

# **Business Valuation on Divorce: Problems With Current Approaches and Possible Alternatives**

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## Business Valuation on Divorce: Problems With Current Approaches and Possible Alternatives

by

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**I. INTRODUCTION.** This Article deals with the following topics:

- Definitions of Value
- Standards of Value (Fair Market Value, Investment Value, Intrinsic Value, Fair Value, Liquidation Value, Going Concern Value, Book Value, Sentimental Value).
- Approaches to Estimating Market Value
- The Importance of an Active Market for Determining Fair Market Value.
- Is Fair Market Value Required for Divorce Valuations?
- Where there is no Market From Which to Determine Market Value.
- Law and Logic of Applying Buy-Sell Formulas Upon Divorce.
- The Paradox in Valuing Partial Ownership Interests.

**II. STANDARDS OF VALUE.** In Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 22-30 (3d ed. 2008), Pratt recognizes seven measures of value: (i) fair market value; (ii) fair value; (iii) investment value; (iv) intrinsic or fundamental value; (v) going-concern value; (vi) liquidation value; and (vii) book value. In business valuation parlance, these are called "standards of value." See also James R. Hitched, FINANCIAL VALUATION: APPLICATIONS AND MODELS (2d ed. Wiley 2006) pp. 3-6. Texas law recognizes "sentimental value" in some instances. Each of these standards will be discussed below, followed by an analysis of the "inputs" to be considered in estimating fair market value. The remainder of the article examines issues that arise in divorce valuations.

**III. DEFINITIONS OF VALUE.** Here are the commonly-used legal, tax, accounting, and business valuation definitions of value. An important thing to remember about fair market value, and the willing buyer/willing seller formulation of it, is that the willing buyer and willing seller cannot be made particular, meaning that "the hypothetical persons are not specific individuals or entities." *Estate of Simplot v. Commissioner of Internal Revenue*, 249 F.3d 1191, 1195 (9<sup>th</sup> Cir. 2001).

**A. DEFINITIONS OF VALUE IN TEXAS LAW.** Texas statutes and cases give varying definitions "value," depending on the situation.

**1. Value.** The term "value" under Texas law embraces different measures of value, not just "fair market value" or "market value." In one case involving the value stock of a closely-held business, the jury charge told the jury to find "the value of his stock in Vector Industries . . . without specific reference to market value, book value, or some other measure of value . . ." *Vector Indus., Inc. v. Dupree*, 793 S.W.2d 97, 103 (Tex. App.--Dallas 1990, no writ). The appellate court held that the jury issue "refers to value generally, without specific reference to market value, book value, or some other measure of value. Therefore, all testimony as to value became relevant for the purpose of answering this question." *Id.* at 103.

**2. Market Value (Condemnation Cases).** In *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 182 (Tex. 2001), (land condemnation case), the Texas Supreme Court defined "market value" (leaving off the "fair") in this way:

Market value is "the price the property will bring when offered for sale by one who desires

to sell, but is not obliged to sell, and is bought by one who desires to buy, but is under no necessity of buying.”

In *State v. Windham*, 837 S.W.2d 73, 77 (Tex. 1992) (land condemnation case), the Supreme Court said:

Market value is “the price which the property would bring when it is offered for sale by one who desires, but is not obligated to sell, and is bought by one who is under no necessity of buying it.” *Carpenter*, 89 S.W.2d at 202. In deciding market value the jury is permitted to consider all of the uses to which the property is reasonably adaptable and for which it is, or in all reasonable probability will become, available within the foreseeable future.

In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex. 1977) (land condemnation case), the Court quoted the definition from *City of Austin v. Cannizzo*, 267 S.W.2d 808 (1954): “the price which the property would bring when it is offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it . . . .”

In *City of Pearland v. Alexander*, 483 S.W.2d 244, 247 (Tex. 1972) (land condemnation case), the Supreme Court emphasized the willing buyer/willing seller aspect of market value, saying:

The jury is instructed that the term market value is the price the property will bring when offered for sale by one who desires to sell, but is not obliged to sell, and is bought by one who desires to buy, but is under no necessity of buying.

The Court went on to say:

The willing-seller willing-buyer test of market value is to be applied and those factors are to be considered which would reasonably be given weight in negotiations between a seller and a buyer. *City of Austin v. Cannizzo, Supra*.

In *Texas Electric Service Co. v. Campbell*, 161 Tex. 77, 336 S.W.2d 742 (1960), we ruled evidence based on possibilities rather than reasonable probabilities to be incompetent,

citing *State v. Carpenter, Supra*, that ‘evidence should be excluded relating to remote, speculate, and conjectural uses, as well as injuries, which are not reflected in the present market value of the property.’ This is but saying, as in *Cannizzo*, that the question of the competency of evidence bearing on the issue of market value at the time of the taking rests on those factors of reasonable weight in the factual determination of what a willing seller would sell for and what a willing buyer would pay.

**3. Fair Market Value (Local Government Code).** Tex. Atty. Gen. Op. DM-441 (May 20, 1997) considered the meaning of “fair market value” for purposes of government entities swapping land pursuant to the Local Government Code. The AG Opinion states:

The term “fair market value” is not defined for purposes of section 272.001 and we define it according to its common usage. Gov’t Code § 311.011 (Code Construction Act). “Fair market value” is generally defined as the price that a willing buyer, who desires to buy, but is under no obligation to buy, would pay to a willing seller, who desires to sell, but is under no obligation to sell. *City of Pearland v. Alexander*, 483 S.W.2d 244, 247 (Tex. 1972); *Atterbury v. Brison*, 871 S.W.2d 824, 828 (Tex. App.--Texarkana 1994, writ denied). We also note that the measure of damages in an eminent domain proceeding where an entire tract or parcel of land is condemned is “local market value.” Prop. Code § 21.042(b). Cases construing this provision indicate that “market value” means a fixed, ascertainable sum. *Melton v. State*, 395 S.W.2d 426, 429 (Tex. Civ. App.--Tyler 1965, writ ref’d, n.r.e.) (“Market value should be based upon reasonable cash value.”); *Houston v. Charpoit*, 292 S.W.2d 677, 680-81 (Tex. Civ. App.--Galveston 1956, writ ref’d n.r.e.) (market value may be determined on basis of credit transaction, rather than on cash price of land).

Tex. Atty. Gen. Op. DM-441, \*4 (May 20, 1997).

**4. Market Value (Texas Tax Code).** The Texas Tax Code defines “market value” in this way:

“Market value” means the price at which a property would transfer for cash or its equivalent under prevailing market conditions if:

(A) exposed for sale in the open market with a reasonable time for the seller to find a purchaser;

(B) both the seller and the purchaser know of all the uses and purposes to which the property is adapted and for which it is capable of being used and of the enforceable restrictions on its use; and

(C) both the seller and purchaser seek to maximize their gains and neither is in a position to take advantage of the exigencies of the other.

Tex. Tax. Code § 1.04(7). The Austin Court of Appeals noted that “[t]his statutory definition, first enacted in 1979, accords with the traditional definition applied by Texas courts that market value means the price property would bring when offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it.” *Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724, 727 (Tex. App.—Austin 1997, writ denied).

Under the Texas Tax Code, real property must be appraised at market value as determined by generally accepted appraisal methods or techniques. See Tex. Tax Code § 23.01. A business’s inventory, however, must be appraised at the price for which it would sell as a unit to a purchaser who would continue the business. See *Id.* § 23.12.

**5. Market Value (Leased Equipment).** The *City of Harlingen v. Estate of Sharboneau* definition of market value was applied to the value of leased equipment contributed to a partnership in *Brogan, Ltd. v. Brogan*, 2007 WL 2962996, \*6 (Tex. App.—Amarillo 2007, pet. denied) (mem. op.).

**B. FEDERAL TAX DEFINITION OF FAIR MARKET VALUE.** Treasury Regulation 20.2031-1-(b) defines “fair market value” in this way:

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

Treasury Reg. 20.2031-1(b) goes on to say:

The fair market value of a particular item of property includible in the decedent’s gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

*Id.*

In *United States v. Cartwright*, 411 U.S. 546, 550-51, 93 S.Ct. 1713, 1716-17, 36 L.Ed.2d 528 (1973), the U.S. Supreme Court said:

In implementing 26 U.S.C. § 2031, the general principle of the Treasury Regulations is that the value of property is to be determined by its fair market value at the time of the decedent’s death. ‘The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.’ Treas. Reg. § 20.2031-1(b). The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves, and is not challenged here.FN7 Under this test, it is clear that if the decedent had owned ordinary corporate stock listed on an exchange, its ‘value’ for estate tax purposes would be the price the estate could have obtained if it had sold the stock on the valuation date, that price being, under Treas. Reg. § 20.2031-2(b), the mean between the highest and lowest quoted selling prices on that day.

**C. ACCOUNTING DEFINITION OF FAIR MARKET VALUE.** The accounting profession has adopted the term “fair value” as the equivalent to

the legal “fair market value.” The current definition and description of “fair value” is set out by the Financial Accounting Standards Board, in Accounting Standards Codification 820, Glossary:

Fair value is 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. (FASB ASC 820 Glossary).

Additional considerations have been established by the FASB regarding determining fair value:

A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability (FASB ASC 820-10-35). The exit price objective applies for all assets and liabilities measured at fair value.

Fair value measurements of assets assumes the highest and best use by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. FASB ASC Topic 820 Implementation Guidance, p. 5 (10-20-2009).

Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same--to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds

the asset or owes the liability). FASB ASC 820-20-05-1B (as amended May 2011)

<<http://asc.fasb.org/imageRoot/00/7534500.pdf>>.

Fair value measures should consider the utility of the asset or liability being measured and specific attributes to the asset or liability. FASB ASC Topic 820 Implementation Guidance, p. 5 (10-20-2009).

Transaction costs should be excluded from all fair value measurements. FASB ASC Topic 820 Implementation Guidance, p. 5 (10-20-2009).

FASB has issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements, which “defines fair value, [and] establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) . . . .” It represents the latest authoritative statement about determining fair value for purposes of financial statements. The document can be found at <<http://www.fasb.org/pdf/fas157.pdf>>.

**D. BUSINESS VALUATION DEFINITION OF FAIR MARKET VALUE.** The most-frequently cited source of the business valuator’s definition of “fair market value” comes from Revenue Ruling 59-60, which took its definition from Treasury Regulations for estate and gift taxes. The Revenue Ruling 59-60 definition of “fair market value” 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.

Rev. Rul. 59-60, § 2.02. Rev. Rul. 59-60 goes on to add: “Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.” *Id.*

**IV. APPROACHES TO ESTIMATING FAIR MARKET VALUE.** There are three main approaches to determining the value of an asset:

Texas courts have recognized three general approaches to determining market value: (1) the market data (or comparable sales) approach; (2) the cost approach; and (3) the income (or income-capitalization) approach. *See Religious of the Sacred Heart v. City of Houston*, 836 S.W.2d 606, 615–16 (Tex.1992); *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex.1977). In addition, when circumstances dictate, the Texas Supreme Court has not hesitated to recognize alternative methods of valuation. *See Missouri–Kansas–Texas R.R. v. City of Dallas*, 623 S.W.2d 296, 299–301 (Tex.1981). These approaches are not different definitions of market value; they are simply different ways of arriving at an estimate of what a willing buyer would pay a willing seller.

*Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724, 730 (Tex. App.–Austin 1997, writ denied). “These approaches are not different definitions of market value; they are simply different ways of arriving at an estimate of what a willing buyer would pay a willing seller.” *Id.* at 730.

One Attorney General’s Opinion made this statement about the method and factors to be considered in estimating the fair market value of property:

The method used to calculate the fair market value of a particular property and the factors that must be considered in arriving at the fair market value of a particular piece of property are for a qualified appraiser to determine in accordance with accepted standards of appraisal; [FN8] they are not questions of law that are susceptible to the opinion process. [FN9]

[FN8] See generally *Travis Cent. Appraisal Dist.*, 947 S.W.2d at 730 (listing three general approaches to determining market value and acknowledging alternatives); USPAP, *supra* note 5; Real Estate Valuation in Litigation, *supra* note 7; The Appraisal of Real Estate, *supra* note 3.

[FN9] See, e.g., Attorney General Opinions DM-98(1992) at 3, H-56 (1973) at 3, M-187 (1968) at 3, O-2911 (1940) at 2.

Tex. Atty. Gen. Op. LO-98-082, p. 2 (September 28, 1998). The AG Opinion suggests that the methods and factors to consider in determining fair market value are not questions of law and cannot be promulgated by the Attorney General through the AG Opinion process. This view could be applied to the appellate opinions, as well as opinions of the U.S. Tax Court, on business valuation issues.

Texas Tax Code § 23.01(b) says this about determining market value:

The market value of property shall be determined by the application of generally accepted appraisal methods and techniques. If the appraisal district determines the appraised value of a property using mass appraisal standards, the mass appraisal standards must comply with the Uniform Standards of Professional Appraisal Practice. The same or similar appraisal methods and techniques shall be used in appraising the same or similar kinds of property. However, each property shall be appraised based upon the individual characteristics that affect the property's market value, and all available evidence that is specific to the value of the property shall be taken into account in determining the property's market value.

**A. MARKET APPROACH.** Wikipedia gives a serviceable definition of the market approach to business valuation:

The market approach to business valuation is rooted in the economic principle of competition: that in a free market the supply and demand forces will drive the price of business assets to a certain equilibrium. Buyers would not pay more for the business, and the sellers will not accept less, than the price of a comparable business enterprise. It is similar in many respects to the “comparable sales” method that is commonly used in real estate appraisal. The market price of the stocks of publicly traded companies engaged in the same or a similar line of business, whose shares are actively traded

in a free and open market, can be a valid indicator of value when the transactions in which stocks are traded are sufficiently similar to permit meaningful comparison.

<[http://en.wikipedia.org/wiki/Business\\_valuation#Market\\_approaches](http://en.wikipedia.org/wiki/Business_valuation#Market_approaches)> [9-18-2011]. Ibbotson said this:

Implementation of the market approach using publicly traded companies typically relies on the use of financial ratios that compare the stock price of a company to its various accounting measures of fundamental data. Many ratios contain stock price or market value of equity and work well in the market approach to determining value:

- Price to Earnings
- Price to Cash Flow
- Price to Shareholders' Equity

IBBOTSON SBBI 18 (2011 Valuation Yearbook).

Shannon Pratt recognizes two types of market approach: one involves guideline publicly trade companies and the other involves guideline merged and acquired companies. Shannon Pratt, VALUING A BUSINESS 950 (5<sup>th</sup> ed.2008). Under the guideline publicly traded company method, the valuator develops “valuation multiples” based on the prices at which stock representing minority interests in comparable companies is trading. These multiples might be net sales, gross cash flow, net cash flow, net income before taxes, net income after taxes, etc. *Id.* at 265. There will usually be a significant difference in size between the guideline companies and the company being valued. Under the guideline merged and acquired company method, the valuator develops “valuation multiples” based on the transfers of controlling interests in publicly traded companies. The key to both of these approaches is the comparability of the guideline companies to the company being valued.

The Texas Supreme Court has said that, in real property condemnation cases, the market approach is preferred:

Texas recognizes three approaches to determining the market value of condemned property: the comparable sales method, the cost method, and the income method. *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 182 (Tex.2001). The comparable sales method is the favored approach, but when comparable sales figures are not available, courts will accept testimony based on the other two methods. *Id.* at 182–83. The cost approach looks to the cost of replacing the condemned property minus depreciation. *Id.* at 183 (citing *Religious of the Sacred Heart v. City of Houston*, 836 S.W.2d 606, 615–16 (Tex.1992)). The income approach is appropriate when the property would be priced according to the rental income it generates. *Sharboneau*, 48 S.W.3d at 183 (citing *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex.1977)). All three methods are designed to approximate the amount a willing buyer would pay a willing seller for the property. *Id.*

*State v. Central Expressway Sign Associates*, 302 S.W.3d 866, 871 (Tex. 2009). Of course, there is a great distinction between the market for real property and the market for closely-held businesses.

**B. INCOME APPROACH.** Ibbotson said this about the income approach:

One of the most common business valuation methodologies is the income approach. Under the income approach, the analyst must first identify future cash flows to be generated by the asset being valued. Second is the identification of the appropriate rate to use in discounting the cash flows to present value. The discount rate, or cost of capital, should reflect the level of risk inherent in the cash flows being valued.

IBBOTSON SBBI 13 (2011 Valuation Yearbook).

In *Polk County v. Tenneco, Inc.*, the Supreme Court said this about the income approach:

The income approach to value, on the other hand, proceeds on the premise that a buyer of



income-producing property is primarily interested in the income which his property will generate. In simple terms, the approach involves estimating the future income of the property and applying a capitalization rate to that income to determine market value. Comment, *The Road to Uniformity in Real Estate Taxation: Valuation and Appeal*, 124 U.Pa.L.Rev. 1418 (1976). The capitalization rate may be defined as the rate of interest investors would require as a return on their money before they would invest in the income-producing property, taking into account all the risks involved in that particular enterprise. Fisher, *Capitalization Rates*, 25 Nat'l Tax J. 263 (1972). See also *Real Estate Appraisal Terminology* 33, 34, 67 (1975). The income approach thus involves an estimate of two variables, future income and the capitalization rate, which are used to find the market value figure. The more precisely the variables are estimated, the more accurate the market value estimate will be. Conversely, if the variables used are inaccurate, then the resulting market value figure will also be incorrect.

*Id.* at 921.

In another case, the Supreme Court has stated that “the traditional income approach measures the value of property based on its known ability to produce income in its current state.” *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 184 (Tex. 2001). In *Sharboneau*, the Supreme Court rejected using the income approach to valuing a tract of land purchased for development but which had not yet been subdivided and was not yet being marketed.

**C. ASSET-BASED APPROACH.** The asset-based subtracts the business’s debts from its liabilities to reach a net asset value. Shannon Pratt says:

The asset-based approach focuses on the value of the enterprise’s component assets, properties, and business units.

Shannon Pratt, *VALUING A BUSINESS* 64 (5<sup>th</sup> ed.2008). The asset approach can be used with any of the premises of value: going-concern, value as an assemblage of assets, value as an orderly disposition, or value as a forced liquidation. *Id.* at 64, 47-48.

The court in *Estate of Dunn v. Comm'r*, 301 F.3d 339, 353 (5th Cir. 2002), said:

By definition, the asset-based value of a corporation is grounded in the fair market value of its assets (a figure found by the Tax Court and not contested by the estate), which in turn is determined by applying the venerable willing buyer-willing seller test. . . . In other words, when one facet of the valuation process requires a sub-determination based on the value of the company's assets, that value must be tested in the same willing buyer/willing seller crucible as is the stock itself, which presupposes that the property being valued is in fact bought and sold.

Ibbotson notes that “[t]he asset-based approach to valuation is primarily used when appraising a holding company, family limited partnership, or entities in bankruptcy proceedings.” *IBBOTSON SBBI 19* (2011 Valuation Yearbook).

The asset-based approach needs to be distinguished from “net book value.” In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 923 (Tex. 1977), the Supreme Court made this comment about “net book value”:

The reasoning of the court of civil appeals, then, was erroneous unless the net book value of Tenneco's gas transmission system is equal to its market value. [4] For the reasons discussed below, we hold that it is not.

The net book value figure used by the court of civil appeals is the accounting figure representing the original cost of Tenneco's pipeline division utility plant plus the value of construction work in progress, less depreciation, amortization and depletion. It was undisputed at trial that this figure was not equal to market value. Tenneco's expert testified a number of times that the net book figure was not necessarily equal to market value and that he did not contend that it was. The evidence showed that the net book value of the pipelines in Polk County was \$842,798, but Tenneco contended the pipelines' market value was \$2,178,000. Given these facts, and the definition of market value in *City of Austin v. Cannizzo*, supra, we

hold that the court of civil appeals erred in equating net book value with market value.

Note that “net book value” is based on historical cost, with adjustments, while the asset-based approach considers the current value of the assets of the business.

**D. COST APPROACH.** The cost approach is a valuation approach used in valuing real estate. Shannon Pratt says this about the cost approach:

The cost approach is based on the economic principle of substitution. That is, no one would pay more for an asset than the price required to obtain (by purchase or by construction) a substitute asset of comparable utility. This assumes, of course, that the subject asset is fungible. In other words, the cost approach assumes that substitute properties of comparable utility can be obtained.

Shannon Pratt, VALUING A BUSINESS 358 (5<sup>th</sup> ed.2008).

In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex. 1977), the Supreme Court said this about the cost approach:

The cost approach to value assumes that an informed purchaser of the property would pay no more than the cost of constructing a like property with the same usefulness as the property to be valued. Real Estate Appraisal Terminology 53 (1975). In using this method, the appraiser first estimates the cost of reproducing or replacing the subject property; he then subtracts accumulated depreciation and adds estimated land value to arrive at his value estimate. The method is usually a secondary approach to valuation and tends to set the upper limit of true market value. E. Johnson, Cost Approach to Value, Encyclopedia of Real Estate Appraising 37 (1959).

In *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 183 (Tex. 2001), the Supreme Court said:

The cost approach, which looks to the cost of replacing the condemned property, is best suited for valuing improved property that is unique in character and not frequently exchanged on the marketplace. *Religious of the Sacred Heart*, 836 S.W.2d at 616 (citing American Institute of Real Estate Appraisers, The Appraisal of Real Estate 62, 349 (9th ed.1987)). While the cost method takes the property's depreciation into account, it still “tends to set the upper limit of true market value.” *Polk Cty. v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex.1977).

**E. HIERARCHIES OF INPUTS IN DETERMINING VALUE.** The IRS through Treasury Regulations, and the accounting profession, through FASB standards, have established a hierarchy of inputs for the valuator to consider in determining the fair market value of an asset using the market approach.

**1. Indicators of Value for Tax Purposes.** The IRS Regulations set out a hierarchy of information to consider in estimating fair market value for estate and gift tax purposes. The more reliable indicators of value must be used if they are available; if none are available, then the next highest level of indicator should be used, and so on, in descending order.

**IRS Regulation § 20.2031-2 Valuation of stocks and bonds.**

**(a) In general.** The value of stocks and bonds is the fair market value per share or bond on the applicable valuation date.

**(b) Based on selling prices.** (1) In general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond. [Note: the *closing* price is not used to fix value for tax purposes.] If there were no sales on the valuation date but there were sales on dates within a reasonable period both before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the valuation date. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the valuation date. If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be employed if such records are available in a generally available listing or publication of general circulation. In the event that such records are not so available and such stocks or bonds are listed on a composite listing of combined exchanges available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed. In valuing listed securities, the executor should be careful to consult accurate records to obtain values as of the applicable valuation date. If quotations of unlisted securities are obtained from brokers, or evidence as to their sale is obtained from officers of the issuing companies, copies of the letters furnishing such quotations or evidence of sale should be attached to the return.

\* \* \*

**(c) Based on bid and asked prices.** If the provisions of paragraph (b) of this section are inapplicable because actual sales are not available during a reasonable period beginning before and ending after the valuation date, the fair market value may be determined by taking the mean between the bona fide bid and asked

prices on the valuation date, or if none, by taking a weighted average of the means between the bona fide bid and asked prices on the nearest trading date before and the nearest trading date after the valuation date, if both such nearest dates are within a reasonable period. The average is to be determined in the manner described in paragraph (b) of this section.

**(d) Based on incomplete selling prices or bid and asked prices.** If the provisions of paragraphs (b) and (c) of this section are inapplicable because no actual sale prices or bona fide bid and asked prices are available on a date within a reasonable period before the valuation date, but such prices are available on a date within a reasonable period after the valuation date, or vice versa, then the mean between the highest and lowest available sale prices or bid and asked prices may be taken as the value.

**(e) Where selling prices or bid and asked prices do not reflect fair market value.** If it is established that the value of any bond or share of stock determined on the basis of selling or bid and asked prices as provided under paragraphs (b), (c), and (d) of this section does not reflect the fair market value thereof, then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value. Where sales at or near the date of death are few or of a sporadic nature, such sales alone may not indicate fair market value. In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. Complete data in support of any allowance claimed due to the size of the

block of stock being valued shall be submitted with the return. On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

**(f) Where selling prices or bid and asked prices are unavailable.** If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any

examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

**(g) Pledged securities.** . . .

**(h) Securities subject to an option or contract to purchase.** Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

It is interesting to note that the description of factors to consider, when there is no market data from which to draw value inferences, is very much like *Intrinsic Value*. See Section X.

**2. Indicators of Value for Purposes of Financial Statements.** The accounting profession has developed its own hierarchy of indicators of fair market value to be used by accountants when they are valuing assets (and liabilities) to be listed on a financial statement (like a balance sheet or statement

of assets and liabilities). Take care to note that the accounting profession uses the term “fair value” to mean what lawyers mean when lawyers say “fair market value.”

In the USA, the ultimate authority on Generally Accepted Accounting Principles (GAAP) is the Financial Accounting Standards Board (FASB). In September 2006, FASB promulgated Financial Accounting Standard 157 (“FAS 157”). FAS 157 established a hierarchy of information to use in determining the “fair value” of assets or liabilities under GAAP.

Here is the Federal Reserve Bank of New York's summary of FAS 157:

FASB Statement No. 157, Fair Value Measurements (FAS 157), issued in September 2006, defines fair value, establishes a framework for measuring the fair value of assets and liabilities based on a three level hierarchy, and expands disclosures about fair value measurements. The FASB's three-level fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the reporting branch or agency has the ability to access at the measurement date (e.g., the FFIEC 002 reporting date). Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

<<http://www.newyorkfed.org/banking/regrept/2q08002.pdf>>

Here is what FAS 157 itself says about the hierarchy of inputs for estimating fair value:

#### Fair Value Hierarchy

22. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to

measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

23. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

#### *Level 1 inputs*

24. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 25 and 26.

25. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an

active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

26. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

27. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.<sup>11</sup>

[FN11] The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

#### *Level 2 inputs*

28. Level 2 inputs are inputs other than quoted prices included within Level 1 that are

observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)

c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

29. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.<sup>11</sup> The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within

the scope of the AICPA Audit and Accounting Guides for those industries.

*Level 3 inputs*

30. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, un-observable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

**3. When The Market Approach Cannot be Used.** The Supreme Court has recognized that the market approach may have to be abandoned in some instances, and reliance placed on the cost and income approaches. In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex. 1977), the Supreme Court said:

The market value of Tenneco's pipelines was highly contested at trial, and it was not an easy question to resolve. Segments of natural gas pipelines, such as those which lie in Polk County, are rarely sold; and their market value

therefore generally cannot be determined by comparing the prices brought by sales of similar properties. This fact makes the assessment of pipelines by the taxing authority a difficult task, because market value is defined as "the price which the property would bring when it is offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it . . . ." *City of Austin v. Cannizzo*, 153 Tex. 324, 334, 267 S.W.2d 808, 815 (1954). See also Article 7174, and *State v. Carpenter*, 126 Tex. 604, 89 S.W.2d 194 (1936). Thus, the "comparable sales" method of appraising property is of little use in valuing pipelines; and two other methods of appraisal must be used in assessing those properties. These two methods are the cost approach to value and the income approach to value.

**V. THE IMPORTANCE OF AN ACTIVE MARKET FOR DETERMINING FAIR MARKET VALUE.** Wikipedia defines "marketplace" as "the space, actual, virtual or metaphorical, in which a market operates" and "goods and services are exchanged." <<http://en.wikipedia.org/wiki/Marketplace>>. An "efficient market" is a marketplace where "the aggregate decisions of all the market's participants accurately reflect the value of public companies and their common shares at any moment in time."

<<http://www.investopedia.com/ask/answers/05/marketefficiency.asp#ixzz1WOQkzYcY>>. Stated differently, an "efficient market is one where the market price is an unbiased estimate of the true value of the investment." <[http://people.stern.nyu.edu/adamodar/New\\_Home\\_Page/invemgmt/effdefn.htm](http://people.stern.nyu.edu/adamodar/New_Home_Page/invemgmt/effdefn.htm)>. Both federal tax law and FASB standards treat the price indicators of an active market as superior inputs compared to "Fundamental Analysis" of the company in question.

Larry J. Kasper, *BUSINESS VALUATIONS: ADVANCED TOPICS* (Quorum Books 1997) pp. 13-20, discusses the efficient market hypothesis that underlies the idea of fair market value:

The efficient market hypothesis is the cornerstone for the foundation of modern

financial theory. It also provides a basis for examining many well-established and long-held assumptions and concepts in the valuation of privately held businesses. The validity of the definition of fair market value, the basis for comparisons to publicly held companies, the development of capitalization rates, and the application of premiums and discounts can all be tested by reference to the efficient market hypothesis. As such, it, is the appropriate place to begin the study of advanced business valuation topics for privately held companies.

\* \* \*

The efficient market hypothesis states that security prices in a market reflect all relevant and ascertainable information about a company. Because the security price reflects all relevant information about the security, that price must represent its fair market value. Security analysts of publicly held companies and business valuers of privately held companies must implicitly believe in the correctness of the hypothesis each time they make comparisons to and draw inferences from the prices of other publicly traded stocks and securities. The efficient market hypothesis is one of the most tested hypotheses in the financial literature.

Kaspar continues:

The efficient market hypothesis has been expressed at three different levels, each testable to some degree [3]. How widely available information needs to be for there to be efficiency in the market depends upon the form of the hypothesis.

\* \* \*

*Weak Form*

The weak form asserts that stock prices already reflect all information that can be derived from studying market trading data, such as past transaction prices and trading volume.

\* \* \*

*Semi-Strong Form*

The semi-strong form of the hypothesis states that all publicly available information regarding the prospects of a firm must already be reflected in the stock prices. All publicly available information includes not only trading information (weak form) but also published

information regarding financial statements, product information, forecasts, and management. As this information is readily available, at least to professional analysts, one would expect it to be reflected in stock prices.

\* \* \*

*Strong Form*

The strong form of the efficient market hypothesis states that stock prices reflect all information relevant to the firm, even including information available only to insiders.

\* \* \*

Kaspar continues:

**IMPLICATIONS FOR VALUING PRIVATE SMALL BUSINESS**

The implicit assumption in the efficient market hypothesis (in any form) is that there exists a market where securities can be traded with little effort or cost. When this is not true, efficient (information) markets cannot exist. Small private company stocks do not have an established market. If they did, there would be little need for business valuations.

However, there are lessons to be learned by examining the efficient market hypothesis. First, more is to be learned about the appropriate price of a stock by examining current events and information than by examining past events, including stock sales (weak form). Second, the more diligent the gathering of information and analysis, the better the estimate of value for small companies (semi-strong form). Third, as with publicly held companies, the analyst hopes, through fundamental analysis, to attain insight into future performance of the firm in order to estimate the appropriate price for the company (semi-strong form). Finally, the small-company analyst, like the public security analyst, will probably never have access to all information (strong form).

Fundamental analysis will have a more fruitful role in a private company valuation than in a publicly held company valuation because little information is public. Furthermore, as there are not many other analysts competing for information about the privately held



company, estimates of private-company value are likely to have much more variation than one would expect for estimates of the value of a publicly traded company by members of the security analysis industry. Expressed another way, the confidence that can be placed in a single estimate of value for a privately held company is less than that for a publicly traded company, and the range of estimates is likely to be wider.

**VI. WHEN THERE IS NO MARKET TO COMPARE TO.** The Texas Supreme Court has recognized that in some situations property has no ascertainable fair market value.

In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex.1977), the Supreme Court said:

Segments of natural gas pipelines, such as those which lie in Polk County, are rarely sold; and their market value therefore generally cannot be determined by comparing the prices brought by sales of similar properties. This fact makes the assessment of pipelines by the taxing authority a difficult task, because market value is defined as “the price which the property would bring when it is offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it ....” *City of Austin v. Cannizzo*, 153 Tex. 324, 334, 267 S.W.2d 808, 815 (1954). See also Article 7174, and *State v. Carpenter*, 126 Tex. 604, 89 S.W.2d 194 (1936). Thus, the “comparable sales” method of appraising property is of little use in valuing pipelines; and two other methods of appraisal must be used in assessing those properties. These two methods are the cost approach to value and the income approach to value.

In *Missouri-Kansas-Texas R. Co. v. City of Dallas*, 623 S.W.2d 296, 300 (Tex. 1981), the Supreme Court said:

This court in *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex.1977), recognized the difficulty of determining market value of pipelines because comparable sales are of so little use. We also recognized that alternative

methods, such as the cost approach and the income approach to value, may be used as alternative tax valuation methods when correctly used.

The Texas Pattern Jury Charges (Family) recognizes that sometimes an asset has no fair market value:

PJC 203.1 Value

The value of an asset is its fair market value unless it has no fair market value.

"Fair market value" means the amount that would be paid in cash by a willing buyer who desires to buy, but is not required to buy, to a willing seller who desires to sell, but is under no necessity of selling.

If an asset has no fair market value, its value is the value of its current ownership as determined from the evidence.

Under PJC 203.1, an asset either has a fair market value or it does not. If it does, then the fair market value must be determined. If the assets does not have a fair market value, then an alternative approach to value must be used.

The Texas Supreme Court has recognized that railroad right-of-ways and pipeline easements do not have a fair market value. What about closely-held business interests?

In *Bendalin v. Delgado*, 406 S.W.2d 897, 900-01 (Tex. 1966), the Supreme Court said:

By his seventh and eighth points, petitioner asserts that there is no evidence to support the jury's finding that the value of the stock was \$2,867.44, or \$57.35 per share, at the time respondent's employment with Consumers terminated. Consumers was a small, closely held corporation, and there was no market for its stock. The par value of the stock was \$100.00 per share, and respondent introduced a balance sheet showing that its book value on December 31, 1961, was \$63.22 per share. Book value is entitled to little, if any, weight in determining the value of corporate stock, and many other

factors must be taken into consideration. See *Warner v. E. C. Warner Co.*, 226 Minn. 565, 33 N.W.2d 721; *Marnik v. Northwestern Packing Co.*, 335 Ill. App. 568, 82 N.E.2d 195; *Barsan v. Pioneer Savings & Loan Co.*, 163 Ohio St. 424, 127 N.E.2d 614; *Kelley v. 74 and 76 West Tremont Ave. Corp.*, 24 Misc.2d 370, 198 N.Y.S.2d 721; O'Neal, Close Corporations § 7.24.

On the present record the book value of the Consumers stock constitutes nothing more than a scintilla of evidence as to its reasonable worth. The company had lost a substantial amount of money since its organization, and evidently was still losing money in 1962. Petitioner testified that its assets were not worth book value. He was the only witness who undertook to estimate the value of the stock, and according to his testimony it was worth only ten or fifteen cents on the dollar. His testimony in this respect could be disregarded by the trier of fact, but no attempt was made to prove the actual value of the assets or the rate of earnings or losses at or about the time respondent left the company's employ. It does appear that on an undisclosed date in 1962 petitioner bought 100 shares of stock for \$35.00 per share, and some time in 1963 he bought another 100 shares for ten cents per share. He claimed that the relatively high price paid in the earlier of these transactions was due to his sympathy for the seller, whose husband had died recently, and that the low price paid in the later transaction was attributable to the seller's desire to take a tax loss. The foregoing is a summary of all the evidence tending to establish the value of the stock. In our opinion it is sufficient to warrant submission of Special Issue No. 2, but the record is devoid of any evidence to support the conclusion that the stock was worth as much as \$57.35 per share as found by the jury.

The Texas courts of appeals also have spoken to that issue.

In *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ), the court said:

Fair market value has been consistently defined as the amount that a willing buyer, who desires to buy, but is under no obligation to buy would pay to a willing seller, who desires to sell, but is under no obligation to sell. *City of Pearland v. Alexander*, 483 S.W.2d 244 (Tex. 1972). This standard or test presupposes an existing, established market.

The case of *Roberts v. Harvey*, 663 S.W.2d 525, 528 (Tex. App.--El Paso 1983, no writ), says:

There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price. Where there is no evidence of market value, it is error to submit to the jury an issue on market value. *Continental Oil and Cotton Co. v. Wristen & Johnson*, 168 S.W. 395 (Tex. Civ. App.--Fort Worth 1914, no writ). In the absence of testimony or evidence of a reasonable cash market value of corporate stock, the method employed in determining the worth or value of such stock is to determine the difference between the value of the assets and the amount of liabilities of the corporation. *Citizens National Bank of Lubbock v. Maxey*, 461 S.W.2d 138 (Tex. Civ. App.--Amarillo 1970, writ ref'd n.r.e.).

*Beavers v. Beavers*, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ), said:

Mr. Beavers' third point of error addresses the proper valuation to be placed on the community one-third interest in all outstanding stock of Great West Energy, Inc. The valuation problem arises because the sale of these shares is restricted by a requirement that they be offered first to other shareholders at book value. Experts from both parties testified that essentially because of this restriction, the market value of the stock was zero. This does not mean, however, that the trial judge erred in assigning a value of \$170,000.00 to the stock for the purpose of making an equitable division of the community property. While market value is usually the best evidence of the value of the personal property, in the absence of a market value, the actual value of the property to the

owner may be shown. *Bryant v. Stohn*, 260 S.W.2d 77, 83 (Tex. Civ. App.--Dallas 1953, writ ref'd n.r.e.); *Ft. Worth and D.C. Railway v. Hapgood*, 210 S.W. 969 (Tex. Civ. App.--Amarillo 1919, no writ). There is expert testimony from Mrs. Beavers' witness that, based on the value of the assets of the company, a one-third interest would be worth as much as \$395,850.00. Even according to Mr. Beavers' expert witness, the book value of the company was \$173,000.00 when substantial oil reserves were valued at only development costs. In assigning values to closely held corporations in contested divorce actions, those considerations given here by the trial judge to company assets and to the realities of corporate control are appropriate. *Dorfman v. Dorfman*, 457 S.W.2d 417 (Tex. Civ. App.--Texarkana 1970, no writ). The third point of error is overruled.

In *Strenk v. Strenk*, 2001 WL 1379924, \*6 (Tex. App.--Austin 2001, no pet.) (unpublished opinion), the court said:

Swanson's expert, Peña, testified as to the stock's "book value"; he did not calculate its fair market value. Strenk objected to the evidence of book value and questioned Peña regarding his failure to analyze the stock's fair market value. Strenk cites authority for the proposition that the value of an asset is its fair market value. See *City of Pearland v. Alexander*, 483 S.W.2d 244 (Tex. 1972); *Wendlandt v. Wendlandt*, 596 S.W.2d 323 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ). Neither case holds that fair market value is the only basis for valuing a closely held stock; indeed, *City of Pearland* involved the narrow question of valuation damages for severed property in an eminent domain proceeding. See *City of Pearland*, 483 S.W.2d at 245-46.

The case of *Elliott v. Whitten*, 2004 WL 2115420 at \*12 (Tex. App.--Houston [1st Dist.] 2004, pet. denied) (mem. op.), says:

There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price.

The case of *Roberts v. Harvey*, 663 S.W.2d 525, 528 (Tex. App.--El Paso 1983, no writ), says:

There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price. Where there is no evidence of market value, it is error to submit to the jury an issue on market value. *Continental Oil and Cotton Co. v. Wristen & Johnson*, 168 S.W. 395 (Tex. Civ. App.--Fort Worth 1914, no writ). In the absence of testimony or evidence of a reasonable cash market value of corporate stock, the method employed in determining the worth or value of such stock is to determine the difference between the value of the assets and the amount of liabilities of the corporation. *Citizens National Bank of Lubbock v. Maxey*, 461 S.W.2d 138 (Tex. Civ. App.--Amarillo 1970, writ ref'd n.r.e.).

In *Akin, Gump, Strauss, Hauer & Feld, L.L.P. v. National Development and Research Corp.*, 232 S.W.3d 883, 890 (Tex. App.--Dallas 2007), *reversed on other grounds*, 299 S.W.3d 106 (Tex. 2009), the court of appeals said:

Generally, the fair market value of closed corporation stock, or stock having no public market, as here, is "what a willing purchaser would pay to a willing seller who was not acting under compulsion to sell." *Willis v. Donnelly*, 118 S.W.3d 10, 40-41 (Tex. App.-Houston [14th Dist.] 2003), *aff'd in part and rev'd in part on other grounds*, 199 S.W.3d 262, 279 (Tex. 2006); *InterFirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 889 (Tex. App.--Texarkana 1987), *disapproved on other grounds by Tex. Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240 (Tex. 2002). When stock sales do not exist upon which fair market value may be determined, other methods of assessing fair market value include the asset approach and the earnings, or income, approach. See *Willis*, 118 S.W.3d at 41.

In *Mandell v. Mandell*, 310 S.W.3d 531, 536-37 (Tex. App.--Fort Worth 2010, pet. denied), the court said:

As a general rule, the value to be accorded community property that is to be divided in a divorce proceeding is “market value.” See *R.V.K. v. L.L.K.*, 103 S.W.3d 612, 618 (Tex. App.--San Antonio 2003, no pet.) (citing *Walston v. Walston*, 971 S.W.2d 687, 690 (Tex. App.--Waco 1998, pet. denied)). “Fair market value has been consistently defined as the amount that a willing buyer, who desires to buy, but is under no obligation to buy would pay to a willing seller, who desires to sell, but is under no obligation to sell.” *Id.* (quoting *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ)).

A straight fair market value is not an appropriate valuation method, however, when a community estate owns shares in a closely held corporation and, by agreement, any sale of the shares of stock is restricted to the corporation or other stockholders. See *Beavers v. Beavers*, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ). When the sale of stock is restricted by a requirement that the shares be offered first to the corporation or to other shareholders, then essentially the fair market value of the stock is zero. See *id.* FN5 In this situation, the parties may show the actual value of the property interest to the owner. See *R.V.K.*, 103 S.W.3d at 618. Such evidence might include the value of being able, by virtue of ownership of the closely held stock, to drive a new automobile, to have health insurance paid for by the company, to have a company-financed life insurance policy, to belong to a country club at company expense, and other similar financial benefits. See James M. Loveless & Kimberly M. Naylor, *Handling a Divorce Involving a Closely-Held Corporation*, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, M, M-3 (1996).

FN5. See also Edwin Terry et al., *Handling the Divorce Involving a Medical Practice*, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, B, B-5 (1996) (explaining that “the concept of market value assumes an existing, established market” and that “as a practical matter there is often little or no actual

market for a closely-held medical practice.... Therefore other methods of value must be used”).

**VII. IS FAIR MARKET VALUE REQUIRED FOR DIVORCE VALUATIONS?** Accountants are accustomed to finding a fair market value for every business, since tax law requires it, and business valuation theory provides a model for doing so even in the absence of reliable market data. The question arises whether Texas case law requires that a business be valued at fair market value for purposes of divorce, which presents entirely different policy issues that gift tax or death tax. A review of Texas divorce cases suggests that a trial court is not required to use fair market value of a closely-held business in dividing the marital estate.

Divorce business valuations were litigated in *Nail v. Nail*, *Geesbreght v. Geesbreght*, *Finn v. Finn*, *Beavers v. Beavers*, *Keith v. Keith*, *Ashley v. Ashley*, *R.V.K. v. L.L.K.*, *Strenk v. Strenk*, *Von Hohn v. Von Hohn*, and *Mandell v. Mandell*. Of the cases listed, only *R.V.K.* dealt with a marketability discount associated with a sale to a third party, and in that case the evidence pitted testimony regarding the formula price set in buy-sell agreements against testimony of a hypothetical sale between a willing buyer and a willing seller. None of these Opinions (save Justice Duncan's Plurality Opinions in *R.V.K.*) say whether a marketability discount should or should not be considered when valuing a closely-held business interest on divorce.

**VIII. FAIR VALUE (IN CORPORATE LAW).** In Section III.C above we noted that the accounting profession uses the term “fair value” to mean what lawyers call “fair market value.” The term “fair value” as used in the law, as distinguished from its use in the accounting profession, is a special type of value that is used when minority owners of a business require the business to buy their interest at “fair value” in the event of a merger or sale of substantially all of the business’s assets. Texas Business Organizations Code § 10.362, “Procedure for Dissent by Shareholders as to Said Corporate Actions,” provides:

§ 10.362. Computation and Determination of Fair Value of Ownership Interest

(a) For purposes of this subchapter, the fair value of an ownership interest of a domestic entity subject to dissenters' rights is the value of the ownership interest on the date preceding the date of the action that is the subject of the appraisal. Any appreciation or depreciation in the value of the ownership interest occurring in anticipation of the proposed action or as a result of the action must be specifically excluded from the computation of the fair value of the ownership interest.

(b) In computing the fair value of an ownership interest under this subchapter, consideration must be given to the value of the domestic entity *as a going concern without including in the computation of value any control premium, any minority ownership discount, or any discount for lack of marketability*. If the domestic entity has different classes or series of ownership interests, the relative rights and preferences of and limitations placed on the class or series of ownership interests, other than relative voting rights, held by the dissenting owner must be taken into account in the computation of value.

(c) The determination of the fair value of an ownership interest made for purposes of this subchapter may not be used for purposes of making a determination of the fair value of that ownership interest for another purpose or of the fair value of another ownership interest, including for purposes of determining any minority or liquidity discount that might apply to a sale of an ownership interest. [Emphasis added]

This Texas statute is representative of other state statutes that use the same concept. The essential feature of this concept of "fair value" is that the court must ignore the effect of the business event that triggered the liquidation of the minority interest, and the court must ignore a control premium, a minority discount, and a marketability discount, all of which are hallmarks of the concept of the fair market value mental construct of a sale to a hypothetical third party.

**IX. INVESTMENT VALUE.** *Investment Value* is the value of an asset to a particular investor, based

on that investor's investment requirements. *Investment Value* can also be seen as the value of a business to a specific buyer, as distinguished from a hypothetical buyer.

**X. INTRINSIC OR FUNDAMENTAL VALUE.**

**1. What is Intrinsic Value?** Ibbotson defines "intrinsic value" as "the value that an investor considers, on the basis of an evaluation or available facts, to be the 'true' or 'real' value that will become the market value when other investors reach the same conclusion." IBBOTSON SBBI 12 (2011 Valuation Yearbook). The *Intrinsic Value* of a company is the value of a company determined from an analysis of its true value, as distinguished from the value that is recognized by others, as reflected in the marketplace. *Intrinsic Value* involves all aspects of the business, tangible and intangible. *Intrinsic Value* may or may not equate to fair market value, since fair market value represents the prevailing view of value of the business, or its *value in exchange* and not its actual value.

From an investment perspective regarding publicly-traded stock, *Intrinsic Value* is the underlying value of a company separate from its market value or share price. It is based on both quantitative factors (capital, earnings, revenue) and qualitative factors (management quality, intellectual capital, past record). The *Intrinsic Value* of a company may be lower or higher than what is indicated by the price at which its shares trade on an exchange, indicating that the firm is undervalued or overvalued. *Intrinsic Value* is most often determined using what is called "Fundamental Analysis." The theory of *Fundamental Analysis* holds that an individual security has an *Intrinsic Value* (equilibrium price) that depends on the security's earning potential. Eugene F. Fama, *Random Walks in Stock-Market Prices* 3 (1965) <<http://www.chicagobooth.edu/faculty/selectedpapers/sp16.pdf>>. This earning potential depends on fundamental factors such as the quality of management, outlook for the industry, outlook for the economy, etc. *Id.* p. 3. *Fundamental Analysis* proceeds through the study of an investment by looking at the firm's (1) competitive advantage, (2) earnings growth, (3) sales revenue growth, (4) market share, (6) financial reserves, and (6) quality of management, all as reflected in its financial statements.

< [www.businessdictionary.com/definition/fundamental-analysis.html](http://www.businessdictionary.com/definition/fundamental-analysis.html)>. Through this form of analysis the investor can determine whether the current price of the security is above or below its *Intrinsic Value*. Because the actual price tends to move toward *Intrinsic Value*, the investment can be made so as to profit from the move of the price to intrinsic value. Fama (1965) p. 3.

**2. Intrinsic Value Under Texas Law.** In *City of Austin v. Cannizzo*, 267 S.W.2d 808, 812 (Tex. 1954), the Texas Supreme Court acknowledged case authority for the proposition that “where property has no market value its intrinsic value may be shown.” The court said:

We see no need to ferret out of the decided cases the nice distinctions made by our courts between ‘market value’ and ‘intrinsic value’ as those terms are used in eminent domain and kindred proceedings. Most of the cases to which we are referred and which we have investigated use the term ‘intrinsic value’ in the sense of intrinsic worth based upon such factors as cost, depreciation, present usefulness, past return on investment, etc., and hold that where the evidence establishes the absence of a market for the kind of property involved evidence of intrinsic value is admissible for the purpose of arriving at the final figure to be established whether that figure be for the purpose of awarding damages in an eminent domain proceeding, fixing a basis for tax liability, or establishing the rights of individual suitors. As examples, see *Lower Colorado River Authority v. Hughes*, Tex. Civ. App., 122 S.W.2d 222, writ dismissed; *West Texas Hotel Co. v. City of El Paso*, Tex. Civ. App., 83 S.W.2d 772, writ dismissed; *Foley Bros. Dry Goods Co. v. Settegast*, Tex. Civ. App., 133 S.W.2d 228, writ refused.

The Supreme Court neither endorsed or rejected the idea of intrinsic value, but found that it did not apply to the present case. The land owners had not pled that there was no fair market value; they complained that they had not received fair market value; and they called three witnesses to testify to fair market value. The Court held that “[i]t was clearly error to instruct the jury that the 4.57 acre tract had no market value

unless the evidence revealed ‘a sufficient number of recent sales of comparable property to establish a prevailing price.’” *Id.* at 812-13. The Court concluded:

Thus it appears as a matter of law that there was no such record before the court as justified the abandonment in the charge to the jury of the standard of market value and the adoption therein of the standard of intrinsic value in measuring damages.

*Id.* at 813. The Supreme Court cited *City of Trinity v. McPhail*, , 131 S.W.2d 803, 806 (Tex. Civ. App.–Galveston 1939, no writ), which said:

It is unquestionably the rule that where the evidence is uncontradicted, or where the jury finds that the property involved has no market value, that then the intrinsic value of the property becomes the measure in determining damages in condemnation suits. However, where the measure of damages in an action is based upon market value, as in a condemnation suit, and there is evidence that the property in question has a market value, it is error for the trial court to submit to the jury an issue on the measure of damages based upon the intrinsic value of the property, without a prior determination by the jury that the property has no market value.

*Id.* at 806.

Texas Pattern Jury Charges PJC 203.1 reflects this line of authority when it says: “if an asset has no fair market value, its value is the value of its current ownership as determined from the evidence.” The Pattern Jury Charges (Family) cites to *Crisp v. Security National Insurance Co.*, 369 S.W.2d 326, 329 (Tex. 1963), which said “[w]here property, such as household goods and wearing apparel, has no recognized market value, the actual value to the owner must be determined without resort to market value.”

**XI. LIQUIDATION VALUE.** *Liquidation Value* describes the total value that could be realized if all of a company's physical assets were sold and the business terminated. Liquidation value is determined

by assets such as the real estate, fixtures, equipment and inventory. Residual intangible assets are not included in a company's liquidation value. <<http://www.investopedia.com/terms/l/liquidation-value.asp>>. Shannon Pratt distinguishes “value as an orderly disposition” from “value as a forced liquidation.” Shannon Pratt, VALUING A BUSINESS 47-48 (5<sup>th</sup> ed. 2008).

**XII. GOING-CONCERN VALUE.** *Going Concern Value* is the value of a company viewed as an operating enterprise. A profitable, functioning business is made up of individual assets, but the assets taken as a whole are worth more when they are assembled into a functioning business than if each asset were to be valued separately. *Going Concern Value* at a minimum reflects the cost and time it would take for someone to assemble a going concern from replacement assets. But if the business is profitable, the *Going Concern Value* reflects not only the cost of duplicating the business, but also the proven ability of the business to make a profit for its owners. The Free.Dictionary.com describes *Going Concern Value* in this way: “the value inherent in an active, established company as opposed to a firm that is not yet established; the value of the assets of a business considered as an operating whole.”

**XIII. BOOK VALUE.** *Book Value* is the value of a company as reflected in its accounting records and on its financial statements. *Book Value* is constructed from the historical purchase price of its assets, less depreciation. Depreciation is a creature of tax law, and does not necessarily relate to the economic or functional obsolescence of the improvements or equipment that are being depreciated. *Book Value* can vary from actual value when assets have appreciated or diminished in value since being purchased, or when depreciable assets have declined in value more or less than the tax law assumes. *Book Value* includes some tangible assets, but almost never reflects enterprise goodwill, except for the enterprise goodwill of subsidiary businesses that have been purchased for more than the value of their tangible and intangible assets. *Book Value* also omits self-created intangible value, which accounting principles requires to be expensed rather than booked as an asset. It is possible that *Book Value* could reflect the fair market value of a business, but that would

usually occur only when the business is a passive vehicle for holding saleable assets.

In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 923 (Tex. 1977), the Supreme Court held that “net book value” did not equate to market value. In *Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724 (Tex. App.--Austin 1997, pet. denied), the court approved the “development approach” for use in valuing tracts of land that had been subdivided, or nearly so. In *Cheek v. Humphreys*, 800 S.W.2d 596 (Tex. App.--Houston [14<sup>th</sup> Dist.] 1990, writ denied), the court said “[b]ook value is an improper method of determining the value of partnership equipment on dissolution of the partnership. . . . Book values are arbitrary values and cannot be used in the valuation of partnership assets.” [Citations omitted]. In *Coastal States Petroleum Co. v. Corpus Christi Indep. Sch. Dist.*, 707 S.W.2d 206, 212 (Tex. App.--Corpus Christi 1986, writ ref'd n.r.e), the court said “At most, book value is recognized as only an indication or approximation of true value. . . . Book value is not a proper measure of taxable value when the evidence shows that it differs from market value.” [Citation omitted]. In *Bendalin v. Delgado*, 406 S.W.2d 897, 900-01 (Tex. 1966), the Supreme Court said: “Book value is entitled to little, if any, weight in determining the value of corporate stock, and many other factors must be taken into consideration.” The statement is a bit overbroad.

The appellate court in *Sears Roebuck & Co. v. Dallas Cent. Appraisal Dist.*, 53 S.W.3d 382, 390 (Tex. App.--Dallas 2000 pet denied), noted that “[n]one of these cases involve the valuation of merchandise inventory and there is no indication that the book value at issue in any of these cases was calculated in accordance with GAAP.” These cases were therefore distinguished from the case at hand, which involved a property tax valuation of a business’s inventory. The Dallas Court of Appeals rejected a blanket assertion that *Book Value* was no evidence of market value. The Court said:

In some circumstances, book value of inventory may be probative of market value by either serving as some indication of market value or by being equivalent to market value. See *In re Quality Beverage Co.*, 170 B.R. at 316-17; *Coastal States*, 707 S.W.2d at 211, 212; *Cauble*

*v. Handler*, 503 S.W.2d 362, 365 (Tex. Civ. App.--Fort Worth 1973, writ ref'd n.r.e.). In other circumstances, the two values may be entirely unrelated. See *Polk*, 554 S.W.2d at 923; *Cheek*, 800 S.W.2d at 598. Whether the book value of inventory is in fact indicative of or equivalent to its market value is an issue to be determined by the trier of fact on a case by case basis. We decline Sears's invitation to hold that, as a matter of law, inventory book value derived according to generally accepted accounting principles is not equal to market value.

**XIV. SENTIMENTAL VALUE.** The Texas Supreme Court has recognized the right of persons to recover for the loss of the sentimental value of personal property. In *City of Tyler v. Likes*, 962 S.W.2d 489, 496-97 (Tex. 1997), the Supreme Court said:

While few persons suffering serious bodily injury would feel made whole by the mere recovery of medical expenses and lost wages, many whose property has been damaged or destroyed will be entirely satisfied by recovery of its value. As a rule, this is measured by the property's market value or the cost of repairing it. See *Pasadena State Bank v. Isaac*, 149 Tex. 47, 228 S.W.2d 127, 128-29 (1950). In some cases, however, the damaged property consists of "articles of small market value" that "have their primary value in sentiment." *Brown v. Frontier Theatres, Inc.*, 369 S.W.2d 299, 304-05 (Tex. 1963). Such property can only be adequately valued subjectively; yet, the owner should still be compensated. As the Court discussed in *Brown*, special rules apply in a suit to recover for the loss of property that is primarily of sentimental value:

It is a matter of common knowledge that items such as these generally have no market value which would adequately compensate their owner for their loss or destruction. Such property is not susceptible of supply and reproduction in kind, and their greater value is in sentiment and not in the market place. In such cases the most fundamental rule of damages that every wrongful injury or loss to persons

or property should be adequately and reasonably compensated requires the allowance of damages in compensation for the reasonable special value of such articles to their owner taking into consideration the feelings of the owner for such property.

**XV. ISSUES WITH BUSINESS VALUATION IN A DIVORCE.** Valuing a closely-held business interest in a divorce presents policy considerations that are not addressed by the approaches to valuation taken for purposes of tax reporting and financial reporting, or even the appraisal of businesses for purposes of purchase or sale.

**1. Tax Focus on Fair Market Value.** Federal tax law requires that the estate tax and gift taxes be levied on the fair market value of assets. The Federal tax law concept of fair market value involves the sale of the asset—the so-called "willing buyer/willing seller" test. Federal tax law does not recognize that some assets may not have a fair market value. Federal tax law does not recognize that, in the absence of a true market, there is no way to directly observe a market price. In 1959, the IRS promulgated Rev. Rul. 59-60, which essentially fell back on *Fundamental Analysis* of a business as a way to estimate fair market value when no free and active market existed for the company's stock. Tax practitioners, including the people who value closely-held business interests for tax purposes, when faced with no market in which to observe a true market value, are by necessity forced to engage in the legal fiction of hypothesizing a market value using *Fundamental Analysis*, to arrive at a figure for what a buyer would pay for the interest in the business if such a buyer could and would buy the business.

**2. Accounting Focus on Exit Price.** The accounting industry, as reflected in FAS 157, is interested for financial reporting purposes in reporting the "exit price," or the money which the asset (including a business) would fetch if sold.

The philosophical, or economic, or financial justification for insisting on an exit price for assets that have no market, or assets that are not being held for sale, is not explained in industry literature.



**3. Modern Business Valuation Methods.** In recent times, the business valuation community has striven to connect the *Fundamental Analysis* of a closely-held business to objective market data as much as possible. The Income Approach requires two things: a projection of future earnings/cash flows, and the proper discount rate to discount the future stream of payments to present value. The “buildup method” reflects this, where the discount rate is arrived at through the addition of measurable components: the safe rate (objective), the equity risk premium (objective), the industry premium (objective), the size premium (objective), and specific company risk (subjective). The CAPM does this by determining the Beta for investments that are comparable to the business being called. Both methods are discussed below.

**a. Rev. Rule in 59-60.** Modern business valuation theory originates with Rev. Rul. 59-60, where the IRS grappled with the difficulty of determining the fair market value of an ownership interest in a business where there was no market from which a fair value could be determined. The IRS eschewed any specific instructions on how to value the business: “No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases.” Rev. Rul. 59-60 § 3.01.

Rev. Rule 59-60 § 3.03 asserts that the best indicator of value is the price at which stock in a company trades in a free and active market. But where the stock is closely held, or traded infrequently, or traded in an erratic market, some other measure must be used. *Id.* § 3.03. Rev. Rule 59-60 suggests that the next best measure may be the price of stock in comparable companies that are trading in a “free and open market.” *Id.* If comparable companies whose shares are traded on an exchange cannot be found, then sales of comparable companies whose stock is sold “over the counter” should be used. *Id.* § 4.02 (g).

Rev. Rule 59-60 thus talks in terms associated with the market data approach to business valuation. In current practice, however, modern business valuation theory relies more heavily on the income approach, which does not look to guideline companies to develop market multipliers. Part of Rev. Rule

59-60 is easily adapted to the income approach. Earning capacity and dividend paying capacity are both listed as factors to consider in valuing a company. *Id.* § 4.01. In Section 5, Rev. Rule 59-60 says: “Earnings may be the most important criterion of value in some cases . . . . In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public. . . .” *Id.* § 5(a). Section 6 discusses capitalization rates, saying that “[a] determination of the proper capitalization rate presents one of the most difficult problems in valuation.” *Id.* § 6. The buildup method and Capital Asset Pricing Model (CAPM) are the way most business appraisers arrive at a defensible capitalization rate.

**b. The Buildup Method.** The buildup method is an additive model in which the rate of return on an investment that would be sufficient to attract a buyer is estimated by taking the “risk free rate” and adding to that various premia that reflect a return investors require for taking a specific risk. These premia include the equity risk premium, the firm size premium, the industry premium, and the specific company risk premium.

In theory, there is an investment that has no risk of default, and the rate of return on that investment is the “risk free rate.” For most purposes, the risk free rate in the U.S. is the interest rate on a three-month U.S. Treasury bill. However, for longer-term investments, a longer government security would be considered the risk free rate. With S&P’s downgrade of the United States’ long term sovereign credit rating, it makes less sense to talk of a risk-free rate. See <<http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563>>. Additionally, with the Federal Reserve System buying government bonds in order to artificially depress the rate on U.S. Treasury securities, the “risk free rate” is no longer solely determined by market forces and may therefore be sending inaccurate signals about investors’ expectations.

The expected “equity risk premium” is the additional return an investor expects to receive to compensate for the additional risk associated with investing in equities as opposed to investing in riskless assets.

It is the excess return of stocks over bonds. An article on the Internet commented: "If we do a little data picking, we can see that long-term Treasury bonds have outperformed stocks since the summer of 1987, and come in just behind stocks since late 1980. Reasonable people can disagree but that certainly sounds like the long-term to me. This means that you could have sat out the entire stock market over the last 28 years, parked your money in long-term T-bonds and done just as well as the stock market, which we know beats the vast majority of fund managers." <<http://seekingalpha.com/article/98784-what-equity-risk-premium>>. However, long term rates of return can be affected by the beginning and ending points you select.

"Specific company risk" has been defined to be "[a]n unsystemic risk specific to a certain company's operations and reputation." <<http://financial-dictionary.thefreedictionary.com/Company-Specific+Risk>>

Some judges are skeptical about specific company risk, as the following passage indicates:

In an appraisal action, "the proponent of a company specific premium bears the burden of convincing the Court of the premium's appropriateness."<sup>41</sup> Defendants accept this burden and point the Court to cases in which the Court has deemed a company-specific risk premium to be appropriate.<sup>42</sup> Yet as Vice Chancellor Strine explained in one of the cases defendants cited, even though courts may approve the use of these premiums, "[t]o judges, the company specific risk premium often seems like the device experts employ to bring their final results in line with their clients' objectives, when other valuation inputs fail to do the trick."<sup>43</sup> Proponents of a company-specific risk premium thus not only bear a burden of proof but also must overcome some level of baseline skepticism founded upon judges' observations over time of how parties have employed the quantitative tool of a company-specific risk premium.

<sup>42</sup> See, e.g., Delaware Open MRI Radiology Assoc. P.A. v. Kessler, 898 A.2d 290, 340-41 (Del. Ch. 2006) (declining to "quibble" with

including a company-specific risk premium, and ultimately selecting the more conservative of the two premiums the parties presented); Henke v. Trilithic Inc., 2005 WL 2899677, at \*10 (Del. Ch. Oct. 28, 2005) (agreeing that an upwards adjustment to account for company-specific risk was appropriate); Lane v. Cancer Treatment Ctrs. Of Am., Inc., 2004 WL 1752847, at \*30-31 (Del. Ch. July 30, 2004) (accepting adjustments for company-specific risk); ONTI, Inc. v. Integra Bank, 751 A.2d 904, 919-20 (Del. Ch. 1999) (applying a company-specific risk premium yet reducing the suggested value thereof after finding that not all risks outlined by valuation experts were risks specific only to the company).

43 Delaware Open MRI, 898 A.2d at 339.

Consol. C.A. No. 16089-CC, In the Court of Chancery of the State of Delaware, *In re Sunbelt Beverage Corp. Shareholder Litigation*, MEMORANDUM OPINION, Date Submitted: November 20, 2009, Date Decided: January 5, 2010, Date Revised: February 15, 2010 <[http://www.delawarebusinesslitigation.com/uploads/file/Sunbelt%20\(2\).pdf](http://www.delawarebusinesslitigation.com/uploads/file/Sunbelt%20(2).pdf)>.

A good explanation of specific company risk is at <<http://www.mercercapital.com/print/?id=191>>. One effort to objectify specific company risk is described at <<http://www.bvresources.com/bvwirecentral/material/bvwire54-1/0207BVUPB.pdf>>.

Shannon Pratt suggests that the required total rate of return on an equity investment in a small closely-held business varies from 20% to 40%.

**c. The CAPM.** The Capital Asset Pricing Model (CAPM) is used to describe the expected future rate of return on a security or portfolio of securities. According to the originator of the Model, William F. Sharpe, the CAPM can be used to determine the rate of return required before an investment should be added to an existing well-diversified portfolio. According to portfolio management theory, risk of an investment is broken down into firm-specific risk and market risk. An investor tries to diversify away as much firm-specific risk as possible. Firm-specific risk is diversified away by spreading investments

throughout the entire market, in the extreme leading to an investment portfolio that includes every asset in the market in proportion to that asset's share of the market. Such an investment strategy (at its theoretical extreme) eliminates all risk but market risk. Market risk can be reduced by diversifying the array of markets in which investments are made.

In portfolio management theory, risk is measured statistically as the variance around an expected rate of return. In theory, assuming a well-diversified investor, the only risk of variance in the portfolio is systematic or non-firm specific risk that cannot be diversified away.

Under the CAPM, the correct price for an investment is determined by discounting to present value its expected rate of return, after adjusting that rate of return by a risk factor. That risk factor is known as the beta coefficient ( $\beta$ ). Beta is a measure of the volatility of an investment, which is determined by determining how much the stock price moved when the entire market moved up and down by one percent, viewed over a historical 5-year period. A market index, like the S&P 500 or Wilshire 5000, is used to reflect movements of the entire market. Higher betas mean more volatility. A Beta of more than one means the stock is more volatile than the market; a Beta of 1 means that the stock has moved up and down in step with the market; a Beta between one and zero means the stock is less volatile than the market. A Beta of zero means there is no correlation between the investment and the market, which would apply to a cash and to risk-free investments like Treasury bills. A negative Beta means that the investment moves inversely to the market (i.e., decreases in value when the market goes up, or vice versa). See

<[www.businessdictionary.com/definition/beta.html](http://www.businessdictionary.com/definition/beta.html)>.

For an investment, the difference between the actual rate of return and the risk free rate is called "excess return." Under CAPM, the expected return of an investment is equal to the risk free rate, plus the product of Beta times the investment's excess return. The Arbitrage Pricing Theory (posited in 1976) determines overall Beta for an individual investment by comparing the investment's volatility to multiple macro-economic factors (GDP, inflation rate, etc.),

determining a Beta for each factor, and combining these measures into an overall Beta for that investment.

The original CAPM was based on simplifying assumptions that made the model perform poorly against empirical data. Successive efforts to make the model more robust have addressed particular criticisms, but on the whole, according to Professor Eugene F. Fama, "the empirical record of the model is poor—poor enough to invalidate the way it is used in applications"). *Eugene F. Fama and Kenneth R. French, The Capital Asset Pricing Model: Theory and Evidence (2004) p. 1* <<http://www-personal.umich.edu/~kathrynd/JEP.FamaandFrench.pdf>>.

#### **XVI. LAW AND LOGIC OF APPLYING BUY-SELL FORMULAS UPON DIVORCE.**

Federal cases distinguish between transfer restrictions that destroy marketability of an ownership interest and transfer restrictions that merely impair it.

In *Helvering v. Tex-Penn Co.*, 300 U.S. 481, 499, 57 S. Ct. 569, 577, 81 L. Ed. 755 (1937), the U.S. Supreme Court said:

The court is also of opinion that the judgments must be affirmed upon the ground that in the peculiar circumstances of this case, the shares of Transcontinental stock, regard being had to their highly speculative quality and to the terms of a restrictive agreement making a sale thereof impossible, did not have a fair market value, capable of being ascertained with reasonable certainty, when they were acquired by the taxpayers.

However, in *Kolom v. C. I. R.*, 644 F.2d 1282, 1288 (9<sup>th</sup> Cir. 1981) *cert. denied*, 454 U.S. 1011 (1981) the Ninth Circuit considered the effect of the six-month resale restriction imposed by Section 16(b) of the Securities and Exchange Act of 1934, which reads as follows:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity

security of such issuer ... within any period of less than six months ... shall inure to and be recoverable by the issuer ....

The taxpayer exercised employment-related options that were “in the money.” The IRS taxed the taxpayer based on the market value of the shares on the day he exercised his options, without regard to the fact that if he had sold the shares for a profit on that day he would have had to turn over the profit to the issuing company. The taxpayer unsuccessfully argued that the value to him was zero, because if he had sold the shares on that day Section 16(b) would have required him to turn the proceeds back to the company. The taxpayer also unsuccessfully argued that his shares had no market value on the day of exercise, because he could not be a willing seller. The Ninth Circuit rejected this contention, saying that the fact he was unwilling to sell his stock did not establish that he could not sell his stock. *Id.* Justice Powell dissented to the Supreme Court’s denial of certiorari. *Kolom v. C.I.R.*, 454 U.S. 1011, 102 S. Ct. 548 (1981).

*See Mailloux v. Commissioner*, 320 F.2d 60, 62 (5th Cir. 1963) (“where there is no absolute prohibition against a sale, a restriction may reduce but does not destroy fair market value”); *Cohu v. Commissioner*, 8 T.C. 796 (1947) (trial court overvalued shares that were subject to contingencies and restrictions); *Goldwasser v. Commissioner*, 47 B.T.A. 445 (1942), *aff’d*, 142 F.2d 556 (2nd Cir.), *cert. denied*, 323 U.S. 765, 65 S. Ct. 119, 89 L. Ed. 612 (1944) (while contract provision requiring no public offering of stock “did not constitute a restrictive covenant preventing petitioner from disposing of the stock if she had seen fit to do so, we think it did have the effect of depressing the market for her particular shares”).

In *United States v. Cartwright*, 411 U.S. 546, 550-51, 93 S. Ct. 1713, 1716-17, 36 L. Ed.2d 528 (1973), the U.S. Supreme Court invalidated a Treasury Regulation that valued shares in a front-end loaded mutual fund at the cost to buy into the mutual fund, not the price at which the decedent’s interest could be liquidated, which was solely through redemption by the mutual fund. In response to the government’s argument that the only true market transaction was when buyers bought into the mutual fund, the U.S.

Supreme Court reasoned that the redemption was the final act in a willing buyer-willing seller transaction. Thus, the redemption price for sellers prevailed over the market price for buyers.

Texas cases on the effect of buy/sell provisions on divorce value include:

-- *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192, 201-202 (Tex. Civ. App.--Houston [1 Dist.] 1975, no writ):

The legal justification for the refusal to effectuate transfer of the 1300 shares of capital stock of Earthman's, Inc. was based upon a provision of Article V of the articles of incorporation of that company which provides as follows:

“The shares of stock of the corporation are to be held by each shareholder upon the condition that he will not sell, assign, transfer, pledge or in any way dispose of or encumber any of such shares without first offering (in writing, mailed to the Corporation's office) the same for sale to the Corporation which shall have the right to purchase all or any portion of such shares within sixty (60) days from the date of the offer. . . . If for any reason the Corporation does not purchase any shares of stock which it has the right to purchase under any provision of this Article, the remaining shareholders of the Corporation so electing shall have the right to purchase all or any portion of such shares (prorata, according to their stock ownership, or as they may otherwise agree) within ten (10) days following the end of the time during which the Corporation had the right to purchase such shares under this Article. The price for purchase of shares of stock under any provision of this Article shall be the book value of such shares as at the close of the month preceding the date of the offer . . . such book value to be determined by the certified public accountants serving the Corporation at such time, in accordance with the accounting practices followed in preparing the most recent annual financial statement to the corporation. Such purchase price shall be paid in cash forthwith after notification of the election to

purchase or, at the option of the purchaser, 20% Of the purchase price may be so paid in cash and the balance may be paid in no more than four equal annual installments with interest at the rate of 6% Per annum.'

In the letter of April 5, 1972 counsel for Earthman's, Inc. stated that Earthman's, Inc. construed the delivery of the two certificates representing 1300 shares of the company stock as an attempt by J. B. Earthman, III to transfer stock to Mrs. Earthman in derogation of Article V, that the company was therefore entitled to purchase such stock at book value and that it exercised its right and option to purchase such stock on terms as stated in the article.

A provision which restricts a stockholder's right to sell or transfer his stock, particularly one which affords a prior right of purchase to the corporation or to another stockholder, is not looked upon with favor in the law and is strictly construed. *Casteel v. Gunning*, 402 S.W.2d 529 (Tex. Civ. App. 1966, writ ref'd n.r.e.); *Gulf States Abrasive Manufacturing, Inc. v. Oertel*, 489 S.W.2d 184 (Tex. Civ. App.--Houston (1st), 1972, writ ref'd n.r.e.). It has generally been held that such a restriction is inapplicable to a transfer occurring as a result of an involuntary sale or by operation of law unless by specific provision in the restriction it is made applicable. 18 C.J.S. *Corporations* § 391 (1939); 2 A.L.R.2d 745, 754, *Restrictions on Corporate Stock*.

In *Messersmith v. Messersmith*, 229 La. 495, 86 So.2d 169 (1956), it was contended that certain community owned stock should not be divided in kind, as decreed by the divorce court, and that the husband should be permitted to retain the stock and to pay his wife one-half its book value in accordance with a restrictive clause in the corporate charter requiring a stockholder, who wished to sell his stock, to first offer it to the other stockholders or officers of the corporation. The Louisiana Supreme Court determined that the restrictive provision of the charter could not prevent the recognition of the wife's share of ownership in the corporation and held that she was entitled to have

delivered to her in kind the interest awarded to her under the divorce decree. In so holding that court stated:

' . . . The restriction in the charter cannot affect the status of the stock purchased during the existence of the community or the rights the wife may assert thereunder. Such a restriction cannot negative the wife's present interest as a co-owner, and as a co-owner in community she is clearly entitled to be recognized as such and obtain the exclusive management and control of her vested interest. (citing cases).' (86 So.2d p. 173)

We are of the opinion that the restrictive provision in question should not be construed so as to preclude Mrs. Earthman's right to have her shares of ownership reflected on the books of the corporation and to have the stock certificates evidencing her ownership issued to her. We hold that the trial court properly determined that this provision did not afford to the corporation the right or option to purchase the shares of Earthman's, Inc. so awarded to Mrs. Earthman.

--*Finn v. Finn*, 658 S.W.2d 735, 742, 749-750 (Tex. App.--Dallas 1983, writ ref'd n.r.e.):

VANCE, Justice.

The lack of any legal right of the husband to realize the value of the firm's goodwill is a decisive factor. It distinguishes the present case from *Geesbreght* wherein the corporate structure provided a mechanism which enabled Dr. Geesbreght to realize the value of accrued goodwill by enhancing the value of his stock. In the present case the only mechanism through which the husband may possibly realize the value of the accrued goodwill is through continuing to practice law as a member of the firm, a circumstance depending not only on his own individual capacity, but also on the uncontrolled discretion of his partners. Thus his position is no better than that of the physician in *Nail*, in which the supreme court found the value of accrued goodwill in an individual professional practice to be realized only through

enhanced future earning capacity. Such realization in the future is no more than an expectancy entirely dependent on the husband's continued participation in the firm, and, therefore, is not property in the community estate. Nail, 486 S.W.2d at 764. Consequently, we hold that the trial court properly instructed the jury not to consider the law firm's accrued goodwill or future earning capacity FN3 when placing a value on the community interest in the husband's law practice.

STEWART, Justice, concurring.

The partnership agreement does not control the value of the individual partnership interests. The asset being divided is the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. *Slater v. Slater*, 100 Cal. App. 3d 241, 160 Cal. Rptr. 686, 688-689 (1980). The formula in the partnership agreement may represent the present value of the husband's interest, but it should not preclude a consideration of other facts. *Slater*, 160 Cal. Rptr. at 689; *Stern v. Stern*, 66 N.J. 340, 331 A.2d 257 (1975). The value of the husband's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill, if any. Goodwill is property and, although intangible, it is an integral part of a business, the same as its physical assets. *Taormina v. Culicchia*, 355 S.W.2d 569, 573 (Tex. Civ. App.--El Paso 1962, writ ref'd n.r.e.); *Ordway-Saunders Co. v. Little*, 568 S.W.2d 711, 717 (Tex. Civ. App.--Amarillo 1978, writ ref'd n.r.e.). Whether the law firm possessed goodwill, and, if so, its value are fact questions for the trier of facts. *Taormina*, 355 S.W.2d at 574.

The majority are concerned with future contingencies. All assets of the community estate are valued as of the time of dissolution of the marriage. There is no valid reason to exclude a professional partnership interest from this basic rule when the partner intends to continue as a member of the firm.

--*Keith v. Keith*, 763 S.W.2d 950, 953 (Tex. App.--Fort Worth 1989, no writ):

Charles asserts in point of error number three that the trial court erred by failing to find the market value of the partnership by applying the formula set forth in the partnership agreement, since his wife, Glenda, signed the agreement stating her approval of the agreement and her acceptance of its provisions, agreeing to be bound by it.

The partnership agreement entered into between Charles and Ty provided a method for determining the value of the business in the event it was terminated due to the withdrawal, other act, or death of one of the partners. The trial court did not use the method provided in determining the value of the partnership. Since the partnership is not being terminated, we do not find this provision of the agreement has any applicability to the matter before the trial court. Accordingly, the trial court did not err in failing to use the formula.

--*R.V.K. v. L.L.K.*, 103 S.W.3d 612 (Tex. App.--San Antonio 2003, no pet.):

Opinion by: SARAH B. DUNCAN, Justice.

Contrary to R.V.K.'s argument, the divorce proceeding has not triggered the buy/sell agreements. There has not been an "operative event"--an attempted sale, transfer, gift, mortgage, or pledge of stock without the corporations' consent; termination of R.V.K.'s employment; or termination of his marriage by death or divorce in a manner that dictates that R.V.K. will not succeed to L.L.K.'s community interest in the Medical Practice Group and the Medical Equipment Business stock.

\* \* \*

Concurring and Dissenting opinion by: ALMA L. LÓPEZ, Chief Justice.

I concur in the majority's conclusion that the trial court erred in failing to properly derive a fair market value for R.V.K.'s ownership interest, but I agree with the dissent that

we should address whether *Finn* or *Keith* should be followed in determining whether goodwill should be included in valuing a professional practice. I also agree with the dissent that we should follow the holding in *Keith* and the reasoning in Justice Stewart's concurring opinion in *Finn*.

\* \* \*

Dissenting opinion by: SANDEE BRYAN MARION, Justice, joined by CATHERINE STONE, Justice.

I respectfully dissent and I would affirm the trial court's judgment. [FN1] I believe this court should answer the question presented at trial and on appeal: should the *Finn* decision or the *Keith* decision be followed when determining the value of a professional practice upon divorce? I agree with Annette Stewart's concurring opinion in *Finn* and the court in *Keith*, and would hold that the value of R. V. K.'s interest should be based on the present value of the entities as ongoing businesses, which would include such factors as limitations associated with the buy/sell agreements and consideration of commercial goodwill.

--*Von Hohn v. Von Hohn*, 260 S.W.3d 631 (Tex. App.--Tyler 2008, no pet.):

Based on these facts, we agree with the concurrence in *Finn* that the Nix Law Firm partnership agreement does not control the value of the individual partnership interests in the event of a divorce. See *Finn*, 658 S.W.2d at 749. The Nix Law Firm was an ongoing partnership as of the time of divorce, Edward had not died nor had he withdrawn from the partnership, and, thus, none of the triggering events specified in the partnership agreement had occurred. See *R. V. K.*, 103 S.W.3d at 623; *Keith*, 763 S.W.2d at 953. Consequently, the formula in the partnership agreement was not determinative of the value of Edward's interest in the Nix Law Firm. See *Keith*, 763 S.W.2d at 953. Therefore, the trial court did not err when it determined that the proper measure of the value of the community interest in the Nix Law Firm could include methods other than those set forth in the partnership agreement.

In answering the legal policy question of what to do about transfer restrictions in determining value for purposes of divorce, the choices fall into four categories: (i) always assume the restrictive provision will trigger at the time of divorce; (ii) never assume the restrictive restriction will trigger at the time of divorce; (iii) determine from the evidence whether and when the restrictive provision will trigger; and (iv) use a value that permits a just and right property division. The plurality Opinion in *Finn* tacitly assumed that the withdrawal provision applied at the time of divorce. The Opinion in *Earthman*, the Concurring Opinion in *Finn*, the opinion in *Keith*, all three Opinions issued in *R. V. K.* and the Opinion in *Von Hohn* all said that the transfer provision did not trigger and thus did not control the divorce value. Intellectually we must be ask whether the definition of fair market value, which assumes a hypothetical sale by an imaginary seller to an imaginary buyer, forces us to assume that there is an imaginary trigger of the buy-sell or withdrawal clause that results from the hypothetical sale.

--*Mandell v. Mandell*, 310 S.W.3d 531, 537 (Tex. App.--Fort Worth 2010, pet. denied):

A straight fair market value is not an appropriate valuation method, however, when a community estate owns shares in a closely held corporation and, by agreement, any sale of the shares of stock is restricted to the corporation or other stockholders. See *Beavers v. Beavers*, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ). When the sale of stock is restricted by a requirement that the shares be offered first to the corporation or to other shareholders, then essentially the fair market value of the stock is zero. See *id.* FN5 In this situation, the parties may show the actual value of the property interest to the owner. See *R. V. K.*, 103 S.W.3d at 618. Such evidence might include the value of being able, by virtue of ownership of the closely held stock, to drive a new automobile, to have health insurance paid for by the company, to have a company-financed life insurance policy, to belong to a country club at company expense, and other similar financial

benefits. See James M. Loveless & Kimberly M. Naylor, Handling a Divorce Involving a Closely-Held Corporation, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, M, M-3 (1996).

FN5. See also Edwin Terry et al., Handling the Divorce Involving a Medical Practice, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, B, B-5 (1996) (explaining that “the concept of market value assumes an existing, established market” and that “as a practical matter there is often little or no actual market for a closely-held medical practice.... Therefore other methods of value must be used”).

**XVII. THE PARADOX OF VALUING PARTIAL OWNERSHIP INTERESTS.** When all ownership interests in a business are minority interests, and the value of each minority interest is reduced below its proportionate share of the entity’s overall value due to a minority discount, then a paradox occurs: the value of all ownership interests added together does not total to the value of the entire business. This problem was exemplified in the context of real estate in *Watkins v. Shurley*, 2010 WL 5690100 (Tex. App.--Austin 2011, no pet.) (mem. op.). There the issue was an agreed division of land owned by a trust into two undivided fractional interests, a 5/12 interest and a 7/12 interest. Under a settlement agreement, one family member’s original contribution was to be valued at fair market value, but would remain in trust. The person’s contribution amounted to a 5/12 interest in the land. In determining the fair market value of the 5/12 interest, the appraiser did not apply a marketability discount because, after the valuation, the two interests would be combined into a whole again. *Id.* \*6. The appellate court criticized this approach as not arriving at fair market value. In an explanation that demonstrates the weakness of using the fair market value concept in a situation where there is no sale, the Austin Court of Appeals wrote:

“Fair market value” attempts to ascertain the price a willing buyer would pay to a willing seller on the open market if the seller and buyer were not compelled to enter into the transaction. *State v. Windham*, 837 S.W.2d 73, 77 (Tex.

1992). It is, by its very nature, a hypothetical determination—“an imaginary price to be paid by an imaginary buyer to an imaginary seller in an imaginary sale.” *City of Austin v. Cannizzo*, 267 S.W.2d 808, 816 (Tex. 1954) (Garwood, J. dissenting). The sale in question “has not been made and never will be,” *id.* at 818, and the seller and the buyer are unidentified. Further, Texas courts have long held that it is appropriate to consider “all factors ... which would reasonably be given weight in negotiations between a seller and a buyer” of the property in arriving at a fair market value. *Cannizzo*, 267 S.W.2d at 813-14; *State v. Carpenter*, 89 S.W.2d 194, 200 (Tex. 1936) (“Generally, it may be said that it is proper as touching the matter of the value and depreciation in value to admit evidence upon all such matters as suitability and adaptability, surroundings, conditions before and after, and all circumstances which tend to increase or diminish the present market value.”). Thus, to arrive at the fair market value required here, the appraiser must determine the price at which a hypothetical unobligated seller would sell the undivided 5/12 interest in the tract to a hypothetical unobligated buyer, whom the appraiser must assume will consider the size, ownership interest, and various other conditions of the property being conveyed in determining what he is willing to pay for that tract. See *Spindor v. Lo-Vaca Gathering Co.*, 529 S.W.2d 63, 65 (Tex. 1975) (noting that a “hypothetical willing buyer-willing seller would take [relevant factors related to certain property] into consideration in negotiating for the purchase of that property”). Here, the settlement agreement provides that the undivided 7/12 interest be removed from the appraisal process. Thus, because the agreement requires a division based on fair market value, the appraiser must value the undivided 5/12 interest on its own, taking into account its fractional undivided status without regard to who owns or will eventually own the undivided 7/12 interest in that tract.

*Id.* at \*5.

To be fair to the family member whose contribution was being valued, the settlement agreement should have provided that the family



member's interest would be the pro rata value of the entire tract. It is interesting to note that a lack of control discount would not be appropriate since a partial cotenant's undivided interest in land is not subject to the control of any one cotenant or even a group of other cotenants. However, since the property was held in trust, both the 5/12 and the 7/12 interests were subject to the control of the trustee, who could refuse to sell a 5/12 interest to a third party. While the Court of Appeals was constrained to recognize the "fair market value" determination contained in the settlement agreement, it is easy to see how the willing buyer-willing seller approach can lead to undesirable results in certain situations where it would be better to avoid it or abandon it.