

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 elements of each standard of value. We also introduce two fundamental 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.

Price, Value, and Cost

Oscar Wilde wrote:

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

Wilde's quote illuminates the relationship between price and value as social concepts, highlighting clearly that the words are not interchangeable. Although not interchangeable, 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

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

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 concepts, value is a less concrete concept, not necessarily requiring the arrival at a set price between parties in a transaction. Value, in fact, represents a more general concept of worth that may not be easily represented by a transactional price or cost. 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 an arm’s-length 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.

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

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;

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: Michie Company, 1937), at 19.

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 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 necessitates 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 in which it recognized:

. . . the necessity to identify and define the applicable standard of value as a critical part of any appraisal report or appraisal engagement. It (*identifying and defining the applicable standard of value*) 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

Whereas 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.

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*, 2012-2013, Standards Rule 2-2 a(v), “state the type and definition of value and cite the source of the definition.”

Bonbright perhaps sets the issue up best when he writes:

At first thought one might suppose the problem with defining 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 fundamental premises of value: value in exchange and value to the holder. The premise chosen establishes the “value to whom?”

- *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 for cash or cash equivalent. The fair market value standard

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

¹³ *Id.*, at 11.

¹⁴ *Id.*, at 11–12.

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. For instance, What is being valued? Does the property change hands? Who are the buyer and seller?

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.

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.

Accordingly, it is essential that the practitioner have a clear understanding of what the appropriate standard of value should be for the given circumstance. This includes seeking clarification from legal counsel, preferably in writing.

Fair Market Value

Fair market value is perhaps the best-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 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.

¹⁵ Shannon P. Pratt and Alina Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), at 41.

¹⁶ Treasury Regulation § 20.2031-1.

¹⁷ Garner, *Black's Law Dictionary*, at 1587.

¹⁸ Pratt and Niculita, *Valuing a Business*, at 42.

Fair Value

Fair value may be the applicable standard of value in a number of different situations, including financial reporting, appraisals for dissenting shareholders, buyouts of oppressed shareholders, fairness opinions, 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 to, 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 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.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; it is also an *exit value*. 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 Commentators have been clear that *fair value* for financial reporting purposes is not identical to *fair market value* as used for estate and gift tax purposes. For example, blockage discounts are not considered in fair value for financial reporting purposes while they are typically considered under fair market value.

In judicial appraisals, fair value is a legally mandated standard that applies to specific transactions and is commonly used in matters involving dissenters, shareholder oppression, and litigation challenging the fairness of transactions. 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 have established that the fair value of the shares, absent special circumstances, is their pro rata share of enterprise value. Two prominent commentators on Delaware law define fair value as the pro rata share of “the present value of the corporation’s existing assets [plus] the present value of the reinvestment opportunities available to and anticipated by the firm.”²¹

¹⁹ FASB Accounting Standards Codification (ASC) Topic 820 (formerly SFAS 157).

²⁰ David Laro and Shannon P. Pratt, *Business Valuation and Federal Taxes* (Hoboken, NJ: John Wiley & Sons, 2011), at 14.

²¹ Lawrence A. Hamermesh and Michael L. Wachter, “Rationalizing Appraisal Standards in Compulsory Buyouts,” 50 B.C.L. Rev. 1021 (2009).

Investment Value

Investment value, in the nomenclature of business valuation, means the value of an asset, business, or business *interest 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.²² 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 of acquiring 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 often 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 necessarily be accorded a minority discount under the standard of investment value.

²² *Id.*, at 16–17.

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 standalone 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:²³

- The economic needs and abilities of the parties to the transaction
- The parties' 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";²⁴ 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."²⁵

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, *Graham and Dodd's Security Analysis*, has an entire chapter on intrinsic value.²⁶ Graham and Dodd define intrinsic value as "*the value which*

²³ *Id.*, at 16.

²⁴ *Webster's Third New International Dictionary* (Springfield, MA: G&C Merriam Company, 1966).

²⁵ Garner, *Black's Law Dictionary*, at 1587.

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

is justified by assets, earnings, dividends, definite prospects, and the factor of management" (emphasis original).²⁷

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 market 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.²⁸

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. . . . [I]ntrinsic value is in essence the central tendency in price."²⁹

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. Here is a representative example from a divorce case.

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.

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

²⁷ *Id.*, at 41.

²⁸ *Id.*, at 43.

²⁹ *Id.*

value is more reliant on characteristics adhering to a particular purchaser or owner.³⁰

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.³¹

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.”³²

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.³³

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.³⁴ Practitioners often will see

³⁰ Pratt and Niculita, *Valuing a Business*, at 44.

³¹ *Howell v. Howell*, 31 Va. App. 332, 523 S.E.2d 514 (2000).

³² *Robbins v. Beatty*, 246 Iowa 80, 91, 67 N.W.2d 12, 18.

³³ Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith and James R. Hitchner, *PPC’s Guide to Business Valuation* (Fort Worth, TX: Thompson PPC, 2011), at 201.15.

³⁴ Pratt, *Valuing a Business*, at 350.

“book value,” or some slight modification to book value, in shareholder agreements, where a transfer of stock is based on historical audited financial statements. Sometimes a modification would include replacing adjusted book value of real estate with market value. Here, again, this is not the same as a fair market value on a going-concern premise of value.

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.

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 and managed to maximize shareholder value. 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 with future earning power as opposed to the liquidation value of the business or of the assets.”³⁵

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

³⁵ Garner, *Black's Law Dictionary*, at 1587.

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.”³⁶ 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 not only considers the proceeds from selling the assets of a business but also may take into consideration any associated expenses.³⁷

The liquidation value of a business is most relevant in the case of an unrestricted 100% control interest.³⁸ 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 has attempted to apply these definitions to valuing a business:³⁹

- *Value as an orderly disposition.* 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.
- *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.

³⁶ *Id.*

³⁷ Fishman, Pratt, Griffith and Hitchner, *PPC's Guide to Business Valuation*, at 201.12.

³⁸ Michael Bolotsky, “Valuation of Common Equity Securities When Asset Liquidation Is an Alternative,” in *Financial Valuation: Businesses and Business Interests*, James H. Zukin, ed. (New York: Warren Gorham & Lamont, 1990), at 10-3.

³⁹ Pratt and Nicalita, *Valuing a Business*, at 47-48.

Fair Value in Alternative 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 most fairness opinions because it is the “minimum level of financial fairness.”⁴⁰ A *fairness opinion* is generally prepared by a knowledgeable 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, to investors. Fairness opinions are advisable in a variety of situations, including acquisitions, recapitalizations, share buybacks, sales of assets, and related-party transactions.⁴¹

Another alternative context in which the fair value standard is applied is when the Delaware courts are evaluating “entire fairness” in transactions with conflicted parties. The Delaware courts generally utilize the same standard of fair value in these cases as is used in determining fair value in a dissenting shareholder action.⁴²

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.”⁴³

Standard & 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 stock is currently worth.”⁴⁴ These assessments, however, are all outside the scope of our studies for the purposes of this book, as we are primarily

⁴⁰ M. Mark Lee and Gilbert E. Matthews, “Fairness Opinions,” in *The Handbook of Advanced Business Valuation*, Robert Reilly and Robert Schweihs, eds. (New York: McGraw-Hill, 2000), at 311.

⁴¹ *Id.*

⁴² Hamermesh and Wachter, “Rationalizing Appraisal Standards,” at 1030; *In re Southern Peru Copper Corp. S’holder Deriv. Litig.* 30 A.3d 60, 117 (Del. Ch. 2001), *aff’d*; *Americas Mining Corp. v. Theriault*, A.3d (Del. 2012), 2012 Del. LEXIS 459.

⁴³ Capital Market Risk Advisors, www.cmra.com/html/body_glossary.html.

⁴⁴ S&P Advisor Insight Glossary, www.advisorinsight.com/pub/cust_serv/glossary.html.

concerned with the tax, judicial, and regulatory treatment of standards of value, rather than their use in the financial markets.

Fair Market Value in Alternative 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 2012-2013 *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.⁴⁵

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*.⁴⁶ 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 floodplain 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.

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. Interestingly, the term *highest price*, used by real property appraisers in the United States, is also used in Canadian business and property valuations.⁴⁷

⁴⁵ <http://commerce.appraisalfoundation.org/html/2012%20USPAP/DEFINITIONS.htm>.

⁴⁶ 279 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.

⁴⁷ "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

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 an asset should exchange on the valuation date 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.⁴⁸

It defines *investment value* as:

The value of an asset to the owner or a prospective owner for individual investment or operational objectives. This is an entity-specific *basis of value*. Although the value of an asset to the owner may be the same as the amount that could be realized from its sale to another party, this *basis of value* reflects the benefits received by an entity from holding the asset and, therefore, does not necessarily involve a hypothetical exchange. *Investment value* reflects the circumstances and financial objectives of the entity for which the

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).

⁴⁸ *International Valuation Standards, 2011* (London: International Valuation Standards Council, 2011), at 20.

valuation is being produced. It is often used for measuring investment performance. Differences between the *investment value* of an asset and its *market value* provide the motivation for buyers or sellers to enter the marketplace.⁴⁹

Similarly, the recent Toronto Valuation Accord⁵⁰ 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.

⁴⁹ *Id.*, at 23.

⁵⁰ The Toronto Valuation Accord is comprised of organizations and representatives of the valuation profession. These organizations take steps to coordinate efforts to work jointly with legislative and regulatory bodies, standards-setting groups, and other professions to aid in expediting the simplification and convergence of financial reporting standards. For more information, see the Financial Accounting Standards Board Letter of Comment Number 47. www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175818471205&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

