

# Fair Value VS. Fair Market Value

## IS THERE A PLACE FOR FAIR VALUE IN MARITAL DISSOLUTION?



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## **Introduction**

Previously, the concept of “fair value” has been limited strictly to shareholder oppression or shareholder rights matters. State law - including family statutes - typically does not define fair value, other than in the dissenters’ rights statutes. Recently, however, family law practitioners have attempted to value business interests for marital purposes using the fair value standard.

## **What is the Fundamental Difference?**

The standard of value drives the ultimate valuation of any asset. Currently, the most widely used standard is fair market value, which is required for any tax or other federally mandated valuations and is widely accepted as the standard for marital dissolutions. Fair value is a creation of state legislatures and was designed to be applied to shareholder oppression actions. The definition and application of the fair value standard varies widely from state-to-state.

The most basic difference between the valuation of an ownership interest under the fair market value standards and valuation under the fair value standard is the consideration and application of discounts or premiums relating to majority, minority, and marketability. Under most fair value standards, minority and marketability discounts are either limited or not applicable. So why the move from the widely accepted and understood fair market value standard to the less frequently used fair value standard? Quite simply, in most instances, the fair value of a minority, non-marketable ownership interest is higher than the fair market value of the same ownership interest.

## **Guidance from the Courts**

The movement to create a “divorce value” or “fair value” for marital proceedings has slowly moved across the country from the east coast to the west. *Bown v. Brown*, was probably the most clear statement from a Court regarding the use of fair value in a family law context.<sup>1</sup> I have argued both at the trial court level, as well as in writings and presentations that the use of “fair value” or a newly defined “Divorce value” presents a distortion of the value of an asset that is part of the marital estate.



The Colorado Supreme Court rendered a decision on the concept of fair value in a dissenters' rights matter in *Pueblo Bancorporation v. Lindoe, Inc.*<sup>ii</sup> This decision provides guidance on the difference between fair value and fair market value.<sup>iii</sup> Close examination of this case points out the difficulties that arise with the use of fair value in determining the value of a business interest.

The sole issue in the case was whether the dissenting shareholders' shares should be discounted for lack of marketability. The parties agreed on the value of the shares prior to the application of discounts. The court explained that the dissenting shareholder rights statutes provide detailed procedures that ultimately result in the filing of an action to determine the appropriate value of the dissenting shareholders' shares.

In the ruling, the court concluded that "the meaning of fair value is ambiguous. It is a term that does not have a commonly accepted meaning in ordinary usage, much less in the business community." Their comment was footnoted to the testimony of Leslie Patten (one of the experts in the case), who stated that "fair value has no common meaning." In his view, the term is "judicially ambiguous," a legal standard of value, not a "recognized business valuation standard of value."<sup>iv</sup>

The court went on to state, that fair value must a "definitive meaning" and that prior Colorado appellate courts had not provided a consistent interpretation of fair value, particularly on the issue of discounts. The court also pointed out that the legislature chose the term fair value for dissenting shareholders for a reason, and that it must therefore mean something different than fair market value. If the legislature had wanted to provide for dissenting shareholders to receive fair market value for their shares, "it knew how to provide it: the phrase has been used many times in a wide variety of statutes."

The court further commented that in the 60-year history of Colorado's dissenters' rights statute, the measure of compensation has changed from 'value' to 'fair value', but the legislature has never required that dissenters be paid fair market value for their shares. With the *Pueblo* case, the Colorado Supreme Court made a clear distinction between fair value and fair market value in the dissenters' rights arena.



## The Argument for Fair Value in Divorce Matters

Those advocating the creation of a new valuation standard for divorce choose to follow the fair value standard and argue that the breakup of a marriage is similar to a shareholder objecting to a corporate transaction, being oppressed, or being forced out by the majority. On the surface, this seems to be a compelling argument, but when viewed in an economic light, the shareholder analogy is not really accurate.

Unlike a shareholder dispute, the breakup of a marriage normally does not impact the day-to-day operations of the business. In fact, most of the fair value proponents make that very argument, that is, that the corporation operates the same on the day after the divorce as it did the day before. That is precisely why a fair value standard should not apply. The entity is not fundamentally changing the way it does business. No one is objecting to a business transaction. No shareholder is being oppressed or squeezed out.

## Fair Value Standard Unfair to Propertied Spouse

What is the justification for applying a seldom-used standard versus one that has been in place for over 50 years? Why should we apply a valuation standard that will yield a higher value conclusion than what the owner can achieve without as a shareholder oppression action? **Judge Courlis** raised that very issue as a concern in her dissent, namely, that one of the parties would reap a windfall, rather than the value that reflects an arm's-length transaction, taking into consideration the investment's illiquidity.

Fair value proponents also argue that the non-propertied spouse is not a "willing seller," and therefore the fair market value standard cannot apply by definition. This is another specious argument. The reality is that the ownership is not being sold, but the fair market value standard assumes a universe of willing buyers and sellers a one of the foundations for the methodology. The fair value proponents further argue that there will be no sale, and therefore any marketability or minority interest is fictitious and/or remote. But an imminent sale is not necessary for a valuation. For gift and estate tax purposes, this hypothetical exercise is conducted every day, with no expectation of a sale, and in fact, the fair market value standard is required for all tax valuations.



Last, the proponents imply that a fair value standard is fairer to the non-propertied spouse, No empirical evidence suggest that the creation of a new standard will be any fairer than the proper application of existing standards and methodologies. The corollary is whether fair value is also fair to the propertied spouse. The fair value proponents do not address this issue. Why? Because it is inherently unfair to the propertied spouse.

## **The Unintended Consequences of a New Standard for Divorce**

Let us assume, for the sake of argument, that for divorce purposes and only divorce purposes that a new standard of value should be adopted, and that the appropriate standard of value is fair value. What dichotomies does this create? How do we reconcile the conflicting outcomes? If we had to complete a valuation the day before the divorce, or the day after divorce, for tax purposes or other federally mandated purpose, the most likely required standard of value would be fair market value. If, on the day of the divorce, we had to apply a "fair value" or "divorce value" standard, it is most likely that this value would be higher than the fair market value requirements. Is it appropriate for one spouse to compensate the other using a value that cannot be achieved in an arm's-length transaction?

Should we apply this same fair value standard to any publicly traded stock held by the parties? The general consensus in the business valuation community is that, by definition, publicly traded stock is valued on a minority, marketable basis. Since the fair value standard would allow no minority discount, must we then increase the value of the public stock holdings to remove the implicit minority discount? If not, what is the rational for treating closely held investments differently from publicly held investments?

**Alan Zipp**, a leading proponent of the creation of a new standard of valuation for divorce, has admitted that the larger the closely held entity, the less appropriate is fair value, as opposed to fair market value. What increment of size triggers that distinction, and how do we measure it? Is the size differential based on revenues, profits, or market capitalization? Why can we apply fair market value standards to any size valuation, but fair value will cease to be relevant when an entity reaches a certain size? Is this a standard only for small divorces? What is a small marital action?



## The Argument for Fair Market Value

Fair market value has been used for more than 50 years. Every major business valuations professional association, the federal government, and most states agree on the definition of fair market value. In the *Pueblo Bancorporation* decision, the court noted that a number of Colorado statutes use the term fair market value. Fair value is used only in the dissenting shareholders' rights statutes. Myriad judicial decisions discuss fair market value in detail, as well as address the issue of discounts and premiums for marketability and minority/control. Fair market value can be applied to any business of any size. Many generally accepted methodologies can be followed to determine the fair market value of a business interest.

Despite all the collective years of practitioners' and courts' experience in applying and refining fair market value, the ultimate conclusion of value remains subjective. The experience, judgment, and reasonableness of the valuation professional all impact the ultimate conclusion. Two very competent analysts can reach different conclusions on the same engagement. However, competent valuation professionals can describe the difference in their methodologies or assumptions and can reconcile (or at least compare) the different conclusions.

What would be gained by creating a new fair value standard? Would any of those potential differences be eliminated? Some might argue yes, that the discounts for minority and/or lack of marketability would no longer be part of the calculation. That is naïve. A fundamental theory of business valuation says that the rate of return required by an investor is directly impacted by the perceived risks of the investment. Removing any discounts for the risk of illiquidity, or of being in the minority does not change that theory. If the risk involved with being a minority owner, or holding non-marketable stock is not recognized as a separate and distinct item (such as a discount for minority or marketability), then the investor will recognize that risk somewhere else, perhaps in the capitalization rate.

We cannot legislate an increase in the value of an interest in a closely held business simply by saying that minority and marketability discounts cannot be applied.



As **Judge Courlis** stated in the *Pueblo Bancorporation* decision, investors are going to account for the illiquidity of the stock when they buy minority shares in a close corporation. If this is the reality of the marketplace, doesn't it seem logical that the fair market value standard should apply to dissolution of marriage matters?

## **The Real Issue is Competent Valuation Conclusions**

The argument most widely advanced by fair value proponents is that using fair market value and allowing discounts for minority or marketability undervalues the ownership interest in the divorce context and engenders additional argument over the appropriate size, if any, of those discounts. The fair value proponents' undervaluation argument considers only the viewpoint of the spouse who will not be retaining the business interest.

If the rationale of *Pueblo Bancorporation* is applied to marital litigation, no minority or marketability discounts can be taken from the pro-rata value of the entity. Doubtless, under this application, the fair value of a business interest will never be less than the fair market value of the same interest and will almost always be substantially greater. If the only concern of the fair value proponents is undervaluation of business interests in marital litigation, their proposal does not solve the problem.

It is not so much the standard of value that under or overvalues an ownership interest, but the competence and independence of the valuation professional. Applying inappropriate and unsupported discounts, for example, has far greater impact on the value conclusion than any other item. There is no "normal" discount for marketability or minority. The appropriate discount is determined by careful analysis of the subject entity.

While it is true that a fair value standard eliminating these discounts conveniently makes that issue disappear, it does nothing to demonstrate that the ultimate valuation conclusion is appropriate. It appears that using fair value is a way of "dumbing down" the valuation process. We might remove difficult issues, but that doesn't make the process better. In fact, we even complicate matters if we need to quantify the real risk in another way.



## Conclusion and What Should Appraisers Do?

Either the legislature or judiciary should clearly state that fair market value is the appropriate standard of value for marital dissolution matters. Today, we have guidance from a recent Colorado case, which I believe to be the first family law matter to directly address this issue. In August of 2008, the Colorado Court of Appeals handed down a decision in the marital dissolution matter of Thornhill v. Thornhill.<sup>v</sup> In their opinion, the Court of Appeals specifically stated that the "fair value" language that was the basis of the Pueblo Bancorporation litigation is not contained in the dissolution statutes of the State of Colorado. The Court also declined to adopt the holdings of Brown v. Brown regarding using the shareholder statutes as part of marital litigation. The Court went on to state "We are instead persuaded by the decisions of numerous other jurisdictions that have concluded marketability discounts may be applied in valuing shares in closely held corporations in dissolution proceedings. Such a discount would be applied to reflect the fact that shares of stock in such corporations are less marketable than publicly traded stock, a factor that an ordinary buyer would take into consideration in deciding what to pay for the shares."<sup>vi</sup>

Furthermore, expert witnesses need to apply the fair market value standard consistently. Valuation conclusions must meet the minimum requirement of expert testimony. Valuation reports and/or testimony should demonstrate reasonable, well thought out, and supported assumptions; appropriate financial statement adjustments; and proper determinations of the appropriate capitalization rates.

In addition, the valuation professional owes the court a cogent discussion of any discounts taken for minority and or marketability and why those discounts are appropriate for the case at hand. It is the responsibility of the valuation professional to provide independent expert opinion to the court, and not to become an advocate for a specific side in the litigation. Over the last 15 years or more, the business valuation profession has changed dramatically, becoming more sophisticated and relying more on empirical data.

With an agreed standard of value and a common use of the business valuation body of knowledge, business valuers still might not agree on the value of a specific business interest. However, they can reconcile their differences and explain them to all of the parties, as well as to the judge.







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<sup>i</sup> Brown v. Brown, 792 A.2d 463 (N.J. Super. Ct. App. Div. 2002)

<sup>ii</sup> *Pueblo Bancorporation v. Lindoe, Inc.*, 2003 Colo. LEXIS 53 (Colo. Jan. 21, 2003) (*en banc.*)

<sup>iii</sup> The decision covers only dissenters' rights but is used here to illustrate the difference that could arise in a marital litigation context.

<sup>iv</sup> See footnote 4 to the decision.

<sup>v</sup> Thornhill v. Thornhill, Colorado Court of Appeals No. 07CA1654 (Mesa County District Court No. 05 DR 1025) Announced August 21, 2008.

<sup>vi</sup> Page 10, & 11, of the Thornhill decision.

