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Lessons Learned about Statutory Standards of Value

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Standard of value is the fundamental assumption that governs many aspects of a business valuation assignment. It is often dictated by state law and varies depending on the type of case. For example, the standard of value for marital property divisions in Arkansas is fair market value, while the standard of value for dissenting shareholder matters is fair value. It is vital for valuation analysts and attorneys to understand the legal requirements that govern how a business valuation is conducted.

Case in point: a few years ago, I performed a valuation of a noncontrolling interest in a company I will refer to as Company X. Company X had three owners – one controlling, and two non-controlling. My assignment was to calculate the price that one of the noncontrolling owners could expect to receive if he sold his interest on the open market. In other words, it was a fair market valuation.

Two years later, the controlling owner asked me to update my previous valuation report. The noncontrolling owner had recently died, he told me, and the Company needed to repurchase his ownership interest. Company X's attorney informed me that the owner's death is an event of dissociation, and therefore the redemption would be governed by Ark. Code Ann. § 4-32-602, which dictates that the fair value standard be used in determining the repurchase price. Because the earlier valuation was performed under the fair market value standard, I suspected that the updated valuation would result in a much higher price than the controlling owner expected. The reason for this expectations gap will be explained later. First, let's look at what is meant by the term "standard of value".

Standard of Value, or, Value to Whom?

Every business valuation involves making an assumption about the answer to the question: value to whom? An investor that has business synergies with a company will often pay more for that company than the price derived from the open market. If the valuation is being prepared with specific investor synergies in mind, the standard of value is referred to as investment value. If the valuation assumes an open market transaction, the standard of value is fair market value. Different standards of value can result in widely different valuations of the same business.

As noted above, Arkansas law requires the use of the fair value standard in events of dissociation and dissenting shareholder matters (Ark. Code Ann. § 4-27-1302). Despite the similar terminology, fair value is different from fair market value. A common definition of fair market value, found in IRS Revenue Ruling 59-60, is "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 relevant facts". Fair value, on the other hand, is a legal concept that is focused on fairness and equity.

Fair Value vs. Fair Market Value

The primary difference between fair value and fair market value is in the application of certain discounts. Under the fair market value standard, the analyst applies a discount for lack of marketability and, if valuing a non-controlling interest, a discount for lack of control. These discounts are applied because the market places less proportional value on a non-controlling interest in a company than a controlling interest, and less value for non-liquid shares of a closely held company compared to liquid shares of a publicly traded company.

In most states, fair value means the value of a company *without* the control and marketability discounts common in fair market valuations. Although the Arkansas Code does not provide a precise definition of fair value, Arkansas case law is helpful in deciphering the term's meaning. In *General Securities Corp. v. Watson* [1], the Arkansas Supreme Court, recognizing that there was at that time no case authority on what constitutes fair value, cited a Maryland case [2] that held that discounts should not be applied in determining the fair value for a dissenting shareholder. In a more recent case, *Winn v. Winn Enterprises* [3], the Arkansas Court of Appeals held that fair value to withdrawing owners does not include discounts for lack of control or lack of marketability. The court's decision in the Winn case includes an instructive explanation of the rationale for not allowing discounts:

> "…the individual (whether a dissenting shareholder or a withdrawing partner) is exercising a statutory right to withdraw from the entity and the entity is absorbing that interest. If discounts are applied, the entity obtains the withdrawing shareholder or partner's interest for less than that interest would be worth in the hands of the withdrawing shareholder or partner".

The court made it clear that the answer to the question "value to whom?" under the Arkansas fair value standard is the value to the dissenting or withdrawing owner.

Conclusion and Take-aways

I was correct about Company X's controlling owner's expectations gap. The previous fair market valuation included discounts for lack of control and lack of marketability. The fair value valuation did not include the discounts and, therefore, the calculated value was significantly higher. It was a challenge to explain why the Company had to repurchase the noncontrolling interest at a higher price than what the market would demand, but Arkansas courts have clearly determined that it is not equitable for a company to absorb a withdrawing owner's interest at a price that reflects lack of control and marketability discounts.

This situation illustrates how important it is for business valuation analysts to understand the applicable legal statutes and case law. Similar questions of law arise in economic damages matters, marital dissolutions, bankruptcies, and transfer tax reporting. Attorneys should also strive to understand business valuation concepts sufficiently to ensure that laws are being properly interpreted and applied in each situation. Open communication and collaboration between attorney and analyst should occur early in the process so that the valuation is conducted correctly in light of relevant law and the facts of each case.

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[1] *General Securities Corporation v. Lavon V. Watson, et al* (251 Ark. 1066, 477 S.W.2d 461 (1972))

[2] *American General Corp. v. Camp* (171 Md. 629, 190 A. 225 (1937))

[3] *Winn v. Winn Enterprises, Limited Partnership,* et al. (No. CA 06-1375 (2007))

The AADC wishes to thank Clay Glasgow of JPMS Cox PLLC for writing this article.

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