depreciation resulting from the proposed action
Dissent/Appraisal Valuation Date	§ 92A.320: Immediately before the effectuation of the corporate action	§ 293-A:13.01: Immediately before the effectuation of the corporate action to which the shareholder objects	§ 14A:11-3: The day of the meeting of shareholders when the action was approved or the day prior to which the board of directors authorized an action if no vote was needed
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	No—In a Close Corporaiton, only if by provision of the articles of incorporation § 78-A160	Yes*—§ 293-A:14.30(b)(iii)	Yes—§ 14A:12-7(1)(c)
Buy-out election in lieu of dissolution?	No	Yes—§ 293-A:14.34	Yes -§ 14A:12-7
Dissolution Valuation Date		§ 293-A:14.34: The day before the date on which the petition was filed or as of such other date as the court deems appropriate under the circumstances	§ 14A:12-7: The date of the commencement of the action or such earlier or later date deemed equitable by the court, plus or minus any adjustments deemed equitable by the court if the action was brought in whole or in part under paragraph 14A: 12-7(i)(c)
Definition Following RMBCA	Yes—1984	Yes—1984	

*"Oppression" not used as term in statute.

(*continues*)

STATE	NEW MEXICO	NEW YORK	NORTH CAROLINA
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Court's discretion	Generally allows discounts (marketability only)	Court's discretion
Most Recent Case	*McCauley v. Tom McCauley & Sons*—1986: Discounts applied	*In re Brooklyn Home Dialysis Training*—2002: Marketability discount applied	*Tammy Garlock v. South Eastern Gas & Power*—2001: No Minority, Marketability, key man discount applied.
Definition of Valuation Term	§ 53-15-4: Value as of the day prior to the date on which the vote was taken approving the proposed corporate action, excluding any appreciation or depreciation in anticipation of the corporate action	§ 623(h)(4): Nature of the transaction giving rise to the shareholder's right to receive payment for shares and its effects on the corporation and its shareholders, the concepts and methods then customary in the relevant securities and financial markets for determining fair value of shares of a corporation engaging in a similar transaction under comparable circumstances and all over relevant factors	§ 55-13-01: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable
Dissent/Appraisal Valuation Date	§ 53-15-4: The date prior to the day on which the vote was taken for the corporate action	§ 623: The close of business on the day prior to the shareholders' authorization date	§ 55-13-01: Immediately before the effectuation of the corporate action to which the shareholder objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 53-16-16(A)(1)(b)	Yes—§§ 1104-1118	Yes*—§ 55-14-30(2)(ii)
Buy-out election in lieu of dissolution?	No	Yes—§ 1118	Yes § 55-14-31: After dissolution has been okayed by court
Dissolution Valuation Date		*Re Dissolution of Public Relations Aids, Inc.*—1985: The day before the date the petition was filed	
Definition Following RMBCA			Yes—1984

*"Oppression" not used as term in statute.

STATE	NORTH DAKOTA	OHIO	OKLAHOMA
Valuation Term	Fair Value	Fair Cash Value	Fair Value
Case Precedent in Allowing Discounts		Generally allows discounts	Rejects discounts
Most Recent Case		*English v. Atromik Int.*—2000: Discounts applied	*Woolf v. Universal Fidelity Life*—1992: No discounts applied
Definition of Valuation Term	§ 10-19.1-88: Fair value of the shares means the value of the shares the day immediately before the effective date of a corporate action.	§ 1701.85: The amount that a willing seller who is under no compulsion to sell would be willing to accept and that a willing buyer who is under no compulsion to purchase would be willing to pay, but in no event shall the fair cash value of a share exceed the amount specified in the demand of the particular shareholder.	§ 1091: Exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation…the court should take into account all relavent factors.
Dissent/Appraisal Valuation Date	§ 10-19.1-88: Day immediately before the effective date of a corporate action referred.	§ 1701.85: The day prior to that on which the shareholders' vote on the corporate transaction was taken	§ 1091: Effective date of the merger or consolidation
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes*—§ 10-19.1-115(b)(3)	No—§ 1701.91: Attorney general if corporation has acted unlawfully, voluntary dissolution; when it is established that it is beneficial to the shareholders that the corporation be judicially dissolved	No—§ 1906: Majority of shareholders
Buy-out election in lieu of dissolution?	No—§ 10-19.1-115: Only under court compulsion	No	No
Dissolution Valuation Date			
Definition Following RMBCA			

*"Oppression" not used as term in statute.

(*continues*)

STATE	OREGON	PENNSYLVANIA	RHODE ISLAND
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Rejects discounts		Rejects discounts
Most Recent Case	*Hayes v. Olmsted*—2001: No discounts applied		*Dilugio v. PAB*—2000: No discounts applied
Definition of Valuation Term	§ 60.551: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	§ 1572: The fair value of shares immediately before the effectuation of the corporate action to which the dissenter objects, taking into account all relevant factors, but excluding any appreciation or depreciation in anticipation of the corporate action	§ 7-1.2-1202: Value of the shares as of the day prior to the date on which the vote was taken approving the proposed corporate action, excluding any appreciation or depreciation in anticipation of the corporate action
Dissent/Appraisal Valuation Date	§ 60.551: Immediately before the effectuation of the corporate action to which the shareholder objects	§ 1572: Immediately before the effectuation of the corporate action to which the shareholder objects	§ 7-1.2-1202: As of the day prior to the date on which the vote was taken approving the proposed corporate action
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 60.952	Yes—§ 1981	Yes—§ 7-1.2-1314
Buy-out election in lieu of dissolution?	Yes—Close Corporation Provision Only—§ 60.952	No	Yes—§ 7-1.2-1315
Dissolution Valuation Date			§ 7-1.2-1315: The day on which the petition for dissolution was filed
Definition Following RMBCA	Yes—1984		

*"Oppression" not used as term in statute.

STATE	SOUTH CAROLINA	SOUTH DAKOTA	TENNESSEE
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Rejects discounts	Rejects discounts by statute	
Most Recent Case	*Morrow v. Martschink*—1995: Discounts not applied	First Western Bank of Wall v. Olsen—2001: No discounts applied	
Definition of Valuation Term	§ 33-13-101: The value of shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action to which the dissenter objects. To be determined by generally accepted techniques in the financial community.	§ 47-1A-1301: Immediately before the effectuation of the corporate action to which the shareholder objects; using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to subdivision (5) of § 47-1A-1302	§ 48-23-101: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action
Dissent/Appraisal Valuation Date	§ 33-13-101: Immediately before the effectuation of the corporate action to which the dissenter objects	§ 47-1A-1301: Immediately before the effectuation of the corporate action to which the dissenter objects	§ 48-23-101: Immediately before the effectuation of the corporate action to which the dissenter objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 33-14-300(2)(ii)	Yes—§ 47-7-25-35	Yes—§ 48-24-301(2)(B)
Buy-out election in lieu of dissolution?	Yes—close corporation provision—§ 33-18-160	Yes—§ 47-1A-1434	No
Dissolution Valuation Date			
Definition Following RMBCA	Yes—1984	Yes—1999	Yes—1984

*"Oppression" not used as term in statute.

(*continues*)

STATE	TEXAS	UTAH	VERMONT
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Rejects minority discounts by statute	Court's discretion	Rejects discounts
Most Recent Case		*Hogle v. Zinetics*—2002: No discounts applied	*Waller v. American International Distribution*—1997: No discounts applied; *Trapp Family Lodge*—1999: Control Premium applied
Definition of Valuation Term	§ 10.362: The value of the ownership interest on the date preceding the date of the action excluding appreciation or depreciation in anticipation or as a result of the proposed action. (b) Consideration must be given to the value of the organization as a going concern without including in the computation of value any: (1) payment for a control premium or minority discount other than a discount attributable to the type of ownership interests held by the dissenting owner and, (2) limitation placed on the rights and preferences of those ownership interests.	§ 16-10a-1301: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action	§ 13.01: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable
Dissent/Appraisal Valuation Date		§ 16-10a-1301: Immediately before the effectuation of the corporate action to which the dissenter objects	§ 13.01: Immediately before the effectuation of the corporate action to which the dissenter objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	No—§ 21.756: Shareholder may bring a derivative proceeding.	Yes—§ 16-10a-1430(2)(b)	Yes—§ 14.30(2)(B)
Buy-out election in lieu of dissolution?	No	Yes—§ 16-10a-1434	Yes—Close Corporation Provision—§ 20.15
Dissolution Valuation Date		§ 16-10a-1434: The day before the date the petition was filed	
Definition Following RMBCA	No	Yes—1984	Yes—1984

*"Oppression" not used as term in statute.

STATE	VIRGINIA	WASHINGTON	WASHINGTON D.C.
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Rejects discounts by statute	Rejects discounts	
Most Recent Case	*US Inspect v. McGreevy*—2000: No discounts applied	*Norton Co. v. Smyth*—2002: No discounts applied	
Definition of Valuation Term	§ 13.1-729: Value of the shares immediately before the effectuation of the corporate action to which the shareholder objects; using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to subdivision A 5 of § 13.1-730	§ 23B.13.010: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable	
Dissent/Appraisal Valuation Date	§ 13.1-729: Immediately before the effectuation of the corporate action to which the dissenter objects	§ 23B.13.010: Immediately before the effectuation of the corporate action to which the dissenter objects	§ 29-101.73: As of the day prior to the date on which the vote was taken approving the merger or consolidation
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 13.1-747(A)(1)(b)	Yes—§ 23B.14.300(2)(b)	No—§§ 29-101.88 and 101.90: By the court if directors have abused their authority
Buy-out election in lieu of dissolution?	Yes—§ 13.1-749.1	No	No
Dissolution Valuation Date			
Definition Following RMBCA	Yes—1999	Yes—1984	

*"Oppression" not used as term in statute.

(*continues*)

STATE	WEST VIRGINIA	WISCONSIN	WYOMING
Valuation Term	Fair Value	Fair Value	Fair Value
Case Precedent in Allowing Discounts	Rejects discounts by statute	Rejects discounts	
Most Recent Case		*HMO v. SSM Health*—1999: No discounts applied	
Definition of Valuation Term	§ 31D-13-1301: Immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal and without discounting for lack of marketability or minority status except for amendments to § 31D-13-1302(5)(a)	§ 180.130: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding appreciaiton or depreciation in anticipation of the corporate action unless exclusion would be inequitable. With respect to a dissenter's shares in a business combination, means market value—the fair market value as determined in good faith by the board of directors of the resident domestic corporation	§ 17-16-1301: Value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable
Dissent/Appraisal Valuation Date	§31D-13-1301: Immediately before the effectuation of the corporate action to which the shareholder objects	§ 180.1301: Immediately before the effectuation of the corporate action	§ 17-16-1301: Immediately before the effectuation of the corporate action to which the dissenter objects
Dissolution by shareholder as a remedy for oppression or oppressive behavior?	Yes—§ 31D-13-1301	Yes—§ 180.1430(2)(b)	Yes—§ 17-16-1430 (a)(ii)(B)
Buy-out election in lieu of dissolution?	Yes—§ 31D-14-1434.	Yes—close corporation provision—§180.1833	Yes—§ 17-16-1434
Dissolution Valuation Date	§ 31D-14-1434: The day before the date the petition was filed		§ 17-16-1434: The day before the date the petition was filed
Definition Following RMBCA	Yes—1999		Yes—1984

*"Oppression" not used as term in statute.

Appendix C

Standard of Value Divorce Chart

This chart is intended to be used as guidance on the applicable standard of value in a given state. We do not intend it to be used as a definitive determinant of the standard of value in each state, or how goodwill, discounts, and buy-sell agreements are (or should be) treated. We have listed case examples and the substance of the decisions in those cases that assisted us in developing our suggested classification of the standards of value. Before relying on any case, the full text of the decision should be reviewed to determine whether the fact pattern in the case distinguishes it from the facts and circumstances in the subject valuation. A state with an empty box means that we have been unable to identify cases applicable to our analysis. In each state, where possible, we have gathered a selection of representative cases for the applicable categories. This is not a full list of the cases on each topic in each state.

	VALUE IN EXCHANGE		**VALUE TO THE HOLDER**
	Fair Market Value	Fair Value	Investment Value
		ALABAMA	
Goodwill			
Discounts			
Buy-Sell			
		ALASKA	
Goodwill	Richmond v. Richmond, 779 P.2d 1211 (Alaska 1989): Professional goodwill must be marketable in order for it to be included in a marital estate. *Moffitt v. Moffitt*, 749 P.2d 343 (Alaska 1988): If the trial court determines either that no goodwill exists or that goodwill is unmarketable, then no value for goodwill should be considered in dividing the marital assets.		
Discounts	*Money v. Money*, 852 P.2d 1158 (Alaska 1993): Average minority and marketability discounts were applied.		
Buy-Sell	*Money v. Money*, 852 P.2d 1158 (Alaska 1993): Accepts buy-sell as means of valuing business.		

We characterize Alaska as a predominantly fair market value state. Both *Moffit* and *Richmond* require that goodwill must exist and be marketable in order to be considered as marital property. In addition, minority and marketability discounts have been applied in Alaska cases, notably, the *Money* case.

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
ARIZONA			
Goodwill			*Mitchell v. Mitchell*, 152 Ariz. 317, 732 P.2d 208 (1987): Valuation of intangible component of a professional practice attributable to goodwill was proper . . . despite partnership agreement that specified goodwill had no value. *Wisner v. Wisner*, 631 P.2d 115 (Ariz. App. 1981): A sole proprietor corporation may have a goodwill value.
Discounts			
Buy-Sell			*In re: Marriage of Kells*, 897 P.2d 1366 (Ariz. Ct. App. 1995): A buy-sell agreement or other such agreement should be considered as a factor in valuing a business but it is not determinative of the value of marital property.
Investment value appears to be the predominant standard of value in Arizona. The Arizona decisions generally view that goodwill exists in a sole proprietorship and a professional practice, and considers the practitioner's age, health, past earning power, reputation in the community for judgment, skill and knowledge, and comparative professional success as elements of goodwill. *Wisner* specifically rejects the contention that goodwill must be marketable to have value, and *Mitchell* follows *Wisner* on that principle. *Kells* suggests that a buy-sell agreement should be considered, but not necessarily relied upon in determining value.			
ARKANSAS			
Goodwill	Arkansas Statute § 9-12-315(4); *Tortorich v. Tortorich*, 902 S.W.2d 247 (Ark. App. 1995): Business goodwill must be independent of individual goodwill in a sole proprietorship. *Wilson v. Wilson*, 741 S.W.2d 640 (Ark. 1987): For goodwill to be marital property, it has be a business asset with value independent of the presence or reputation of a particular individual.		

(*continues*)

	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
Discounts	*Crismon v. Crismon*, 72 Ark. App. 116, 34 S.W.3d 763 (2000): Allows marketability discount.		
Buy-Sell	*Cole v. Cole*, 82 Ark. App. 47, 110 S.W.3d 310 (2003): Trial court erred by valuing the former husband's 50% interest in a surgery center based on his buy-sell agreement with another shareholder instead of by determining the fair market value as required by statute.		
We categorize Arkansas as a fair market value state, primarily because of the statutory requirement that securities be valued at their fair market value. Arkansas case law follows this principle. Additionally, these cases require that goodwill be a business asset, independent of the presence or reputation of a particular individual.			
CALIFORNIA			
Goodwill			*In re Marriage of Fenton*, 184 Cal. Rptr. 597 (Cal. Ct. App. 1982): Personal goodwill is included in marital estate; proper valuation of community goodwill (business or personal) is not necessarily its fair market value. *In re Foster*, 117 Cal. Rptr. 49 (1974): The value of community goodwill is not necessarily the specified amount of money that a willing buyer would pay for such goodwill. In view of exigencies that are ordinarily attendant to a marriage dissolution, the amount obtainable in the marketplace might well be less than the true value of the goodwill. *Golden v. Golden*, 75 Cal. Rptr. 735 (Cal. Ct. App. 1969: In a matrimonial matter, the practice of a sole practitioner husband will continue with the same intangible value as it had during the marriage. Under the principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during the marriage. She is as much entitled to the recompense for that contribution as if it were represented by the increased value of a stock in a family business.

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
Discounts			
Buy-Sell			
We categorize California as an investment value state. California cases have considered goodwill as a community asset, whether adhering to an individual or a business. *Golden*, the earliest case on this issue in California, argued that the spouse makes an equal contribution to the other spouse's goodwill by his or her contributions as spouse. Further, both *Foster* and *Fenton* establish that the proper valuation of goodwill is not necessarily its fair market value.			
COLORADO			
Goodwill			*In Re: Marriage of Graff*, 902 P.d 402 (Colo. App, 1994). Goodwill was included in valuation of a one man insurance agency. The judge stated "The value of goodwill is not necessarily what a willing buyer would pay for such goodwill, rather, the important consideration is whether the business has a value to the spouse over and above tangible assets" *In re: Huff*, 834 P.2d 244 (Colo. 1992): In determining the intangible value of husband's business, the important consideration is whether the business has a value to him above and beyond the tangible assets. Valuation does not necessarily depend on what a willing buyer would pay.
Discounts			
Buy-Sell			*In re: Huff*, 834 P.2d 244 (Colo. 1992): Trial court is not bound by partnership agreement in determining value of law practice. Where partnership agreement was designed to discourage partners from leaving firm and it appeared husband intended to stay with firm, court was free to use an alternate valuation method, such as the excess earnings method.
We believe that the Colorado case *In Re: Huff* suggests that Colorado is predominantly an investment value state, endorsing the principles of the value to the holder premise, that an asset may have a value to the owner of that asset above and beyond what a willing buyer would pay for it.			

(*continues*)

	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
CONNECTICUT			
Goodwill	*Dahill v. Dahill*, 1998 Conn. Super. LEXIS 846 (Conn. Super. Ct. Mar. 30 1998): In a divorce proceeding, the court did not accept the valuation of stock in a closely held corporation offered by the husband's expert, where it was based on the shareholder agreement and none of the triggering events in the shareholder agreement had occurred. It was the court's duty to find the fair market value, not the book value or the "in-hand value" to the husband. *Eslami v. Eslami*, 591 A.2d 411 (Conn. 1991): Goodwill must be marketable in order to be included in the		
Discounts	*Ferguson v. Ferguson*, No. FA 960713118, 1998 WL 851426 (Conn. Super. Ct. Nov. 13, 1998): Applied marketability discount.		
Buy-Sell	*Stearns v. Stearns*, 494 A.2d 595 (Conn. App. Ct. 1985): A buy-sell agreement or other such agreement should be considered as a factor in valuing a business, but it is not necessarily determinative of the value of marital stock.		

Connecticut's decisions suggest that Connecticut generally follows a fair market value standard. *Eslami* establishes the principle that goodwill must be marketable in order to be included in the marital assets and *Dahill* suggests that although a buy-sell agreement may be in place, the court is looking to find the fair market value, which is not necessarily the value established by that agreement. Connecticut courts have also applied marketability discounts, as in *Ferguson*.

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
DISTRICT OF COLUMBIA			
Goodwill	*McDiarmid v. McDiarmid*, App. D.C., 649 A.2d 810 (1994). Goodwill may exist in a professional practice and if acquired during the marriage is marital property. However, a partner's ability to realize that goodwill upon exiting affects whether that goodwill has any value or not.		
Discounts			
Buy-Sell	*McDiarmid v. McDiarmid*, App. D.C., 649 A.2d 810 (1994): Trial judge erred in valuing goodwill of husband's partnership interest in law firm, given express terms of partnership agreement that made goodwill nonsalable and the absence of any other factors that could make the goodwill valuable.		

The court in *McDiarmid* recognized that goodwill exists in a professional practice, but suggested that the value of the goodwill was dependent on the ability of the professional to realize that value upon exit, and the partnership agreement limited the partner's ability to sell the goodwill. Because of this, we classify the District of Columbia as a fair market value state. The case did not consider the value of the goodwill as if the owner remained, but instead, it valued the goodwill based on the owner's ability to realize it upon exit.

(*continues*)

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
DELAWARE			
Goodwill	*S.S. v. C.S.*, A.2d (Del. Fam. Ct. Aug. 22, 2003): Goodwill should be dealt with in the context of alimony rather than property distribution, so that the risks and rewards may both be shared, instead of ascribing a current value on a speculative future income stream. *E.E.C. v. E.J.C.*, 457 A.2d 688 (Del. 1983). Rejected capitalization of husband's earnings to determine value of business for marital assets. The parties agreed that there were no excess earnings and therefore no goodwill in a sole proprietorship.		
Discounts			
Buy-Sell			

Delaware cases have established that a business should be valued as the market value of the company's tangible assets, in excess of its liabilities, its accounts receivable and work-in-progress. They have also suggested that although goodwill may exist, it should be handled in the form of alimony, where risks and rewards are shared. Because of this treatment of goodwill in the valuation of stock, we believe that Delaware may be predominantly categorized as a walk-away fair market value state.

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
FLORIDA			
Goodwill	*Held v. Held*—the adjusted book value was used in determining the fair market value of the business. The court rejected the inclusion of a non-solicitation agreement in enterprise goodwill. *Williams v. Williams*, 667 So.2d 915 (Fla. Dist. Ct. App. 1996): Business goodwill of a professional practice is a marital asset subject to division if it exists and was developed during the marriage. However, if a non-compete agreement would be required pursuant to a sale, there is no reason to believe that the goodwill adheres to the enterprise. *Thompson v. Thompson*, 576 So.2d 267 (Fla. 1991): Fair market value approach should be the exclusive method of measuring business goodwill.		
Discounts			
Buy-Sell			
Because of the treatment of goodwill in the valuation of businesses in Florida, we consider Florida a walk-away fair market value state. Although business goodwill may be included in a valuation, Florida cases have recognized business goodwill in a professional practice, but they have also suggested that the situation should be considered where a professional could compete with the business he is leaving, therefore minimizing the business goodwill of that entity.			
GEORGIA			
Goodwill	No Clear Decision		
Discounts			
Buy-Sell			

(*continues*)

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
HAWAII			
Goodwill	*Antolik v. Harvey*, 7 Haw. App. 313, 761 P.2d 305 (1988): When dividing and distributing the value of the property of the parties in a divorce case, the relevant value is, as a general rule, the fair market value on the relevant date.		
Discounts			
Buy-Sell			
Antolik v. Harvey indicates that the relevant value is the fair market value on the relevant date. It has acknowledged that goodwill has value, but it must be distinguished from an individual's reputation. In its treatment of goodwill in this case, Hawaii considered that the goodwill of the business in the form of patient charts would not be able to be sold, because the current owner would become a competitor and maintain those patients for himself. Because of this, we classify Hawaii as a walk-away fair market value state.			
IDAHO			
Goodwill	*Chandler v. Chandler*, 136 Idaho 246; 32 P.3d 140; 2001 Ida. LEXIS 87: Trial court found that community business had intangible value independent of personal goodwill.		
Discounts			
Buy-Sell			
Because the *Chandler* case distinguished the intangible value of the community business from the personal goodwill of the owner, we classify Idaho as a fair market value state.			

	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
ILLINOIS			
Goodwill	*In re: Marriage of Head*, 652 N.E.2d 1246 (Ill. App. 1995): Business goodwill may be valued, but not in this case. *In re: Marriage of Zells*, 572 N.E.2d 944 (Ill. 1991): Personal goodwill should not be considered in the valuation of a business.		
Discounts			
Buy-Sell	*In re: Marriage of Brenner*, 601 N.E.2d 1270 (Ill App. Ct. 1992): A buy-sell agreement or other such agreement should be considered as a factor in valuing a business but it is not determinative of the value of marital stock.		
We believe that Illinois should be categorized as predominantly following a fair market value standard. Personal goodwill is excluded from the valuation of a business, but business goodwill may be considered a marital asset where appropriate.			
INDIANA			
Goodwill		*Bobrow v. Bobrow*, 711 N.E.2d 1265; 1999: Goodwill in professional corporation adhered to the corporation itself. Value was calculated the pro rata proportion of the value of the business as a whole. *Yoon v. Yoon*, 711 N.E.2d 1265 (Ind. 1999): Personal goodwill is future earnings capacity and should not be included in valuation. Business goodwill is future patronage and should be considered.	

(*continues*)

	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
Discounts		*In re: Marriage of Conner*, 713 N.E.2d 883 (Ind. Ct. App. 1999): Rejects marketability discount.	
Buy-Sell		*Bobrow v. Bobrow*, 711 N.E.2d 1265; 1999: Case used pro rata proportion of value as a going concern rather than partnership agreement value.	
Indiana's cases may be classified under the value in exchange premise. Business goodwill is considered marital property, while personal goodwill is not. While this would normally indicate a fair market value standard, *Bobrow* suggested that the owner's share was the pro rata proportion of the enterprise, a concept more closely related to fair value in dissenters' rights and oppression cases.			
IOWA			
Goodwill			
Discounts	*In re: Marriage of Steele*, 502 N.W.2d 18 (Iowa. Ct. App. 1993): Accepts minority discount. *In re: Marriage of Hoak*, 364 N.W.2d 185 (Iowa 1985): Accepted marketability discount.		
Buy-Sell			
While we have not discovered Iowa cases dealing directly with the concept of enterprise or personal goodwill, the fact that both minority and marketability discounts have been applied in Iowa cases suggests that the state follows a fair market value standard.			
KANSAS			
Goodwill	*Powell v. Powell*, 648 P.2d 218 (Kan. 1982): Business goodwill in a professional practice may be an asset, but because in a professional practice it adheres to the individual rather than the practice; it should not be an asset subject to distribution in a divorce.		

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
Discounts			
Buy-Sell			
We classify Kansas as a fair market value state. Powell establishes that goodwill in Dr. Powell's practice was not an asset subject to distribution, because it was personal to the practitioner. The court established that goodwill in a professional practice is not an asset, because it is too heavily reliant on an individual. In such a business, the clients only serve the practitioner, and if he or she died, there would be no value to the business. This suggests a walk-away fair market value standard.			
KENTUCKY			
Goodwill			*Drake v. Drake*, 809 S.W.2d 710 (Ky. Ct. App. 991)—business goodwill should be considered in valuing a professional practice. *Clark v. Clark*, 782 S.W.2d 56 (Ky. Ct. App. 1990): Included business and personal goodwill in the value of a professional corporation.
Discounts			
Buy-Sell			*Clark v. Clark*, 782 S.W.2d 56 (Ky. Ct. App. 1990): Utilizing a buy-sell agreement in this case would be unfair as it would not recognize goodwill.
We classify Kentucky as an investment value state, mainly because it does not distinguish between personal and enterprise goodwill in a professional practice. *Clark* cites a variety of cases and considers that practitioner-related elements such as age, skill, and reputation affect goodwill. It also considers that the capitalization of excess earnings is not based on future earnings but the calculation of past earnings. Similarly, both *Drake* and *Clark* rejected the application of a buy-sell agreement when it prevented the inclusion of intangible assets.			

(*continues*)

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
LOUISIANA			
Goodwill	La. Revised Statute. 9:2801.2 prohibits the valuation of personal goodwill; *Godwin v. Godwin*, 533 So.2d 1009 (La. Ct. App. 1988): Business goodwill in a commercial enterprise is marital property and should be considered in the valuation. *Pearce v. Pearce*, 482 So.2d 108 (La. Ct. App. 1986): Goodwill in a medical practice doesn't exist separately from the practitioner and thus, isn't part of the marital estate.	La. Revised Statute. 9:2801.2 prohibits the valuation of personal goodwill. *Pearce v. Pearce*, 482 So.2d 108 (La. Ct. App. 1986): Goodwill in a medical practice doesn't exist separately from the practitioner and thus, isn't part of the marital estate. *Godwin v. Godwin*, 533 So.2d 1009 (La. Ct. App. 1988): Business goodwill in a commercial enterprise is marital property and should be considered in the valuation. *Ellington v. Ellington*, 842 So. 2d 1160; 2003 La. App. LEXIS 675—while the experts came to a fair market value for the assets in question, the trial court rejected the expert's opinion, using the fair value language that the wife was not a willing seller and that it would be unfair not to include the value of the client base, the intangible asset.	
Discounts		*Head v. Head*, 714 So. 2d 231; 1998 La. App. LEXIS 1327: Rejected marketability discount on the basis that a third-party sale was not contemplated.	
Buy-Sell			

We have categorized Louisiana as a fair value state because recent cases in that state have rejected discounts and used "unwilling seller" language, which indicates fair value. This is fair value under value in exchange, because Louisiana statute bars valuation and inclusion of personal goodwill in the marital assets.

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
MAINE			
Goodwill		No Clear Decision	
Discounts			
Buy-Sell			
MARYLAND			
Goodwill	*Strauss v. Strauss*, 647 A.2d 818 (Md. Ct. Spec. App. 1994): Personal goodwill attached to a business is not marital property. *Prahinski v. Prahinski*, 582 A.2d 784 (Md. Ct. Spec. App. 1990): Goodwill of a solo law practice is personal to the individual and thus is not marketable.		
Discounts			
Buy-Sell			
We classify *Maryland* as a fair market value state due to the treatment of goodwill in both the *Strauss* and *Prahinski* decisions. While allowing business goodwill, personal goodwill attached to a business or a sole proprietorship is not marital property.			
MASSACHUSETTS			
Goodwill	*Goldman v. Goldman*, 554 N.E.2d 860 (Mass. App. 1990): There was no goodwill found in a one-man professional corporation.		
Discounts			
Buy-Sell			
Without discussing the valuation of goodwill in depth, the decision in *Goldman* suggests that Massachusetts should be classified as a fair market value state, because no goodwill was assigned to the value of a one-man professional corporation.			

(*continues*)

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
MICHIGAN			
Goodwill			*Kowalesky v. Kowalesky*, 148 Mich. App. 151; 384 N.W.2d 112; 1986 Mich. App. LEXIS 2380: Goodwill was valued in a one-man professional dental practice.
Discounts			
Buy-Sell			
We believe Michigan may be classified as an investment value state. In the *Kowalesky* case, goodwill was valued in a professional practice. No attempt was made to distinguish personal goodwill versus business goodwill. Also, because the practice was expected to continue, no discount needed to be applied in consideration of a sale in liquidation.			
MINNESOTA			
Goodwill	*Bateman v. Bateman*, 382 N.W.2d 240 (Minn. Ct. App. 1986): In valuing an asset for marital dissolution purposes, the market value of the asset is controlling.		
Discounts	*Berenberg v. Berenberg*, 474 N.W.2d 843 (Minn. Ct. App. 1991): Accepted combined minority and lack of marketability discount.		
Buy-Sell	*Berenberg v. Berenberg*, 474 N.W.2d 843 (Minn. Ct. App. 1991): A buy-sell agreement or other such agreement should be considered as a factor, but it is not determinative of the value of marital stock (rejected here).		
Because Minnesota's representative cases have looked to the market value of a company's assets in determining their value for equitable distribution, we believe that Minnesota may be classified as a fair market value state. Discounts have also been accepted in Minnesota divorce valuations.			

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
MISSISSIPPI			
Goodwill	*Singley v. Singley*, 2003 Miss. LEXIS 283: Goodwill may not be included in the determination of a business's fair market value (walk-away value).		
Discounts			
Buy-Sell			
We believe Mississippi is predominantly a walk-away fair market value state, because of the exclusion of goodwill in the valuation of professional practices for marital dissolutions. The court in this case referenced the decision of other jurisdictions like Florida, adhering to the principle that non-marketable goodwill should not be used in a determination of fair market value for equitable distribution purposes.			
MISSOURI			
Goodwill	*Hanson v. Hanson*, 738 S.W.2d 429 (Mo. banc. 1987): Business goodwill may exist in both commercial and professional entities. Accepts the fair market value approach to valuing goodwill. *Taylor v. Taylor*, 736 S.W.2d 388 (Mo. 1987): Without fair market value evidence, it is proper to find no business goodwill for valuation purposes.		
Discounts			
Buy-Sell	*Hanson v. Hanson*, 738 S.W.2d 429 (Mo. banc. 1987): Prefers fair market value but may accept a buy-sell agreement as determinative of value.		
Because the representative Missouri cases require fair market value evidence to consider goodwill to be marital property, we categorize Missouri as a fair market value state. Further, Missouri may give weight to a buy-sell agreement in determining value.			

(*continues*)

	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
MONTANA			
Goodwill			*In re: Marriage of Stufft*, 950 P.2d 1373 (Mont. 997): No distinction between personal and business goodwill. *In re: Marriage of Hull*, 219 M 480, 712 P2d 1317, 43 St. Rep. 107(1986): Court adopted Washington decision in the *Matter of Fleege* that although goodwill may not be readily marketable, it is an asset with value.
Discounts	*DeCosse v. DeCosse*, No. 96-118, 1997 WL 191374 (Mont. Apr. 15, 1997): Accepts minority discount.	*In re: Marriage of Taylor, 848 P.2d 478 (Mont. 1993):* It is inappropriate to apply a discount to the stock when the value is arrived at by determining the market value of underlying assets.	
Buy-Sell			
Although Montana has had cases that accept discounts, the adoption of Washington's decision that goodwill need not be marketable to have value leads us to classify Montana as an investment value state.			
NEBRASKA			
Goodwill	*Taylor v. Taylor*, 222 Neb. 721, 386 N.W.2d 851 (1986):To be properly within the purview of this section as property divisible and distributable in a dissolution proceeding, we conclude that goodwill must be a business asset with value independent of the presence or reputation of a particular individual, an asset which may be sold, transferred, conveyed, or pledged.		
Discounts			
Buy-Sell			
We believe Nebraska predominantly follows a fair market value standard because of its requirement, expressed by the *Taylor* case, that goodwill must be a marketable business asset independent of the reputation or presence of an individual.			

	VALUE IN EXCHANGE		**VALUE TO THE HOLDER**
	Fair Market Value	Fair Value	Investment Value
NEVADA			
Goodwill			*Ford v. Ford*, 782 P.2d 1304 (Nev. 1989): Business goodwill based in a solo medical practice is a marital asset subject to division.
Discounts			
Buy-Sell			
We believe Nevada predominantly follows an investment value standard. The rationale in *Ford v. Ford* relies on cases such as *Dugan v. Dugan* from New Jersey, *Marriage of Foster* from California, and *Marriage of Fleege* from Washington, in supporting the notion that even though goodwill may not be readily marketable, it does have a value in a going business.			
NEW HAMPSHIRE			
Goodwill	*In re: Watterworth*, 821 A.2d 1107 (N.H. 2003). The court upheld the lower court's decision that there was no goodwill in a medical practice because of a binding shareholder agreement setting a fair market value, as well as the fact that no one would pay for the intangible value of the practice because the owner would compete.		
Discounts	*Rattee v. Rattee*, 146 N.H. 44; 767 A.2d 415; 2001 N.H. LEXIS 25: The court held discounts were applicable to calculate fair market value regardless of the intention to sell and therefore discounts must apply.		
Buy-Sell			
We categorize New Hampshire as a fair market value state. In the *Watterworth* case, a restrictive agreement was in place limiting the marketability of the practice. Additionally, the court reasoned that no one would purchase the goodwill of the practice without a noncompete provision from the shareholder. The court focused on the ability and proceeds from the sale of the asset. Additionally, in the *Rattee* case, the court applied discounts in calculating the fair market value of the assets, whether there was an intent to sell those assets or not.			

(*continues*)

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
NEW JERSEY			
	Hybrid—Review case law		
Goodwill			*Dugan v. Dugan*, 457 A.2d 1 (N.J. 1983): The court stated that undoubtedly goodwill exists, and the individual practitioner's inability to sell it should not affect consideration as an asset. *Piscopo v. Piscopo*, 557 A.2d 1040 (N.J. Super. Ct. App. Div. 1989): Goodwill attributable to celebrity status is asset subject to equitable distribution.
Discounts		*Brown v. Brown*, 348 N.J. Super. 466; 792 A.2d 463: Discounts rejected in valuation of a commercial flower shop based on standards of dissent and oppression statutes and case law (*Balsamides* and *Lawson*).	
Buy-Sell		*In re: Marriage of Bowen*, 473 A.2d 73 (N.J. 1984): A buy-sell agreement or other such agreement should be considered as a factor in valuing a business, but it is not determinative of the value of marital stock (rejected in this case). *Stern v. Stern*, 66 N.J. 340; 331 A.2d 257; 1975: The partnership agreement allowed for the value of the capital account plus a frequently revised number indicating a certain intangible value of the individual's contribution to the firm (to be paid upon death). The court stated that if it is established that the books are well kept and the value of the partner's interests are periodically reviewed, the value should not be subject to effective attack.	

	VALUE IN EXCHANGE		**VALUE TO THE HOLDER**
	Fair Market Value	Fair Value	Investment Value
We believe New Jersey is a hybrid state. The *Brown* case used concepts of fair value in rejecting the application of discounts in a valuation, and the court based that decision upon cases dealing with fair value in shareholder oppression and dissent. Interestingly, the language in *Brown* allows for interpretation under either a value in exchange and a value to the holder premise. *Dugan* and *Piscopo* can be considered to adhere to an investment value standard with regard to personal goodwill. Moreover, an area of controversy in New Jersey is the weight to be afforded a buy sell agreement, especially in a professional practice, in light of the New Jersey Supreme Court case *Stern v. Stern.*			
NEW MEXICO			
Goodwill			*Mitchell v. Mitchell*, 719 P.2d 432 (N.M. Ct. App. 1986): Both personal and enterprise goodwill constitute marital property upon divorce. In *Hurley v. Hurley*, 615 P.2d 256, 259 (N.M. 1980), the dispositive question is not whether a doctor can sell his goodwill. As long as he maintains his practice, the physician will continue to benefit from goodwill associated with his name.
Discounts			
Buy-Sell	*Hertz v. Hertz*, 99 N.M. 320, 657 P.2d 1169 (1983): Where a professional spouse's stock in a corporation was subject to restrictive agreements and the value of the goodwill of the corporation was fixed by the agreements, the trial court had to use that value to determine wife's share in a dissolution action.		
Because of the treatment of goodwill in the valuation of businesses in New Mexico, we classify New Mexico to be an investment value state. In *Mitchell*, the court did not distinguish personal and enterprise goodwill. Further, the court in *Hurley* stated that there was no marketability requirement for the goodwill of a business to be valued upon divorce. However, the decision in *Hertz* required that the court in this case adhere to a binding buy-sell agreement, suggesting that the value upon exit must be considered, a concept more closely akin to fair market value.			

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	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
NEW YORK			
	Hybrid—Review case law		
Goodwill	*Beckerman v. Beckerman* (1987, 2d Dept) 126 AD2d 591, 511 NYS2d 33: Trial court's valuation of husband's closely held corporation in the amount of $1.1 million would be affirmed based on capitalization of earnings method adopted by both parties, and upon Internal Revenue Service's Revenue Ruling No. 59-60;		*O'Brien v. O'Brien*, 66 N.Y.2d 576; 489 N.E.2d 712; 498 N.Y.S.2d 743; 1985: The value of a license is includable in the marital assets. Moll v. Moll, 187 Misc. 2d 770, 722 N.Y.S.2d 732 (2001): Personal and enterprise goodwill in a professional practice are included as marital property.
Discounts	*Ellis v. Ellis* (1997, 3d Dept) 235 AD2d 1002, 653 NYS2d 180: Applied marketability discount.		
Buy-Sell			*Harmon v. Harmon*, 173 A.D.2d 98; 578 N.Y.S.2d 897; 1992 N.Y. App. Div. LEXIS 54. The court found the death benefit provision in a partnership a more compelling estimate of value than the withdrawal provision. The withdrawing partner forgoes interest in work in progress, receivables, and goodwill. The death benefit included an amount in excess of the capital account value to reflect these assets. Therefore, the death benefit reflected the economic reality of the value of a partnership interest upon divorce.
While New York considers professional degrees, license, enhanced earning capacity and celebrity status as marital assets, however, as applied to commercial businesses, New York generally considers fair market value. Additionally, in both divorces and shareholder disputes, New York may apply marketability discounts. Because of this divergent treatment of the various elements that allow us to categorize the states, we are calling New York a hybrid state.			

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
NORTH CAROLINA			
Goodwill			*Hamby v. Hamby*, 143 N.C. App. 635, 547 S.E.2d 110 (2001): While the court looked to determine fair market value, it used an expert's testimony of value that looked at the going concern value of the business to the owner, an investment value standard. *Poore v. Poore*, 75 N.C. App. 414, 331 S.E.2d 266, cert. denied, 314 N.C. 543, 335 S.E.2d 316 (1985): There may be goodwill in a professional practice, and if so, it should be included in the value. The court considered personal intangibles such as age, health, and reputation of the practitioner in valuing goodwill.
Discounts			
Buy-Sell			
While North Carolina has used the term *fair market value*, the state has not attempted in its case law to differentiate personal and enterprise goodwill in a professional practice. In *Poore*, the court considered the age, health, and professional reputation of the practitioner himself in determining goodwill. Additionally, the court agreed with the expert's assessment in *Hamby*, where the going concern value to the business owner, a value to the holder premise, was sought. These cases suggest that North Carolina be classified as an investment value state.			
NORTH DAKOTA			
Goodwill	*Sommers v. Sommers*, 2003 ND 77, 660 N.W.2d 586 (2003): Trial court should have used the fair market value of a husband's orthodontic practice during equitable distribution instead of the liquidation value because there was no evidence that a liquidation was imminent or necessary under the circumstances.		

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	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
Discounts	*Kaiser v. Kaiser*, No. 960013, 1996 WL 663189 (N.D. Nov. 18, 1996): Applied discounts.	*Fisher v. Fisher*, 568 N.W.2d 728 (N.D. 1997): Rejected application of discounts.	
Buy-Sell			
North Dakota prescribes fair market value in its valuations of practices upon divorce. Rather than valuing the business at the net value of its assets in liquidation, the court in *Sommers* sought a going concern fair market value. Discounts are applied on a case-by-case basis. Although rejected in the *Fisher* case, in the case there were special circumstances that required the court to view discounts as it would in an oppression case. North Dakota courts appear to be otherwise open to applying discounts in a fair market value assessment.			
OHIO			
	Hybrid—Review case law		
Goodwill	*Goswami v. Goswami*, 152 Ohio App. 3d 151, 2003 Ohio 803, 787 N.E.2d 26 (Ohio App. 7th Dist. 2003): Personal goodwill is not marital property. *Flexman v. Flexman*, No. 8834, 1985 WL 8075 (Ohio Ct. App. Aug. 28, 1985): Business goodwill in a sole-proprietorship corporation does not exist separate of the owner and thus is not marital property.		
Discounts		*Oatey v. Oatey*, No. 67809, 67973, 1996 WL 200273 (Ohio Ct. App. Apr. 25, 1996): Rejects minority discount.	
Buy-Sell		*Herron v. Herron*, 2004 Ohio 5765; 2004 Ohio App. LEXIS 5209: Because the subject company was family held, the court concluded that the provisions of a buy-sell agreement would likely not be enforced, and the wife would be compensated for the liquid asset value of her share.	
We consider Ohio to be a hybrid state. Ohio cases appear to use a fair market value treatment for goodwill, but use a standard of value closer to fair value with regard to shareholder level discounts and the weight accorded buy-sell agreements.			

	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
OKLAHOMA			
Goodwill	*Ford v. Ford*, 840 P.2d 36 (Okla. Ct. App. 1992): Law practitioner's personal goodwill has no value for the purpose of marital property. *Mocnik v. Mocnik*, 838 P.2d 500 (Okla. 1992): If business goodwill is to be divided as an asset, it should be valued using a buy-sell agreement or its fair market value. *Travis v. Travis*, 795 P.2d 96 (Okla. 1990): Personal goodwill in a law practice is not subject to distribution.		
Discounts			
Buy-Sell	*Ford v. Ford*, 840 P.2d 36 (Okla. Ct. App. 1992): Stockholder's agreement is controlling in a marital property division case.		
We believe that Oklahoma may be classified as a fair market value state. According to both *Ford* and *Travis*, personal goodwill is not to be valued in marital dissolution. *Mocnik* goes further to prescribe either a fair market value valuation or adherence to a buy-sell agreement. *Ford* suggests that a buy-sell agreement is controlling as far as the valuation of marital property is concerned.			
OREGON			
Goodwill	*In re: Marriage of Tofte*, 895 P.2d 1387 (Or. Ct. App. 1995): To value the fair market value of a closely held corporation, one must focus on the price that a hypothetical willing buyer would pay a hypothetical willing seller. *Matter of Marriage of Maxwell*, 876 P.2d 811 (Or. App. 1994): There is no goodwill in a sole proprietorship that is based on an individual's talents.		

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	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
Discounts	*In re: Marriage of Tofte*, 895 P.2d 1387 (Or. Ct. App. 1995): Accepts marketability discount. *Matter of Marriage of Belt*, 672 P.2d 1205 (Or. Ct. App. 1983): Discount accepted.		
Buy-Sell			
We believe that Oregon predominantly follows a fair market value standard because of the principle expressed in *Maxwell*, that value based on an individual's characteristics should not be included in the value of goodwill. *Tofte* directly prescribes the use of fair market value, and discounts have been applied in the state.			
PENNSYLVANIA			
Goodwill	*Butler v. Butler*, 663 A.2d 148 (Pa. 1995): Personal goodwill is not marital property. *Beasley v. Beasley*, 1985 Pa. Super. LEXIS 8662 (Pa. Super. Ct. Sept. 18 1985): One's personal reputation is not separate property, as it cannot be sold or even given away and, accordingly, courts should not become embroiled in the impossible task of evaluating professional reputation and distributing it as an asset of the marriage.		
Discounts		*Verholek v. Verholek*, 741 A.2d 792 (Pa. Super. Ct. 1999). Rejects minority discount.	
Buy-Sell	*Buckl v. Buckl*, 373 Pa. Super. 521, 542 A.2d 65, 1988 Pa. Super. LEXIS 1048 (1988): A buy-sell agreement or other such agreement should be considered as a factor in valuing a business, but it is not determinative of the value of marital stock.		
Because Pennsylvania attempts to distinguish and exclude value based on reputation or personal skill, we believe Pennsylvania may be considered a fair market value state. While the *Verholek* case rejected a minority discount, the predominant trend in the treatment of goodwill suggests a fair market value standard.			

	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
RHODE ISLAND			
Goodwill	*Moretti v. Moretti*, 766 A.2d 925 (R.I. 2002): Personal goodwill is not a marital asset subject to distribution.		
Discounts			
Buy-Sell			
While the case law in Rhode Island is limited, because the *Moretti* case specifically excluded the consideration of personal goodwill in equitable distribution, we believe that Rhode Island may be classified as a fair market value state.			
SOUTH CAROLINA			
Goodwill	*Hickum v. Hickum*, 463 S.E.2d 321 (S.C. Ct. App. 1995): Ongoing marital businesses are to be valued at fair market value.		
Discounts			
Buy-Sell			
South Carolina's decision in *Hickum* establishing that ongoing marital businesses are to be valued at fair market value suggests that the state may be classified as a fair market value state.			
SOUTH DAKOTA			
	Personal Goodwill Not Addressed by Courts—See *Endres v. Endres*, 1995 S.D. LEXIS 58 (May 17, 1995).		
Goodwill			
Discounts	*Priebe v. Priebe*, 556 N.W.2d 78 (S.D. 1996): Accepted minority discount.		
Buy-Sell			
While including goodwill in the calculation of value of a commercial concrete business, the court in *Endres* did not need to address whether that goodwill adhering to an individual was includable in the marital assets, as the goodwill in this case adhered to the business. South Dakota has accepted minority discounts, but without further evidence, we believe that the state's case law is inconclusive as far as the standard of value is concerned.			

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	VALUE IN EXCHANGE	VALUE TO THE HOLDER	
	Fair Market Value	Fair Value	Investment Value
TENNESSEE			
Goodwill	*Alsup v. Alsup*, No. 01A01-9509-CH-00404, 1996 WL 411640 (Tenn. Ct. App. July 24, 1996): Business goodwill in a professional practice or sole proprietorship is not a marital asset for equitable distribution purposes. *Smith v. Smith*, 709 S.W.2d 588 (Tenn. Ct. App. 1985): No goodwill exists in a professional practice.		
Discounts			
Buy-Sell			
Tennessee's case law involving the valuation of goodwill suggests that the state should be categorized as following a fair market value standard. Tennessee's *Smith* excludes goodwill altogether in a professional practice, but the later case *Alsup* includes goodwill as long as it adheres to the business rather than the individual.			
TEXAS			
Goodwill	*Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972): Business goodwill dependent on a professional's skills is not marital property.		
Discounts			
Buy-Sell			
Because the *Nail* case established that goodwill is dependent on an individual's skills is not marital property, we believe that Texas may be classified as a fair market value state.			
UTAH			
Goodwill	*Sorenson v. Sorenson*, 839 P.2d 774, 775-776 (Utah 1992): goodwill was not included in the valuation of a solo dental practice, and would not be unless that practice was sold and the goodwill realized by the seller.		

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
Discounts			
Buy-Sell			
The court in *Sorensen* suggests Utah's classification as a fair market value state, including the value of goodwill in a marital business only if it was clear that the practice would be sold and the goodwill value would be realized by the practitioner.			
VERMONT			
Goodwill	*Goodrich v. Goodrich* (1992) 158 Vt. 587, 613 A.2d 203: Supreme Court would not mandate single methodology for determining value of interest in closely held company in divorce action. The court accepted the view that for the purposes of a divorce valuation, as long as the value determined by the trial court was that which a willing buyer would pay a willing seller and that value was supported by credible evidence in record, it was not clearly erroneous.		
Discounts	*Goodrich v. Goodrich* (1992) 158 Vt. 587, 613 A.2d 203: Accepted minority interest discount.		
Buy-Sell			
We believe that Vermont may be classified as a fair market value state. It has allowed discounts in the valuation of businesses upon divorce and has allowed valuations to reflect what a willing buyer would pay a willing seller for shares of a business.			

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	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
VIRGINIA			
Goodwill		*Howell v. Howell*, 31 Va. App. 332, 523 S.E.2d 514 (2000): The value of goodwill can have two components: (1) professional goodwill, also designated as individual, personal, or separate goodwill, which is attributable to the individual and is categorized as separate property in a divorce action, and (2) practice goodwill, also designated as business or commercial goodwill, which is attributable to the business entity, the professional firm, and may be marital property.	
Discounts		*Howell v. Howell*, 31 Va. App. 332, 523 S.E.2d 514 (2000): Rejects minority and marketability discount.	
Buy-Sell		*Bosserman v. Bosserman*, 9 Va. App. 1, 384 S.E.2d 104 (1989): A buy-sell agreement should be considered as a factor in valuing a business, but it is not determinative of the value of marital stock.	

We believe Virginia predominantly follows a fair value standard. Virginia views goodwill under the value in exchange premise, that is, only enterprise goodwill may be included in the valuation of a business for the purposes of divorce. However, the state also rejects minority and marketability discounts in favor of a pro-rata share of the enterprise value, suggesting a fair value standard.

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
		WASHINGTON	
Goodwill			*In re: Marriage of Hall*, 692 P.2d 175 (Wash. 1984): Both personal and enterprise goodwill may be included in the value of a professional practice as community property. *Matter of Marriage of Fleege*, 588 P2d 1136 (1979): Business goodwill is the expectation of continued public patronage, and value of business goodwill to a professional spouse, enabling him to continue to enjoy the patronage engendered by that goodwill is a community asset subject to division.
Discounts		*Baltrusis v. Baltrusis*, 2002 Wash. App. LEXIS 2241: The court rejected the use of marketability discounts, using fair value language that the husband was more like a dissenting shareholder: an unwilling seller of the interest.	
Buy-Sell		*In re: Luckey*, 73 Wn. App. 201, 868 P.2d 189 (1994): Accepts buy-sell agreement as means of valuing business. *In re: Marriage of Brooks*, 756 P.2d 161 (Wash. Ct. App. 1988): A buy-sell agreement or other such agreement should be considered as a factor in valuing a business, but it is not determinative of the value of marital stock (rejected in this case).	

Washington appears to follow a value to the holder treatment of goodwill. Both the *Fleege* and *Hall* cases include goodwill in the valuation of a professional practice without distinguishing and excluding goodwill adhering to the professional. *Baltrusis*, however, uses fair value language in the rejection of discounts to account for the fact that the husband was an unwilling seller of the interest. Overall, however, the state's treatment of goodwill and the established principles in *Hall* and *Fleege* suggest that Washington may be classified as an investment value state.

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	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
		WEST VIRGINIA	
Goodwill	*May v. May*, 214 W. Va. 394; 589 S.E.2d 536; 2003 W. Va. LEXIS 118: Distinguished between the business's enterprise goodwill, which was marital property, and the husband's personal goodwill, which was not subject to equitable distribution. *Tankersley v. Tankersley*, 182 W.Va. 627, 390 S.E.2d 826 (1990): Net value will be the amount realized should the corporation be sold for fair market value.		
Discounts	*Michael v. Michael*, 469 S.E.2d 14 (W. Va. 1996): Accepts marketability discount.		
Buy-Sell	*Bettinger v. Bettinger*, 396 S.E.2d 709 (W. Va. 1990): Buy-sell in closely held corporation setting stock value for equitable distribution should not be considered binding but should be considered as a factor.		
We believe West Virginia may be classified as a fair market value state. The case *May v. May* reviews case law from varying jurisdictions and decides to follow those states that exclude goodwill adhering to an individual from the marital property. Further, *Tankersly* specifically refers to fair market value in its valuation, and *Michael* applies discounts.			
		WISCONSIN	
Goodwill	*Sommerfeld v. Sommerfeld*, 454 N.W.2d 55 (Wis. Ct. App. 1990): Property to be divided at divorce is to be valued at its fair market value. *Peerenboom v. Peerenboom*, 433 N.W.2d 282 (Wis. Ct. App. 1988): If business goodwill exists in a professional practice, it should be included in the distributable assets.		

	VALUE IN EXCHANGE		VALUE TO THE HOLDER
	Fair Market Value	Fair Value	Investment Value
Discounts	*Arneson v. Arneson*, 355 N.W.2d 16 (Wis. Ct. App. 1984): Accepted minority discount.		
Buy-Sell	*Lewis v. Lewis*, 336 N.W.2d 171 (Wis. Ct. App. 1983): The trial court may consider a cross-purchase formula in a partnership agreement in determining the value of the partnership interest, including professional goodwill.		
Wisconsin case law suggests that it may be classified as a fair market value state. *Sommerfeld* establishes that property to be divided upon divorce should be valued at its fair market value. Further, Wisconsin has included business goodwill, accepted discounts, and considered buy-sell agreements where applicable.			
WYOMING			
Goodwill	*Root v. Root*, 65 P.3d 41 (Wyo. 2003): Personal goodwill should not be included in marital assets.		
Discounts			
Buy-Sell			
Because of the court's decision in *Root* to exclude personal goodwill from the distributable assets, we believe that Wyoming may be classified as a fair market value state.			

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