What's Fair About Fair Market Value?

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Imagine a situation in which your clients are divorcing, and the wife is a successful psychologist. For the sake of the example, assume further that her practice is so successful that she earns over $500,000 annually in her practice, much higher than the industry benchmark of $250,000 for solo practitioner psychologists with her level of education.

In a divorce in Washington State, attorneys should be aware of when and how Washington’s “fair value” standard might come into play in determining the value of a privately held business. In certain situations, fair market value (FMV) and fair value analyses will result in significantly different conclusions and attorneys who are unaware of the application of fair value may advise their clients to accept a value for their business interest far below what could be awarded.

Definition of Value

In business valuation, appraisers are most often engaged to determine value under the fair market value standard. Fair market value (FMV) is defined by the American Society of Appraisers as:

“The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”

Although FMV is the standard of value in a marital dissolution context in many states, in Washington, the fair value standard is used. Unlike FMV, there is no commonly accepted definition for fair value. In the AICPA’s published SSVS,[1] it is noted that, “for state legal matters only, some states have laws that use the term fair value in shareholder and partner matters. For state legal matters only, therefore, the term may be defined by statute or case law in the particular jurisdiction.”

In dissenter’s rights actions in Washington State, courts determine the “fair value” of the shareholder’s interest, as opposed to the “fair market value.”[2] In Washington, for the purpose of a shareholder oppression suit, it is agreed that "fair value" does not include a discount for minority status.3

"Fair value" is not synonymous with "fair market value."4 While FMV is *relevant* to determining fair value, the circumstances of a particular case are essential to determining fair value.

If the parties are getting divorced and they own 100 percent of a profitable enterprise, the application of fair value versus FMV will most often not come into play because the FMV of a 100 percent ownership interest in a profitable business is often equal to fair value.

However, in certain cases, identification and recognition of the fair value standard is critical to arriving at the correct value conclusion for the client.

Example # 1: The Professional Practice

Let's return to the example of a wife's thriving psychology practice. Fair market value (FMV) and fair value analyses will result in significantly different conclusions in this case.

In determining FMV, most would agree that the "asset approach" to valuation should be applied, which assigns value to the tangible assets minus liabilities. In this engagement, tangible assets would include cash, accounts receivable, and likely computers, desks, and furniture, net of liabilities. However, the value would not include any intangible value, or "goodwill," for the simple fact that her patients and files are confidential. It would violate HIPAA5 and her ethical standards to disclose this information; therefore, there is no *open and unrestricted market* for selling it to a third party. The existence of her above-benchmark level of compensation establishes that there is goodwill value, but under the FMV standard, there is no market for selling this goodwill.

In contrast, using fair value in the State of Washington, the court would likely assign value to the practice in the hands of its existing owners.6 A common method for valuing professional goodwill is to establish market level compensation (replacement compensation) and to the extent that the owner/operator earns more than market level compensation, the difference is capitalized to arrive at a value conclusion.

The first step in this type of analysis is to establish the existence of goodwill. *Goodwill* is defined in the International Glossary of Business Valuation Terms as: "The intangible asset that arises as a result of name, reputation, customer loyalty, location, and similar factors not separately identified."

The analysis should establish that the owner of the professional practice is generating earnings at a level above his or her market level compensation consistently with expectation that such earnings level is reasonably expected to continue in the future. Without the establishment of professional goodwill, the value of the professional practice is the same under the FMV and the fair value standard, using the asset approach (tangible assets minus liabilities).

Attorneys who are unaware that value can be assigned to a non-saleable practice could potentially harm their client by the additional legal costs associated with debating the issue among valuation experts and possibly taking an unsupportable position all the way to trial.

Example # 2: The Minority Interest

As discussed, in a typical fair value assignment, consideration is given to the value of a minority shareholder's ownership interest due to unfair or oppressive acts committed by the majority shareholder or shareholders. In this context, the concept of fair value is that the minority shareholder has already been wronged and is seeking remedy from the court. It would be "unfair" to further reduce the value of this oppressed shareholder's shares for discounts for lack of control and lack of marketability, having already suffered at the hands of the majority shareholder.

In a marital dissolution in Washington, imagine conducting an appraisal of a one-third interest in a moving company where the other two owners are unrelated business partners. The determination of FMV of this one-third interest would need to include discounts for lack of control and lack of marketability, as it is commonly accepted that the marketplace views the value of a minority interest as less than the pro rata value of the whole. If this one-third interest was not discounted, it would not represent the true value to the marital estate. So, in this case, FMV and fair value would be the same.

Now consider that the subject one-third interest was slated to convert to a 52 percent interest in six months. Further, imagine that the husband and his business partners had signed sale agreements ten years earlier that outlined that on this particular future date, the subject interest was going to convert to a majority interest. In this scenario, the value conclusion from a fair value analysis will diverge from that of FMV.

The subject interest would almost assuredly be incumbered by restrictions on transfer, preventing transfer to a third party. Such restrictions would protect the owners from having an unapproved party as a third owner. With these restrictions on transfer, the FMV analysis would need to include the application of the discounts for lack of control and lack of marketability as is generally applied to minority interests.

However, the fair value analysis would consider this future conversion to a majority interest. The one-third interest, in the hands of the existing parties, will convert to a majority interest in a relatively short period of time and therefore, discounts for lack of control/marketability would not be applied.

In this case, the worst-case scenario would be that the wife hired an attorney and a business appraiser from out of state, both of whom were unaware of how to apply fair value. The result would be that the attorney would have advised the client to accept the FMV determination of the business interest, an amount far below fair value. It is more often the case that attorneys who do not have a grasp of the fair value concept will need to become educated on this issue, ultimately harming the client by the increased billings related to researching and understanding its application.

Conclusion

In certain circumstances, fair value, as used in marital dissolution cases in Washington, can diverge significantly from FMV. In order to best serve their clients, it is imperative that attorneys engage business valuation experts who are familiar with the appropriate methodologies and considerations used by the courts in Washington.

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1 Statement on Standards for Valuation Services: Valuation of a business, business ownership Interest, Security, or intangible Asset (2007)

2 Matthew G. Norton Co. v. Smyth, 112 Wn. App. 865, 873,51 P.3d 159 (2002).

3 Robblee v. Robblee, 68 Wn. App. 69, 78-80, 81 P.2d 1289 (1992).

4 Columbia Management Co. v. Wyss, 94 Or App 195, 202, 765 P2d 207 (1989), rev den 307 Or 571, 771 P2d 1021 (1989).

5 Health Insurance Portability and Accountability Act

6 Matter of Marriage of Fleege, 91 Wash. 2d 324, 588 P.2d 1136 (1979).