Valuations in the Business Setting

This discussion will focus on different types of valuations in a business setting and the types of services professionals can provide to their clients. The presentation will include discussion of the complexities and issues particular to each type of valuation.

I. Valuation Basics

A. Business Valuation Professional Organizations and Valuation Standards
   1. Professional appraisal organizations
      a) American Institute of Certified Public Accountants
      b) American Society of Appraisers.
      c) Institute of Business Appraisers
      d) National Association of Certified Valuation Analysts
   2. Other organizations and regulatory bodies that influence valuation standards
      a) Appraisal Foundation – Appraisal Standards Board
      b) Internal Revenue Service
      c) Department of Labor
      d) Courts
   3. Valuation standards
      a) Appraisal Standards Board - Uniform Standards of Professional Appraisal Practice (USPAP)
      b) American Institute of Certified Public Accountants – currently assessing standards
      c) American Society of Appraisers - Business Valuation Standards
      d) Institute of Business Appraisers – Business Appraisal Standards
      e) National Association of Certified Valuation Analysts – NACVA Professional Standards

B. Valuation Terminology
   1. See Exhibit

C. Definition of Property to be Valued
   1. Entity

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1 International Glossary of Business Valuation Terms (The C.L.A.R.E.N.C.E. Glossary Project comprised of the following professional organizations: American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, and The Institute of Business Appraisers, 2000).

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a) State of incorporation or registration
b) Form of Organization (e.g., C corporation, S corporation, general partnership, limited partnership, sole proprietorship, limited liability company, trusts, estates)

2. Specific business interest
   a) Assets or securities
   b) Equity or Invested Capital
   c) Partial interests
      (1) Relationship of interest to be valued to the whole
      (2) Different classes of stock

D. Effective Date of Valuation
   1. Important because value can be effected over time by changes in entity, industry, and economic conditions.
   2. Certain types of valuations will have effective dates mandated by external authorities (e.g., estate tax valuations, dissenting shareholder valuations, etc.).

E. Purpose of the Valuation
   1. Purpose of valuation may effect:
      a) Definition of value
      b) Valuation approaches and methods applied
      c) Types of adjustments made to financial statements

F. Standard of Value
   1. Standard of value defines the type of value being sought. It answers the question "value to whom?"
   2. The use of the valuation usually determines the applicable standard of value.
   3. Types:
      a) Fair Market Value
         (1) Most widely used. Statutorily mandated standard of value for most federal and state tax-related valuations. Often used interchangeably with "market value."
         (2) Treasury Regulation §1.170A-1(c)(2) defines the standard of value for estate and gift tax matters as follows:
            (a) "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."

b) Investment Value

(1) Reflects value to a particular buyer or seller rather than a hypothetical buyer or seller. Often used in merger and acquisition transactions involving strategic buyers.

(2) Dictionary of Real Estate Appraisal defines standard as follows:
(a) "The specific value of an investment to a particular investor ... based on individual investment requirements; distinguished from market value, which is impersonal and detached." 3

c) Intrinsic Value

(1) Amount an investor considers to the “true” worth of an item based on perceived characteristics inherent in the investment (not characteristic peculiar to any one investor). Often used in the analysis of stocks.

(2) Defined in “Kohler’s Dictionary for Accountants” as follows:
(a) The amount that an investor considers, on the basis of an evaluation of available facts, to be the “true” or “real” worth of an item, usually an equity security. The value will become the market value when other investors reach the same conclusions. 4

d) Fair Value

(1) Created by statute for certain specific purposes. Often used in state statutes for dissenting stockholder actions.

(2) Defined in the Code of Virginia (which is modeled on the Uniform Business Corporations Act) as follows:
(a) “Fair value,” with respect to a dissenter’s shares, means the value of the shares immediately before the effectuation of the

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2 Treasury Regulation §1.170A-1(c)(2).
corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.  

G. Ownership Characteristics

1. The characteristics of the ownership interest being valued is one of the determinants as to whether or not the interest is affected by premiums or discounts.

2. Minority v. Control
   a) Minority – an ownership interest less than fifty percent (50%) of the voting interest in a business enterprise.
   b) Majority – an ownership interest greater than fifty percent (50%) of the voting interest in a business enterprise.
   c) Control - the power to direct the management and policies of a business enterprise. (see Exhibit)

3. Marketable v. Nonmarketable
   a) Marketable – the ability to quickly convert property to cash at minimal cost. (see Exhibit)

H. Premise of Value

1. Defines the status of the business

2. Alternatives
   a) Going-concern value – value of an ongoing operating business enterprise.
   b) Liquidation value – the net amount that can be realized if the business is terminated and the assets are sold piecemeal.
      (1) Orderly liquidation – liquidation value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received.
      (2) Forced liquidation – liquidation value at which the asset or assets are sold as quickly as possible, such as at an auction.
II. Estate and Gift Taxes

A. Introduction

1. Estate and gift taxes are a system of excise taxes levied on the transfer of wealth during life and at death. The law provides for certain exemptions and exclusions from the amount of net assets that would otherwise be taxable in an individual's estate. These include:

   a) The first $650,000 of the fair market value of the estate or previously gifted assets.
   
   b) Any amounts given to one's spouse, either by gift or by will.
   
   c) Up to $10,000 gifted annually from any one donor to each of any number of donees.\textsuperscript{14}

B. General Federal Estate and Gift Tax Valuation Guidelines

1. Guidelines for the valuation of closely held businesses for estate and gift tax purposes are set forth in the Internal Revenue Code, Treasury Regulations to the Code, and Revenue Rulings. In addition, information on IRS positions on various business valuation issues is also provided in Technical Advice Memorandums and Private Letter Rulings.\textsuperscript{15}

2. Internal Revenue Code Section 2031 (b) is the primary source of information on the valuation of closely held businesses:

   a) In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange.\textsuperscript{16}

3. Treasury Regulations set forth the IRS's interpretation of the IRC. Treasury Regulation §20.2031-1 defines the standard of value for estate and gift tax matters as follows:

   a) "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."\textsuperscript{17}

\textsuperscript{15} Pratt, \textit{Valuing a Business} 583.
\textsuperscript{16} Internal Revenue Code §2031(b).
\textsuperscript{17} Treasury Regulation §20.2031-1(b).
4. Revenue Rulings provide guidance for general situations not requiring a specific change in the Regulations.
   a) Revenue Ruling 59-60 is the ruling most often cited relating to the valuation of closely held companies. RR 59-60 expands upon the definition of fair market value:
      (1) "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 [emphasis added]."\(^{16}\)
      (2) RR 59-60 also provides guidance on the valuation approaches and factors to be considered when valuing closely held companies.

5. The IRS also issues opinions on specific situations in the form of Technical Advice Memorandums and Private Letter Rulings.

C. Special Valuation Guidelines under IRC Chapter 14
   1. In 1990 the U.S. Congress passed special valuation rules under Chapter 14 of the IRC to correct for perceived abusive practices involving valuation issues. The Chapter 14 rules override the generally accepted valuation guidelines for estate and gift tax valuations.
      a) Section 2701 – Valuing Recapitalizations and Senior Equity Interests
      b) Section 2702 – Retained Life, Annuity, and Unitrust Interests Transferred via Trusts for Lifetime Gift Tax Purposes
      c) Section 2703 – Buy/Sell Agreements or Sale of Options (discussed elsewhere in this text)
      d) Section 2704 – Lapsing Rights and Other Restrictions

D. Adequate Disclosure of Gifts under Treasury Regulation §301.6501(c)-1
   1. On December 3, 1999, the IRS issued final regulations regarding the manner of adequately disclosing gifts on gift tax returns to preclude the IRS from adjusting the value of gifts for either gift or estate tax purposes. The regulations are applicable to all gift tax returns filed after December 3, 1999, and provide for a three year statute of limitations.
   2. Disclosure is considered to be adequate for a valuation if the following requirements are met:
      a) Qualifications of the appraiser
         (1) Person must hold himself out to the public as an appraiser or perform appraisals on a regular basis.

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\(^{16}\) Revenue Ruling 59-60, 1959-1 C.B. 237.

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(2) Appraiser is qualified to appraise type of property being valued.

(3) Appraiser is not the donor, donee, or employed by either, or a member of the family of either.

b) Information required for the valuation report
   (1) Date of appraisal
   (2) Date of transfer
   (3) Purpose of appraisal
   (4) Description of property
   (5) Description of appraisal process and valuation approach
   (6) Description of assumptions and any hypothetical conditions
   (7) Identification of any restrictions or limiting conditions
   (8) Information considered in determining value
   (9) Reasoning supporting analysis, opinions and conclusions
   (10) Comparative transactions
   (11) Fair market value of 100% of the entity excluding discounts unless this information is not relevant or material in determining the value of the interest. 19 20

E. Pass Through Entities
   1. Types
      a) Family Limited Partnerships, Limited Liability Companies, S Corporations
   2. Estate planning benefits for FLPs
      a) Parents can transfer assets to FLP and retain control over asset and income distribution
      b) Provide for protection against creditors as creditors are legally unable to get to the assets of the partnership
      c) Assets can be retained within the family by properly structuring the partnership agreement to restrict transferability of interests
      d) Avoid problems resulting from gifts of undivided fractional interests in assets
      e) Partnership does not pay income taxes

19 Treasury Regulation §301.6501(c)-1.
20 Pratt, Valuing a Business 598.

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f) Gifting or transfer of an ownership interest in an FLP may be made at a lower value than the interest's pro rata share of the net asset value as the interest is equivalent to a non-marketable minority interest.21

3. Family attribution
   a) IRS aggregated ownership interests of family members for the purpose of determining type of ownership interest prior to February 1993.
   b) In Revenue Ruling 93-12, the IRS reversed its position and acknowledged that the fair market value standard assumed a hypothetical buyer and seller.22

4. Representative transaction

5. Analysis of the Operating Agreement and determination of applicable discounts
   a) Control
      (1) Management
      (2) Distributions
      (3) Transferability of interests
         (a) Section 754 Election – Provides for the transferee to write up the cost basis of a limited partnership interest transferred to the partner to the amount paid for it. Without the election, the transferee inherits the cost basis of the transferor and may be subject to any imbedded capital gains. If the 754 election is made, the transferee realizes a step up in basis of the investment. Availability of the election may at the discretion of the general partner. 23 24
   b) Lack of marketability
      (1) Uncertainties of expected holding period
      (2) General illiquidity of the investment
      (3) Lack of expected interim cash flows
      (4) Potential for adverse cash flow
      (5) Rights of first refusal limiting transferability
      (6) Lack of diversification of assets

22 Revenue Ruling 93-12.
23 Internal Revenue Code §754.
(7) Uncertainties due to risks of future investment strategies
(8) Unlikely candidate for merger/sale/acquisition
(9) Restrictions on use of member interest as loan collateral
(10) Small ownership base

6. Typical discounts for FLPs with certain asset portfolios
   a) Securities (see Exhibit)
   b) Real estate (see Exhibit)

7. Examples of estate planning techniques using pass-through entities
   a) Sale to an Intentionally Defective Grantor Trust
   b) Sale for a Private Annuity or Self-Canceling Note

F. Estate and Gift Valuation Issues and Related Tax Court Cases

1. Discounts for Lack of Control and Lack of Marketability
   a) In Mandelbaum v. Commissioner, the Tax Court considered whether or not a marketability discount was warranted, and if so, the appropriate amount of the discount. Judge Laro identified the following criteria in determining the applicable discount:
      (1) Private v. public sales of stock using empirical studies as a starting point
      (2) Financial statement analysis
      (3) Company’s dividend policy
      (4) Nature of the company; history and economic outlook
      (5) Company management
      (6) Amount of control in transferred shares
      (7) Restrictions on transfer of stock
      (8) Holding period for the stock
      (9) Company’s redemption policy
      (10) Costs associated with a public offering

2. Discounts for Lack of Marketability for Controlling Interests

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a) In *Estate of Cloutier v. Commissioner*, the Tax Court indicated that in some instances where 100% of a closely held stock was owned by one shareholder, a lack of marketability discount may still be applicable. However, it disallowed such a discount in this instance because of its opinion that the taxpayer failed to determine the subject stock’s value by reference to a freely traded value.  

b) In *Estate of Hendrickson v. Commissioner* the Tax Court concluded a 30 percent lack of marketability for a controlling interest was reasonable based on the following factors:

1. Limited opportunities for growth
2. Earnings were subject to interest rate risk
3. No history of company’s repurchasing of shares
4. No public or private market for the shares

3. Discount for Trapped-In Capital Gains Taxes

a) Before 1986, a C corporation could liquidate, distribute all proceeds to its stockholders within a year, and avoid paying capital gains tax under the *General Utilities Doctrine*. The *General Utilities Doctrine* was repealed by the Tax Reform Act of 1986; however, the IRS refused to permit a discount for trapped-in capital gains.  

b) In *Estate of Davis*, the Tax Court ruled that a hypothetical willing buyer and seller would adjust the value to reflect the built-in gains tax in negotiating a price whether or not a liquidation or sale of the assets was contemplated. Judge Chiechi further ruled that the discount should not be equal to the full amount of the taxes unless a liquidation was foreseeable.  

c) In *Eisenberg v. Commissioner*, the Second Circuit Court of Appeals cited the *Estate of Davis* and reversed the lower Court’s decision.

4. Use of subsequent sales

a) Generally, only facts known or knowable as of the date of a valuation should be considered.

b) The U.S. Tax Court re-examined this issue in the *Estate of Jung* and determined that to the extent transactions occurring subsequent to the date of the valuation were
evidence of value as opposed to something affecting value, then such transactions should be considered.\textsuperscript{33}

III. Calculation of Potential Built-In Gains Tax Resulting from C to S Corporation Conversion

A. Overview
1. Built-in gain refers to the excess of the fair market value over the adjusted basis of an asset at the beginning of the first year a company makes an S election.\textsuperscript{34} It applies to C corporations that elect S status after 1986.
2. Generally, any gain from the sale of assets that the corporation recognizes within the 10 post-conversion years is taxed at the highest corporate rate as of the conversion date. The gain flows through to the shareholders, net of the corporate-level tax paid, creating a near double-level tax to the corporation and its shareholders.
3. Any appreciation in assets that occurs after the S conversion (including goodwill) will not be subject to the built-in gains tax.
4. For purposes of determining any potential tax exposure from the C to S corporation conversion, a valuation should be performed as of the date of conversion.
5. The applicable standard of value is fair market value.

B. Valuation Issues and Tax Court Cases
1. In \textit{Estate of Davis}, the Tax Court ruled that a hypothetical willing buyer and seller would adjust the value to reflect the built-in gains tax in negotiating a price whether or not a liquidation or sale of the assets was contemplated. The Court further ruled that the discount should not be equal to the full amount of the taxes unless a liquidation was foreseeable.\textsuperscript{35}
2. In \textit{Eisenberg v. Commissioner}, the Second Circuit Court of Appeals cited the \textit{Estate of Davis} and reversed the lower Court’s decision.\textsuperscript{36}

IV. Buy / Sell Agreements and Shareholder Buy-In

A. Overview
1. A buy/sell agreement is a contract that restricts the ability of a shareholder to freely transfer an ownership interest.
2. The objectives of a buy/sell agreement include:
   a) Identification of events that will trigger the agreement
   b) Providing for liquidity for interest of departing owner

\textsuperscript{33} \textit{Estate of Mildred Herschede Jung v. Commissioner} [101 T.C. No. 29 (1993)]
\textsuperscript{34} Internal Revenue Code §1374.
\textsuperscript{35} \textit{Estate of Artemus D. Davis v. Commissioner}, 110 TC No. 35.
c) Providing for fair method of determining price to pay departing owner or buy-in price for new owner

d) Facilitating continuity of business by providing fair method to fund buy-out

e) Preventing interest from being sold/transferred to unacceptable party

f) Setting price that will be respected by taxing authorities for estate, gift, and income tax purposes or by courts for divorce or other litigation purposes

3. Types of agreements

a) Redemptions (Stock Repurchase) Agreement – provides for entity to buy back interest from departing owner

b) Cross Purchase Agreement – provides for other owners to buy departing owner's interest

c) Hybrid Agreement – combination of above

4. Structuring Buy/Sell Agreements

a) Purchase price

(1) Establishing price
   (a) Fixed price
   (b) Book value/adjusted book value
   (c) Formula method
   (d) Appraisal

(2) Appraisal
   (a) Use qualified business appraiser
   (b) Buy/Sell Agreement should address:
      (i) Selection of appraiser
      (ii) Definition of standard of value
   (c) Consider using business appraiser to assist in developing Agreement to ensure appropriate valuation terminology is used (beware of implications of “Fair Market Value”).
      (d) This is desired method to ensure value is equal to fair market value and will be respected, for example, by IRS for estate tax purposes.

b) Triggering events

c) Terms of purchase/sale

(1) Typically structured around triggering event
(a) Owner's death – purchase price may be paid with lump sum (e.g., from insurance proceeds)

(b) Owner retirement – purchase price may be paid in installments.

(2) Valuation assumes cash equivalent price as of valuation date. If installment purchase is used, present value of purchase should equal value.

d) Funding the purchase obligation

B. Valuation Issues and Tax Court Cases

1. IRC §2703 defines four factors to that determine if Buy/Sell agreements are binding for estate tax purposes:
   a) Agreement must restrict the transfer of the securities to the buy/sell price during owner's life as well as at death.
   b) There must be a valid business purpose for establishing the agreement.
   c) Value established in the agreement must have been an adequate and fair price at the time the agreement was executed.
   d) Value must reflect those typical of arm's-length transactions in the subject company's industry.\textsuperscript{37}

2. IRS may not agree that a transaction is based upon fair market value even if the above criteria are met. This is particularly true when the parties are members of a family.

3. The \textit{Estate of Lauder} related to whether or not the price of shares as determined by a buy/sell agreement was acceptable for estate tax purposes. The Tax Court focused on whether or not the price was equivalent to fair market value at the time the agreement was executed. The Court concluded that since the price did not reflect a price that would have been negotiated between two unrelated parties, then it was not equivalent to fair market value.\textsuperscript{38}

\textsuperscript{37} \textbf{Internal Revenue Code} §2703.

\textsuperscript{38} \textbf{Estate of Joseph Lauder, T.C. Memo} 1992-736.
V. Employee Stock Ownership Plan (ESOP)

A. An ESOP is a qualified retirement plan under the Internal Revenue Code of 1986, as amended. The plan is designed to provide employees an ownership interest in their company by primarily investing in the stock of the sponsoring company. The IRC and the Employee Retirement Income Security Act of 1974, as amended, (ERISA) require satisfaction of a number of requirements in order for the plan to be qualified.39

B. Types of ESOPs

1. Non-leveraged - ESOP acquires company's stock as a result of the company making tax deductible stock contributions or cash contributions that are then used to purchase the stock.

2. Leveraged – A typical transaction involves the company borrowing funds from a bank and then loaning the funds to the ESOP. The ESOP uses the funds to purchase the stock from the company's current shareholders. Each year thereafter, the company makes tax deductible cash contributions (or pays stock dividends) to the ESOP. The ESOP uses the funds to repay the company for the amount due on the bank loan.

a) Benefits

   (1) Company - Can deduct the principal payments on the ESOP acquisition loan.

   (2) Selling shareholder – Ability to defer capital gains tax on the sale of company stock to the ESOP under IRC §1042. The transaction also provides an exit strategy for the selling shareholder to enable him to gain liquidity.

   (3) Employee - Share in the growth of the company.40

C. Standard of Value and Adequate Consideration

1. ERISA requires ESOPs to pay no more than "adequate consideration" when investing in employer securities.

2. "Adequate consideration" is defined in Section 3(18)(B) of ERISA as:

   a) "the fair market value of the asset as determined in good faith by the trustee or named fiduciary...pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor"41

3. On May 17, 1988, the U.S. Department of Labor ("DOL") issued the "Proposed Regulation Relating to the Definition of Adequate Consideration" (the "Proposed Regulation") for ESOP transactions. (Although the DOL has never finalized the Proposed

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39 Pratt, Valuing a Business 698.

40 Pratt, Valuing a Business 700.

Regulation, most appraisers consider it when performing an ESOP-related valuation).

4. The Proposed Regulation requires that a valid determination of adequate consideration in this case satisfy two requirements:
   a) The value assigned to an asset must reflect its fair market value determined pursuant to the Proposed Regulations. Fair market value is defined as follows:
      (1) "the price at which an asset 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, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset."
   b) The value assigned to an asset must be the product of a determination made by the fiduciary in good faith as defined in the Proposed Regulation.42

D. Required ESOP Valuations
1. When ESOP makes initial acquisition of sponsoring company stock
2. Annually, after the ESOP’s initial acquisition of stock
3. Whenever there is a sale of stock involving a controlling shareholder or member of a controlling group
4. If the ESOP sells the stock it owns

E. Selection of the Appraiser
1. The Proposed Regulation notes that under IRC §401(a)(28)(C) ESOP fiduciaries must employ an independent appraiser meeting requirements similar to those under IRC §170(a)(1) for charitable contributions. A qualified appraiser:
   a) Is not a party to the transaction, is not related to any party to the transaction, is not married to any person with a relationship to the transaction, is not regularly used by any of the parties to the transaction and who does not perform a majority of appraisals for these persons.
   b) Holds himself or herself to the public as a valuation practitioner or performs appraisals on a regular basis.
   c) Is qualified to make appraisals of the type of property being valued including, by background, experience, education, and memberships, if any, in professional associations.

d) Understands that an intentionally false or fraudulent overstatement of value may subject the valuation practitioner to a civil penalty.

e) Receives an appraisal fee that is not based upon a percentage of the appraised value of the property.\textsuperscript{43}

F. Valuation Reporting Requirements

1. A summary of the qualifications to evaluate assets of the type being valued of the person making the valuation.

2. A statement of the asset's value, a statement of methods used in determining that value, and the reasons for the valuation in light of those methods.

3. A full description of the asset being valued.

4. The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the property.

5. The purpose for which valuation was made.

6. The relevance or significance accorded to the valuation methodologies taken into account.

7. In cases where a valuation report has been prepared, the signature of the person making valuation and date the report was signed.\textsuperscript{44}

G. Special Documentation Rules for Securities of Closely Held Companies

1. The Proposed Regulation requires that the written document include an assessment of all relevant factors plus an assessment of the factors listed below:

   a) The nature of the business and the history of the enterprise from its inception

   b) The economic outlook in general, and the condition and outlook of the specific industry in particular

   c) The book value of the securities and the financial condition of the business

   d) The earnings capacity of the company

   e) The dividend-paying capacity of the company

   f) Whether or not the enterprise has goodwill or other intangible value

   g) The market price of securities of corporations engaged in the same or a similar line of business, which are actively


traded in a free and open market, either on an exchange or over-the-counter

h) The marketability, or lack thereof, of the securities. Where the plan is the purchaser of the securities that are subject to "put" rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well as the company's ability to meet its obligations with respect to the "put" rights (taking into account the company's financial strength and liquidity)

i) Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account:

1. Actual control (both in form and in substance) is passed to the purchaser with the sale, or will pass to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and

2. It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.

2. The requirement to assess factors (a) through (g) as well as all relevant factors, like the definition of fair market value, has been deliberately modeled after RR 59-60. The DOL believed that the RR 59-60 was familiar to plan fiduciaries, plan sponsors and the corporate community. Factors (h) and (i) are additions specific to ESOPs.  

H. ESOP-Specific Valuation Adjustments

1. ESOP Contributions - If the company being valued has an existing ESOP, the appraiser using debt-free cash flow (cash flow to invested capital) should add back the company contribution to the ESOP. However, if the ESOP contribution represents compensation in lieu of wages or benefits or are expected to remain in place indefinitely, then the contribution should not be added back.  

2. Post-Transaction Adjustments for Leveraged ESOPs - After a leveraged ESOP transaction, the company has reduced cash flow as a result of required debt repayments. As a result, the fair market value of the ESOP shares is reduced. However, the reduction in value is offset by the benefits resulting from the

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45 Valuing ESOP Shares 7-9.  
46 Valuing ESOP Shares 19-20.  

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The company's ability to deduct repayment of the ESOP debt principal for tax purposes.  

I. Discount for Lack of Marketability

1. Factors to consider when determining the discount for lack of marketability for ESOP securities:

   a) Provisions of the Plan documents, including put rights - The most important factor to consider when assessing the marketability of ESOP shares in a closely held company is the put option. The put option requires the employer to repurchase the distributed securities, unless the ESOP distributes cash, or the ESOP repurchases the shares. A put option will typically improve the marketability and liquidity of the participant's interest.

   b) Financial strength and solvency of the company.

   c) Size of share block owned by the ESOP - If the ESOP owns a controlling interest, the discount for lack of marketability may be reduced (or eliminated). This is attributable to the capability of the ESOP shareholders to make their shares liquid by initiating, for example, a public offering of the stock.

   d) Liquidity of the ESOP Trust - If the ESOP Trust has excess cash, it may repurchase the participants' shares as opposed to having the company redeem the shares.

   e) Borrowing capacity of the business.

   f) Repurchase liability and funding requirements – The repurchase liability results from the existence of the put option. As shares vest and the value of the employer securities increases, the repurchase liability tends to grow. If the company lacks the ability to repurchase the stock or honor the put option, the discount for lack of marketability would be increased.

   g) Past repurchase experience by company of ESOP shares.

   h) Form and timing of payment by company to selling shareholders.

   i) Overall priority of acknowledged and contingent financial claims that may conflict with achieving liquidity for participant over time.  

VI. Dissenting Shareholder and Shareholder Oppression

A. Dissenting Shareholder

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47 Pratt, Valuing a Business 70.
48 Valuing ESOP Shares 26.
1. State statutes provide a remedy for shareholders who dissent from extraordinary corporate actions.

2. Triggering Events - Corporate actions to which a shareholder is entitled to dissent are defined in the Code of Virginia as follows:
   a) Consummation of a plan of merger.
   b) Consummation of a plan of share exchange.
   c) Consummation of a sale or exchange of all, or substantially all, of the property of the corporation.
   d) Any corporate action taken pursuant to a shareholder vote to the extent the articles of incorporation, bylaws, or a resolution of the board of directors provides that voting or nonvoting shareholders are entitled to dissent and obtain payment for their shares.  

3. Perfection of dissenters' appraisal rights
   a) Shareholder Notice of Intent to Demand Payment - A shareholder who wishes to assert dissenter's rights must: 1) deliver to the corporation before the vote is taken written notice of his intent to demand payment for his shares if the proposed action is taken, and 2) not vote his shares in favor of the action.
   b) Corporate Dissenters' Notice - The corporation is required to deliver a written "dissenters' notice" within 10 days following the corporate action to all shareholders.
   c) Shareholder Payment Demand - Shareholder must demand payment, certify the date he acquired ownership of the shares, and deposit any certificates as instructed by the corporation.
   d) Corporate Payment - The corporation must pay the dissenter the fair value of the shares within 30 days after receipt of the payment demand.
   e) Shareholder Response if Payment Considered Insufficient - If the shareholder is dissatisfied with the corporate offer, he must notify the corporation in writing within 30 days after the corporate payment or offer.

4. Standard of Value - Fair Value
   a) Defined in the Code of Virginia (which is modeled on the Uniform Business Corporations Act) as follows:

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(1) "Fair value," with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.  

b) No further definition is provided in the Code and there is limited case law in Virginia on this subject.

5. Discounts for Lack of Control and Lack of Marketability

a) Issue is whether or not discounts for lack of control (i.e., minority interest) and lack of marketability are applicable.

b) No discounts – Dissenting shareholder should receive proportionate share of a marketable control value:

(1) Statutory requirement that corporation purchase dissenters' shares creates a market.

(2) The transaction is compulsory, i.e., the shareholder is not a "willing" seller.

c) Discounts are applicable – Shareholder should receive a value equivalent to what they give up, i.e., the value of the shares as if the corporate action to which they objected had not taken place.  

6. Case Law


B. Shareholder Oppression

1. Oppression is not specifically defined in statute.

2. Remedy for Oppressed Shareholder

a) The Code of Virginia §13.1-747 provides that: The circuit court . . . may dissolve a corporation . . . in a proceeding by a shareholder if it is established that: . . . The directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent . . .  

b) No right to fair value – unlike the remedy provided for dissenting shareholders, an oppressed shareholder is not entitled to fair value.

3. Case Law


f)  *Brown v. Scott County Tobacco Warehouse*, 5 Va. Cir. 75 (Scott County 1983).


**VII. Divorce**

**A. Marital Estate**

1.  Estate consists of assets to be divided according to the property laws of the particular state. In Virginia, the standard for division of assets is “equitable distribution.”

   a)  The Code of Virginia §20-107.3(A) states that: “the court... shall determine the legal title as between the parties, and the ownership and value of all property, real or personal, tangible or intangible, of the parties and shall consider which of such property is separate property, which is marital property, and which is part separate and part marital property... The court shall determine the value of any such property as of the date of the evidentiary hearing on the evaluation issue.”

   b)  Code §20-107.3(E) further lists certain factors that are to be considered in the division of the property, including “Such factors as the court deems necessary or appropriate to consider in order to arrive at a fair and equitable monetary award.”

**B. Standard of Value**

1.  The Code of Virginia

   a)  In *Howell v. Howell*, the Court noted that the standard of value for equitable distributions is not specifically defined by the Code of Virginia: “Code §20-107.3(A) directs that the trial court value all property of the parties, but it does not define the term, “value,” for equitable distribution purposes. The statute does not set the standard of value, that is, the measure of property’s worth for equitable distribution. “Value” is a mercurial term; the term has numerous, distinct meanings. The various meanings are not interchangeable. The meaning of the term, “value,” depends on what is being valued, who is interested, and why it is being valued. A piece of property may have different values for different purposes. The purpose for
which it is being valued determines which definition, which standard of value, is proper. Purpose determines the standard of value; that, in turn, determines the appropriate methods of valuation."

2. Case Law

a) **Bosserman v. Bosserman**

(1) The Court noted that: "The purpose of Code §20-107.3 is to fairly divide the value of the marital assets acquired by the parties during marriage with due regard for both their monetary and nonmonetary contributions to the acquisition and maintenance of the property and the marriage . . . Trial courts valuing marital property for the purpose of making a monetary award must determine from the evidence that value which represents the property's intrinsic worth to the parties upon dissolution of the marriage. [emphasis added]"

b) **Howell v. Howell**

(1) While applicable case law is inconsistent with respect to the definition of value, in Howell v. Howell, the Court gave significant weight to the Bosserman case: "Bosserman v. Bosserman, 9 Va. App. 1, 384 S.E.2d 104 (1989), defined "value" for equitable distribution purposes; it set intrinsic value as the standard of value. "Trial courts valuing marital property for the purpose of making a monetary award must determine from the evidence that value which represents the property's intrinsic worth to the parties...." Id. At 6, 384 S.E.2d at 107. The value of an item of marital property is its intrinsic worth to the parties: the worth to the husband and wife, the parties; the value to the marital partnership that the court is dissolving."

(2) The Court further defined intrinsic value in the Howell case as follows: "Intrinsic value is a very subjective concept that looks to the worth of the property to the parties. The methods of valuation must take into consideration the parties themselves and the different situations in which they exist. The item may have no established market value, and neither party may contemplate selling the item; indeed, sale may be restricted or forbidden. Commonly, one party will continue to enjoy the

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benefits of the property while the other must relinquish all future benefits. Still, its intrinsic value must be translated into a monetary amount. The parties must rely on accepted methods of valuation, but the particular method of valuing and the precise application of that method to the singular facts of the case must vary with the myriad situations that exist among married couples.  

3. “Intrinsic value” as defined by the Court appears to be equivalent to “investment value” as defined in Valuing a Business – The Analysis and Appraisal of Closely Held Companies, 4th ed. (i.e., value to a particular owner – the propertied spouse).

C. Valuation Date
1. Alternative dates:
   a) Date of termination of the marriage – date the judge signs the decree giving the divorce legal affect.
   b) Date of separation – While having no legal effect, it is often argued that the use of this date is appropriate in certain instances (e.g., where there is evidence that a marital asset was wasted or converted to non-marital form).
   c) Date of filing
   d) Date of trial – May be the most appropriate date where a long time has passed since the date of filing or separation.

D. Goodwill
1. Goodwill is defined as “that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.”

2. The issue of inclusion of goodwill in the marital estate and its value is usually the most significant issue in valuing a business to be included in the estate.

3. Goodwill in divorce matters may require allocation between two types:
   a) Practice goodwill – “the intangible value that would continue to inure to the business without the presence of that specific owner spouse.”
   b) Professional goodwill – “the intangible value attributable solely to the efforts of or reputation of an owner spouse of the subject business.”

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63 International Glossary of Business Valuation Terms 3.
64 Pratt, Valuing a Business 820.
4. In Howell v. Howell, the Court citing an earlier case, Russell v. Russell, distinguished between the different types of goodwill and also identified the type to be included in the marital estate in this instance:

a) "Goodwill has been defined as "the increased value of the business, over and above the value of its assets, that results from the expectation of continued public patronage." The reputation of an individual, as well as his or her future earning capacity, are not considered to be components of goodwill. Russell v. Russell, 11 Va. App. 411, 415-16 (1990)."  

E. Buy/Sell Agreements

1. Whether or not a buy/sell agreement should be considered when valuing companies for marital dissolution is a disputed issue.

2. In the recent Howell v. Howell decision, the Court rejected the position that a buy/sell agreement should be the controlling factor for valuation of interests in a professional practice.

F. Discounts and Premiums

1. The applicability of discounts for lack of control and lack of marketability is another area of dispute in divorce matters.

2. Discounts

a) Exclude discounts – An argument often made for excluding discounts is that because there has been no change in ownership, there should be no discount.

b) Include discounts – A counter argument for including discounts is that because the propertyed spouse is essentially buying out the other spouse’s interest, there is an effective change in ownership.

3. In the recent Howell v. Howell case, the Court rejected a discount for lack of marketability.

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67 Pratt, Valuing a Business 825.