

Who Ever Said Fair Market Value?

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The opinion from *In re Marriage of Hagshenas* (1992) subtly betrays a dormant, yet provocative issue in Illinois marital dissolution law.¹ In *Hagshenas*, testimony was given regarding the value of a travel agency to the husband as well as to a third party. To choose between such values, an answer is required of the question: *value to whom?* Business valuation experts refer to this question's answer as the *standard of value*. The Appellate Court upheld the trial court's determination of value more closely aligned with that of a third party sale. Although the reasoning behind the adjudicated value is uncertain, the familiar message resulting from it is clear: fair market value (the value to a third party) is the standard of value for privately held companies under Illinois marital dissolution law.

But why? The statute never requires fair market value, nor uses the term. And although case law supports fair market value, no reason appears to have ever been given or advanced.² In our review of case law, both concerning marital dissolution and other laws governing cited precedent, there is an absence of discussion, controversy, debate, or consideration regarding the appropri-

ate standard of value.

Having been consistently neglected, commonly misunderstood, and rarely questioned, the standard of value for privately held companies under Illinois marital dissolution law deserves examination. This article addresses this issue by examining the following questions:

- What exactly are standards of value?
- How does the standard of value impact a valuation expert's conclusion?
- Why is Illinois a "Fair Market Value" state?
- Hypothetically, if the marital dissolution statute and case law are silent on the appropriate standard of value, what theoretical arguments can be made for and against the various standards of value?

What exactly are standards of value?

A standard of value is a definition of the type of value being sought. Although various deviations and permutations exist, conventional business valuation theory effectively recognizes two primary standards of value: fair market value and investment value.³ Fair market value equals value to a *hypothetical* willing buyer and a *hypothetical* willing seller, each possessing reasonable knowledge of the facts, acting under their own volition, and having the means to effectuate such a transaction. Accordingly, fair market value is best evidenced within an efficient marketplace, defined as an active market of buyers and sellers absent of agency costs, preferential financing, or other outside influences that would give either the buyer or seller an undue advantage over the other. In the absence of an active marketplace of *actual* sales, fair market value is a reflection of the price at which a transaction *would* occur between a willing buyer and a willing seller.

Investment value, on the other hand, constitutes value to a *particular* investor or group of investors. Investment value may encompass synergistic value, or value to a particular individual or entity resulting from expected synergies such as cost savings or revenue enhancement. It may also include value to the present owner without the expectation of a sale. Thus, while investment value defines value as that to a particular investor, it does not specify *which* investor.

Any other proposed standards of value are simply variations or combinations of the existing standards. They would result from judicial or statutory fiat, and not the marketplace.

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How does the standard of value impact a valuation expert's conclusion?

The difference between fair market value and investment value can be dramatic in divorce settings. The following four hypothetical scenarios illustrate how using different standards creates differences in perceived value.⁴

Bressler Brothers, Inc., a retail store for formalwear, is equally owned by three brothers. Relationships between the brothers are excellent and they always act in concert with each other. If one brother entered divorce proceedings, how would his 1/3rd equity interest be valued? Under fair market value, a hypothetical buyer, recognizing the likelihood of the remaining two brothers unilaterally controlling the business, would pay an amount net of a discount for lack of control. This could be substantially less than the equity interest valued under the standard of investment value. If investment value was measured as value to the current shareholder, no such discount would be warranted since the current shareholder is effectively able to exercise control (in conjunction with his brothers).

How about a situation involving two equal ownership interests? Two unrelated individuals each own 50% equity interests in Dearborn Distribution Corp. Under a fair market value standard, the value of each equity interest would demand, to some degree, a discount for lack of control in the purchase price (since a 50% equity interest has the ability to block, but not exercise, control). But what if, realistically, the buyer of the interest will be the owner of the other 50% equity interest? Under fair market value, this would merit consideration but would not dictate the final determination of value. In contrast, an investment value standard could value the interest to the other owner (buyer). Since the remaining owner would then possess 100% of the business, with full control, no discount would likely be paid.

The differences between each standard do not solely relate to the acceptance or rejection of discounts for lack of control. Consider the situation of Nanotechnology Endeavors, wholly owned by an individual. The fair market value standard often assumes a transaction involving a financial buyer. But what if a strategic buyer (i.e., a buyer that perceives the development of significant synergies with an acquisition), such as NanoFuture, Inc., is the likely buyer? Such a transaction would

likely occur with a higher purchase price. Accordingly, fair market value may preclude a valuation based upon an anticipated synergistic transaction occurring subsequent to a marital dissolution proceeding.

Finally, consider the podiatry practice of Dr. Foot. A large part of the value of any professional practice is often related to the practitioner's ability to attract and retain clients based upon the individual's skills, expertise, reputation, etc. Dr. Foot's loyal customers refer other patients to Dr. Foot based on her medical skill and personal skills. These visits translate into profits, and based upon her income, the practice is worth a considerable sum to her (investment value), but substantially less to an unrelated buyer (fair market value) due to the buyer's uncertainty regarding his or her ability to retain the current cash flow stream (i.e., the ability to retain and attract clients) post-transaction.

While these scenarios highlight the importance of the standard of value, they are academic exercises if state law requires a particular standard. Such does not appear to be the situation in Illinois.

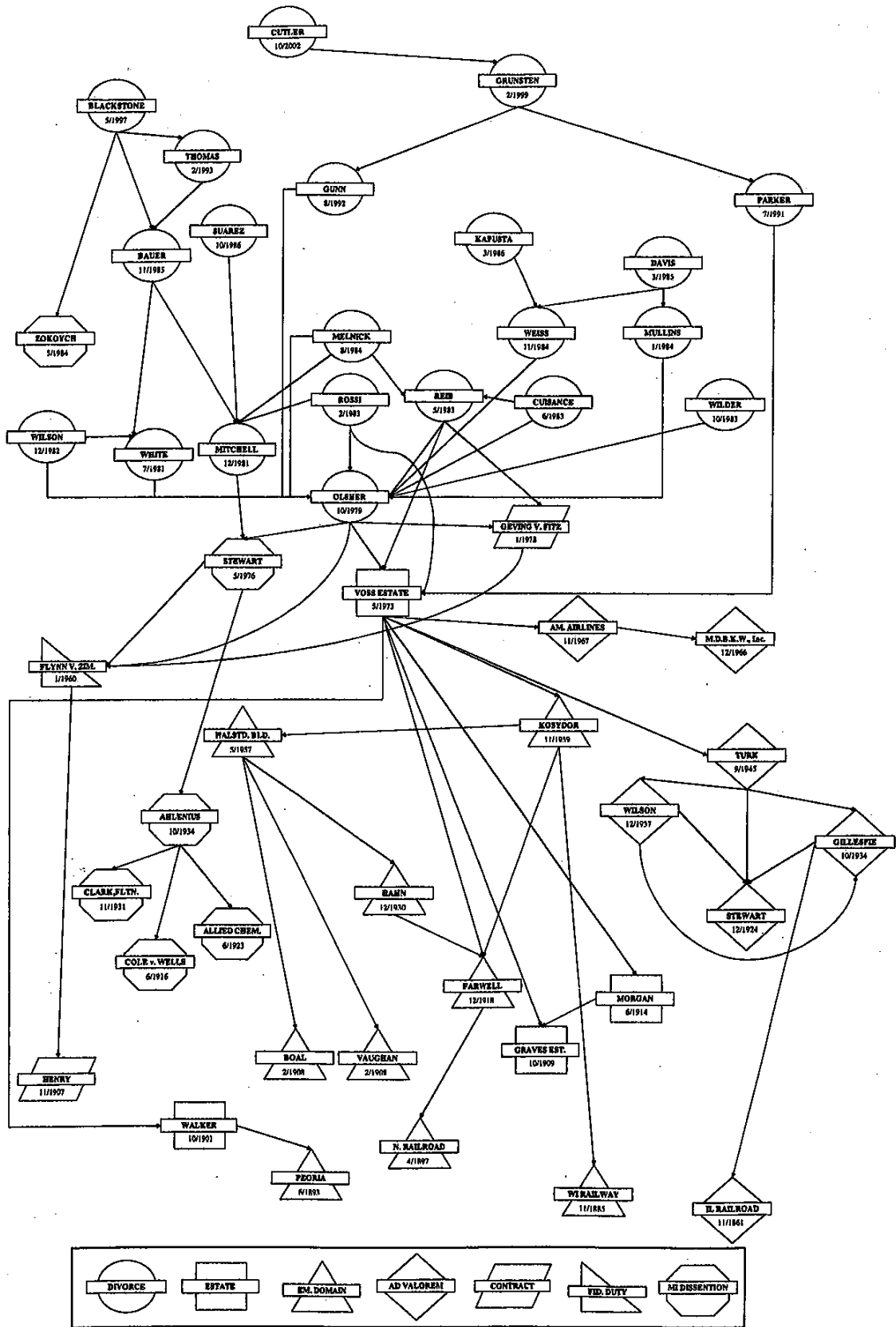
Why is Illinois a "Fair Market Value" state?

The statute merely uses the term "value" without offering a definition. Since the law is vague, case law on its interpretation is pivotal. Our research of case law, depicted in the attached diagram, failed to reveal a landmark opinion discussing the matter and concluding on fair market value as the appropriate standard. The lack of such an opinion is underscored by the following various terms and phrases used when assessing the "value" of a privately held company:

- | | |
|--------------------------|----------------------|
| • Fair Value | • Fair Cash Value |
| • Market Value | • Real Market Value |
| • Actual Value | • Fair Net Value |
| • Value | • Market Price |
| • Market-Quotation Value | • Intrinsic Value |
| • Fair Cash Market Value | • Fair Selling Value |

The misuse and misunderstanding of the term "market value" provides an excellent example of the usefulness (or lack thereof) of case law in establishing guidance as to the appropriate standard of value. In various opinions, the use of the term "market value" alternates between representing a valuation methodology (e.g., using market-based data such as sales of comparable assets or the trading of the subject company's shares on

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an exchange) and a standard of value (e.g., fair market value) (see *Stewart v. D.J. Stewart & Company* [1976], *Flynn v. Zimmerman* [1960], and *Henry v. North American Ry. Const. Co.* [1907]).⁵ Additionally, "intrinsic value" is often used as equivalent to fair market value (see *Ahlenius v. Bunn & Humphreys, Inc.* [1934], *Cole v. Wells* [1916], and *Henry* [1907] among others).⁶

Despite the misuse and misapplication of terminology, the path of case law can still be discerned. Since the enactment of Illinois' latest marital dissolution statute, almost all citations regarding the standard of value for a privately held company identify *In re Marriage of Olsher* (1979) as precedent.⁷ So what does *Olsher* state? Ironically, it defers to an Illinois estate decision for the determination of the standard of value.

From this estate decision, *In re Estate of Voss* (1973), the precedent tree branches out to the laws of eminent domain, contract, and ad valorem taxation as well as other estate opinions.⁸ *Voss* states:

The term "market value" has been considered by this court on several occasions in different situations and has been held to refer to the value of property as determined by the market place. It is the price which a willing purchaser will pay to a willing seller in a voluntary transaction.

In turn, these cases, as well as their citations, omit any declaration of, or reasoning behind, the chosen standard of value until you come to several well-aged eminent domain opinions. In *The City of Chicago v. Harrison-Halsted Building Corporation* (1957), the Illinois Supreme Court stated that "in determining fair cash market value, no account is to be given to values or necessities peculiar to the owner or the condemnor."⁹ Likewise, *The Forest Preserve District of Cook County v. John Hahn* (1930), also decided by the Illinois Supreme Court, stated that:

*The market value of property, under the Eminent Domain act, does not mean the value to the owner or to the purchaser, but the value of the property on the market.*¹⁰

Accordingly, we find the standard of value under Illinois marital dissolution law derives from other Illinois laws and their related opinions that deal with different assets (primarily real estate). Fair Market Value, through the courts' omission of examination, has been adopted as the standard of value in Illinois family law.

In light of the situation of case law precedent without underlying rationale, what should be the standard of value? In other words, if we consider Illinois marital dissolution law as a *tabula rasa*, what non-legal arguments could be made for and against each standard of value?

What theoretical arguments can be made for and against the various standards of value?

Arguments for an investment value standard

As noted, while investment value defines value to a particular investor, it does not specify which investor. Accordingly, the primary advantage of the investment value standard is its flexibility. This inherent flexibility allows for the standard to address two fundamental characteristics of valuation for marital dissolution purposes: the unlikelihood of a transaction and the concept of overall fairness.

In most divorces, the recipient of the marital estate's interest in a privately held company has no intention of selling. Oftentimes, an equity interest in a company simply cannot be sold either due to legal restrictions (e.g., a law practice) or contractual limitations (such as a buy/sell agreement which forbids transfers). Accordingly, if the company will remain in the hands of the current owner, why shouldn't value be assessed from this owner's standpoint?

The concept of overall fairness permeates Illinois marital dissolution law. If a fair market value standard would yield a lower valuation (such as in the scenarios discussed above), would its use be fair despite the unlikelihood of a sale (which fair market value assumes)? Since property divisions are intertwined with maintenance and support decisions, would a lower assessed value on a business compound an unfair decision by also lowering maintenance and support?

To avoid different determinations of which investor by different courts, criteria could be established based upon facts and circumstances. Therefore, the flexibility of the standard would be prevented from devolving into infinite interpretations.

Arguments for a fair market value standard

Supporters of the fair market value standard could offer two key arguments. First, why should privately held companies be valued under an investment value standard, but all other property be based upon fair market value? Such inconsistencies could lead to problems. For instance,

should investment value also be attributed to Chicago Bear's season tickets owned by a life-long fan, or to a spouse with sentimental feelings towards the family residence? In both cases, the value to a specific owner is arguably higher than the value to a hypothetical buyer that does not possess such deep-rooted partiality. However, these possibilities could set aside objective valuation standards, and open up a Pandora's Box of subjectivity.

Second, why is flexibility required? Investment value proponents cite the fundamental characteristics of the unlikelihood of a transaction and the concept of overall fairness. But why is the possibility of a transaction germane? Valuation is commonly assessed under a fair market value standard for numerous purposes (for example, estate and gift planning, damage calculations, ad valorem taxation, etc.) without any contemplation of a sale. In regard to the concept of overall fairness, valuing a privately held business under fair market value does not preclude the fair and equitable dissolution of a marriage. If a disparity in values under each standard violates an equitable distribution, accommodations can be made in the division of other marital property as well as in the calculation of maintenance and support. Also, the argument that investment value is appropriate in the interests of fairness often considers what is fair mostly from the perspective of the non-owning spouse. But what about a situation where the business has to be sold several years after the marital dissolution? If the owner receives a price corresponding to fair market value, would this be fair to the owner after having formerly paid a property settlement based on an (presumably higher) investment value standard?

Ultimately, proponents of the fair market value standard ask: what can be fairer than the price which could be realized if the property was sold?

Conclusion

Proponents of both standards bring excellent opinions and theoretical arguments, otherwise a controversy would not exist. But the law should entail a definitive and consistently employed standard of value. Case law lacking foundation and precariously built can fall from force of argument. The time is ripe for attorneys to challenge the standard of value under Illinois marital dissolution law.

¹ *In re Marriage of Hagshenas*, 234 Ill. 3d 178;

600 N.E.2d 437 (1992).

² As developed later in this article, the standard of value should have been discussed and debated either contemporaneously with or prior to the *In re Marriage of Olsher* (1979) decision. Accordingly, our comments on case law should not be interpreted as a critique of recent judicial decisions.

³ A third commonly recognized standard of value, Fair Value, does not exist within theory or the marketplace, but rather resides solely within statutes and case law and consists of some derivation of one, or both, of the two noted standards.

⁴ As intrinsic value, as defined above, does not lend itself well to marital dissolution matters, the illustrations and the remainder of this article only concern investment value and fair market value.

⁵ *Stewart v. D.J. Stewart & Company* (1976) 37 Ill. App. 3d 848, 346 N.E. 2d 475; *Flynn v. Zimmerman* (1960) 23 Ill. App. 2d. 467, 163 N.E. 2d 568, and *Henry v. North American Ry. Const. Co* (1897) 158 F. 79.

⁶ *Ahlenius v. Bunn & Humphreys, Inc.* (1934) 358 Ill. 155, 95 A.L.R. 913 and *Cole v. Wells* (1916) 224 Mass. 504, 113 N.E. 189.

⁷ *In re Marriage of Olsher* (1979) 78 Ill. App. 3d 627, 397 N.E.2d 488, 34 Ill. Dec. 32.

⁸ *In re Estate of Andrew Voss* (1973) 55 Ill. 2d 313, 303 N.E. 2d 9.

⁹ *The City of Chicago v. Harrison-Halsted Building Corporation* (1957) 11 Ill. 2d 431, 143 N.E.2d 40.

¹⁰ *The Forest Preserve District of Cook County v. John Hahn et al.*

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