

Fair Value Versus Fair Market Value: Dissenting Shareholders and Minority Oppression Valuations

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Fair value is typically the standard of value applied in measuring the value of an organization for the purpose of a dissenting shareholder or minority oppression action. Fair value has long been a standard of value that is interpreted at the state judicial level, through case precedence, due to the lack of uniform direction in applying the standard through regulations or statutory laws. Interpretations of fair value have varied from state to state, as well as the acceptance of applying a marketability or minority discount to derive fair value. Due to the varying definitions of fair value and the limited guidance of application of those definitions in GAAP, the Financial Accounting Standards Board (FASB) has released Statement of Financial Accounting Standards (SFAS) No. 157, effective for financial statements issued for fiscal years beginning after November 15, 2007. It was the FASB's intention that SFAS No. 157 increases consistency and comparability in fair value measurements for financial reporting. As a valuation practitioner, it is important to understand the differences in the standard of fair value versus fair market value and also to understand how the valuation methodologies in both standards of value differ.

How the Standard of Fair Value Differs from Fair Market Value

Fair Market Value

Fair market value is the most commonly used standard of value relating to business valuation. The definition of fair market value as defined in the Internal Revenue Code and Ruling 59-60¹ is as follows,

“the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.”

It is clear that fair market value is a market based transaction, which takes into consideration both the buy and sell side of the transaction. We will see that what distinguishes the fair market value standard from the fair value standard in valuation is that consideration of the buy side of the transaction is eliminated in determining fair value, expected appreciation or depreciation of the value past the measurement date are not factored into the fair value measurement, and discounts and premiums are also largely disregarded.

¹ Internal Revenue Ruling 59-60, 1965-2 C.B. 370

Fair Value

Fair Value is defined as the price a buyer might reasonably expect to pay and a seller might reasonably expect to receive for the subject property, assuming:

- That the subject property is held for sale on the open market for a reasonable period.
- That both the buyer and seller are in possession of all pertinent facts.
- Neither the buyer nor seller is under any unreasonable compulsion to act, and,
- That no adjustment shall be made for the non-control status of the subject block of shares.

This definition incorporates the following assumptions:

- The prospective purchaser is prudent and profit seeking, and without synergistic benefit.
- The business would continue as a going concern and not be liquidated.
- The business would be sold for cash or cash equivalent, and
- The business would be held on the market for a reasonable period of time.

Fair value has been clarified further by the Revised Model Business Corporation Act (RMBCA or the Model Act). This act has been adopted by the American Bar Association's (ABA) Committee on Corporate Laws and recommended by the ABA's Section of Business Law. It serves as a model for many state legislatures in their creation of statutes concerning the rights of objecting shareholders to fundamental Corporate changes and certain exchanges of shares.

In a fair value computation, the value of the corporation's shares will be determined:

- Immediately before the effectuation of the corporate action to which the shareholder objects.
- By using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring valuation, and
- Without discounting for minority status.

For many valuation practitioners the definition of fair value is so close to fair market value in nature that differences in the intended use of the standard of fair value has been confusing. This fuzzy distinction between the two standards of value may be the leading cause of erroneous assumptions made in valuations in which fair value is the standard. Discounts for marketability and minority shareholders have been an especially troublesome issue when deriving fair value.

There are differences in the two standards of value, which dramatically effect the valuation. Not adjusting the non-control status of the subject block of shares increases the value of the shares over the typical non-controlling discount taken on a fair market valuation. Disregarding the effects of the corporate action on the value also protects the value for the seller. This is not typically a consideration for fair market value. Also very important is the lack of a discount for minority status as imposing a minority discount on compensation payable to dissenting stockholders for their shares in proceeding under CLS Bus Corp. Section 623 or Section 1118 would necessarily deprive minority shareholders of their proportionate interest in a going concern, and would result in minority shares being valued below that of majority shares, thus violating mandate of equal treatment of all shares of same class in minority stockholder buy-outs.

Fair Value For Financial Reporting

Previously, fair value was defined in various pronouncements by the FASB, which required or permitted the use of fair value. There was no single pronouncement from which to derive a clear understanding of fair value. SFAS No. 141 defined fair value as

“the amount 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.”

This definition for fair value is similar to Internal Revenue Regulation 59-60, as defined previously. Both sides of the transaction are considered in the fair market standard of value and it would seem that both an exit price and an entry price are taken into consideration when developing a fair value measure when using SFAS No. 141 as guidance. However, this notion becomes obsolete with the release of SFAS No. 157. SFAS No. 157 retains the exchange price notion as defined in earlier definitions but is expanded upon to more clearly define 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.”

Fair value is a market based measurement, not an entity based measurement, which is based on the exit price, which would be received to sell an asset, or paid to transfer a liability. Fair value is focused on one side of a market based transaction, that of the seller. The buy side of the transaction is not considered in fair value as it is considered in fair market value. The reasons for this become clear when we discuss the transactions in which fair value are applied to the practice of valuation.

Discounts for Marketability and Minority Ownership

Fair Market Value

Publicly traded shares, are by definition, minority interests. Though minority interests do have varying levels of control, the elements of control may reduce but rarely eliminate the discount for lack of control. The level of this discount is dictated by the level of control the minority shareholder does or does not have. A review of the company's articles of incorporation and bylaws can shed light on the overall subject company's relative rights of non-controlling and controlling ownership interests.²

Marketability is a term used to describe the ability to quickly convert the business ownership interests to cash at the investor's discretion. In the capital markets, a non-controlling owner can quickly convert their share ownership to cash by selling the stock to an active market of buyers within seconds. In contrast, a non-controlling ownership interest in a privately held company is more time consuming to convert due to the limited pool of investors willing to purchase the investment. On top of that, there are fees paid to brokers to find a buyer and conduct the transaction. Computing a discount for lack of marketability is generally facilitated by restricted stock studies as the IRS specifically recognized the relevance of restricted stock transaction data as evidence for quantification of the discount for lack of marketability in Revenue Ruling 77-287.³

Fair Value

Discounts for marketability or lack of control have generally been disallowed as they further oppress minority and dissenting shareholders and enable controlling shareholders to indirectly accomplish what they cannot accomplish directly.⁴ Courts have varied in their rulings as to the reasons for overruling these discounts but they tend to err against them. SFAS No. 157, though created for financial reporting purposes, gives some clarity on the use of marketability discounts as the standard states

“ The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs

² Valuing a Business: The Analysis and Appraisal of Closely Held Companies, by Shannon Pratt with Alina V. Niculita, McGraw Hill, NY, Pg.

³ Revenue Ruling 77-287, 1977 2 C.B. 319

⁴ Offenbecher v. Baron Service, Inc., 2001 WL 527522 (Ala. Civ. App. 2001)

are not an attribute of the asset or liability; rather they are specific to the transaction and will differ depending on how the reporting entity transacts.”

State Statutes

The definition of fair value can vary from state to state. Judicial decisions have varied, even among courts within the same state. It is prudent to review the statutes of the state in which you are practicing. Upon reviewing the statutes, you will have a more clear idea of what the court will find acceptable. Texas state statutes are presented .

Texas State Statute Article 5.12. Procedure for Dissent by Shareholders As Said to Corporate Actions state

“ The fair value of the shares shall be the value thereof as of the day immediately preceding the meeting, excluding any appreciation or depreciation in anticipation of the proposed action. In computing the fair value of the shares under this article, consideration must be given to the value of the corporation as a going concern without including in the computation of value any control premium, any minority discount, or any discount for the lack marketability.”

Texas state statute makes clear that valuation practitioners performing valuations, for the purposes of dissenting shareholders, should not apply premiums or discounts to the measurement of fair value. Researching your state statutes and case precedent will assist you in more confidently performing your valuation.

Conclusion

Though it is recognized that fair value and fair market value transactions in valuation consider both the sell and buy side of the transaction, fair value emphasis the value of the seller. While fair market value takes into consideration value expectations of both sides of the transaction, each side acting without compulsion to derive a market value that is satisfactory to both sides, fair value is focused on the seller, specifically the dissenting shareholder and the oppressed minority shareholder. Avoidance of discounts and premiums along with disregarding corporate actions, which may have a future impact on the value of the stock, bring the highest value to the seller. A fair market transaction would settle on a value which considers all applicable discounts and premiums and also considers the future effects of a corporate action on the value of the stock.