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What is Fair Value?

Business valuation experts are often asked to express their opinion of the *fair value* for a company's shares when a corporation is contemplating, or has recently undergone, a significant transaction. Although many valuation experts, attorneys, accountants, analysts and other professionals routinely use fair value and *fair market value* interchangeably, fair value is clearly different from fair market value.

Fair value is a statutory standard of value which is granted to dissenting shareholders in most states' business corporation act. Fair value is generally "defined" in the statutes as the value of the dissenting shareholders' interest immediately prior to the transaction which gave rise to the dissenting rights without considering the impact the transaction might have on the corporation's shares. Fair market value is also a legal standard of value that is effectively incorporated into the U.S. Tax Code through the Internal Revenue Service's Revenue Ruling 59-60. Fair market value assumes a hypothetical arms' length transaction between a willing buyer and a willing seller, each of whom is reasonably informed of the relevant facts, and neither of whom is under compulsion to conduct the transaction.

Shareholders are entitled to fair value when dissenting shareholder rights are triggered by such events as a merger, a going private transaction, a reverse stock split in which certain shares are cashed out, and other significant corporate events. In some instances, appraisers may be asked to prepare a fair value opinion if the board believes that a contemplated transaction may trigger dissenters' rights, or in an effort to provide a "fair" price regardless of whether or not shareholders will have the right to dissent.

A fair value appraisal may result in a significantly different value for a block of stock than would a fair market value appraisal. A number of factors should be considered when a fair value appraisal is prepared, including:

- Fair market value involves a willing buyer and willing seller, while fair value involves a transaction in which the dissenter is forced to sell his interest for less than what he perceives fair value to be.
- Fair value is not explicitly defined in the state statutes; rather a general framework for preparing an appraisal is given. Significant effort should be expended in researching how courts in the state in which the subject business is incorporated interpret fair value.
- What is the level of value for the subject interest prior to the application of any discounts or premiums? As shown in the chart on page 2, indications of value can generally be classified as, control or enterprise, marketable minority, or non-marketable minority depending upon the method used to derive a value.

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The Importance of Fairness Opinions in Transactions

The final aspect of many merger/sale transactions is the fairness opinion. A fairness opinion is provided by an independent financial advisor to the board of directors of selling companies in many transactions today, especially those with a significant number of minority shareholders. In cases where the transaction is considered to be "material" for the acquiring company, a fairness opinion from another financial advisor is sometimes retained on its behalf.

A fairness opinion involves a total review of a transaction from a financial point of view. The financial advisor must look at pricing, terms and consideration received in the context of the market for similar companies. The advisor then opines that the transaction is fair, from a

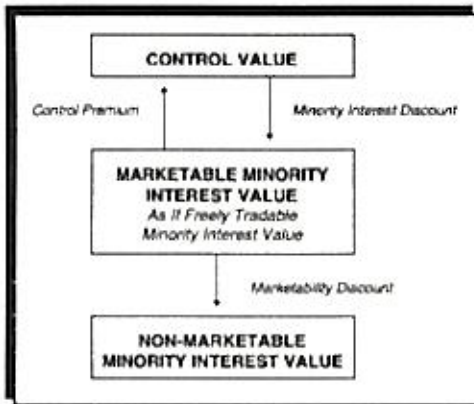
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By definition, a dissenter is a minority shareholder. Case law varies by state, and sometimes within a state, as to whether or not the dissenters' interest should be valued on a prorata basis in the enterprise value, or subject to a minority interest discount (if the initial indication of value is rendered on an enterprise basis). To our knowledge, no state has routinely subjected a dissenters' interest to a marketability discount. The courts may view a marketability discount as "unfair" since the dissenter was forced to sell his interest even though there was no readily established market.

All valuation opinions should be prepared with care, but fair value appraisals often trip up many experts because they assumed that there was no real difference between the two standards of value. In order to assure that a fair value opinion is prepared in a manner which is consistent with the applicable state's statute and case law, the valuation expert should perform certain tasks, including:

- Discuss with the company's counsel his interpretation of fair value and how it should be applied to the interest in question.
- Review the appropriate dissenting shareholder statute(s).
- Thoroughly analyze fair value case law from the state in which the subject business is incorporated, noting in particular the existence or absence of any premiums or discounts and what valuation methods the court accepted.

Valuation experts must also be careful in which valuation methods are

selected in determining fair value. Most states with fair value case law will have one or more cases in which the court used the *Delaware Block* method. The *Delaware Block* entails deriving indications of value under the market, earnings (investment) and asset methods and then considering all indications of value in deriving a conclusion. Experts who use valuation methods which are not consistent with case law history do so at great risk and, at a minimum, should at least consider case law valuation methods and be prepared to defend why a change in venue is appropriate.

Ever since *Weinberger v. UOP, Inc.* (457 A.2d 711, 1983), Delaware courts have generally become more liberal in allowing valuation experts to use discounted cash flow and other valuation methods which are not included in the *Delaware Block* method, but which are widely accepted in the financial community. A prudent step for any appraiser in preparing a fair value opinion may be to include reviewing recent Delaware case law to determine any differences in how Delaware courts interpret fair value relative to the subject's state case law.

Ultimately, fair value is an opinion based upon informed professional judgment, after considering all relevant facts, statutes and case law. ♦

Fairness Opinions

(Continued from Page 1)

financial point of view and from the perspective of minority shareholders.

Why is a fairness opinion important? While there are no specific guidelines as to when to obtain a fairness opinion, it is important to recognize that the board of directors is endeavoring to demonstrate that it is acting in the best interest of all the shareholders by seeking outside assurance that its actions are prudent.

The facts of any particular transaction can lead reasonable (or unreasonable)

people to conclude that perhaps a number of preferable alternatives are present. A fairness opinion from a qualified financial advisor can minimize the risks of disagreement among shareholders and misunderstandings about a deal, as well as litigation that can kill transactions.

Although the following is not a complete list, consideration should be given to obtaining a fairness opinion if one or more of these situations are present:

- Competing bids have been received that are different in price or structure, thereby leading to an interpretation as to the exact terms being offered, and which offer is "best."
- Insiders or other affiliated parties are involved in the transaction.
- The company has experienced a recent history of poor financial performance.
- The offer is hostile or unsolicited.
- There is lack of agreement among the directors as to the adequacy of the offer.
- There is concern that the shareholders fully understand that considerable efforts were expended to assure fairness to all parties.
- The board desires additional information about the investment characteristics of the acquiring company.
- Varying offers are made to different classes of shareholders.
- There is only one bid for the company, and competing bids have not been solicited.
- There is a significant transaction between a significant insider and the company.

Directors have a fiduciary responsibility to the shareholders known as the *business judgment rule*. In general, directors and management are given broad discretion in directing the affairs of a business. Directors are expected to act in good faith based upon the care that an ordinary person would take in supervising the affairs of the business. Inherent in this rule is the requirement that the board of directors be informed about the basis for major decisions prior to reaching a conclusion. In essence, there is an expectation that reasonable decisions will be made in a proper way.

In the landmark case *Smith v. Van Gorkom*, (*Trans Union*), (488 A. 2d Del. 1985), the Delaware Supreme Court expanded the concept of the business judgment rule to encompass a requirement for informed decisions. The *process* by which a board goes about reaching a decision can be just as important as the decision itself. While the Delaware court decision is applicable only to Delaware, the wide influence of Delaware law on business law in general makes the case very important. There have, of course, been other cases relating to fairness opinions since *Smith v. Van Gorkom*, but a case review is beyond our scope in this short article.

The fairness opinion is a short document, typically a letter. The supporting work behind the fairness opinion letter is substantial, however. A well-developed fairness opinion will be based on at least the following five considerations:

- Financial performance and factors impacting earnings.
- Dividend-paying history and capacity.
- Pricing of similar transactions.
- A review of the investment characteristics of the consideration to be received.
- A review of the merger agreement and its terms.

Due diligence work is crucial to the development of the fairness opinion. The financial advisor must take steps to develop an opinion of the value of the selling company and the investment prospects of the buyer (when selling for stock). Many believe that it is prudent to visit the selling company, conduct extensive reviews of documentation, and interview management.

A similar process should be performed with respect to the buying company, especially if the consideration is its stock. If the purchaser is a public company, it is imperative that all recent public financial disclosure documents be reviewed. It is also helpful to talk with financial analysts who routinely follow the purchasing company in the public markets.

Fairness opinions are often memorialized in the form of fairness memoranda. A fairness memorandum examines the major factors of the fairness opinion in some detail, and summarize the considerations of each factor for discussion by the board of directors. In many cases, the financial advisor will participate in these discussions and answer questions addressed by the board. ♦

Barge v. Commissioner T.C. Memo 1997-188

At issue in *Barge v. Commissioner* is the value of a 25% undivided interest in timberland in Mississippi. Bonnie Barge gifted a 25% interest in this timberland in 1987. The parties stipulated that the fair market value of the timberland at the valuation date was \$40 million. Table 1 indicates the various values attributed to the gifts.

Petitioner	Respondent	Court
\$4,750,000	\$8,413,060	\$7,404,649

Background. The timberland was owned by C.A. Barge Lumber Co. ("the Partnership"), a general partnership formed in 1941 for the purpose of carrying on a lumber business. The Partnership purchased 60,000 acres of timberland in Mississippi with each general partner, Bonnie Barge and her husband C.A. Barge, owning an undivided one-half interest as tenants in common.

The Partnership operated using a philosophy known as "saw timber management." Saw timber management allows trees to grow to maturity (as long as 50 years) with the intent for the timber to be used as lumber and poles. Because of the long growing period, saw timber management does not maximize current income and profit from the timberland unlike the opposing philosophy, "pulpwood management." Pulpwood management allows for younger trees to be harvested for use by paper companies as pulpwood, thereby

increasing cash flow from different stands of timber.

Valuation-Internal Revenue Service. The Internal Revenue Service presented a report and testimony from its expert witness, Earl Flowers ("Flowers"). Flowers relied solely on market comparisons to arrive at his valuation. However, Respondent's brief argued that the appropriate method of valuation was the present value of the benefit to be received on partition.

Valuation-Estate of Bonnie Barge. The Estate presented a report and testimony from its expert witnesses, Thomas Ebner ("Ebner") and Richard Pinkowski ("Pinkowski"). Both experts utilized income capitalization methods for valuation. However, Pinkowski considered other methods as well.

Pinkowski capitalized income projected from the Partnership's 1987 income. Ebner capitalized projected income based on the Partnership's cash flows from 1983 through 1986. He determined cash flows available to the 25% interest at issue were \$341 thousand per year. Because partners received distributions totaling 86% of that total, \$293 thousand would be available to a buyer of the 25% undivided interest. He indicated that a private investor (who would be the most likely buyer, not a forest products company or institutional investor) would capitalize that cash flow at 10%. Ebner's calculation of a maximum offer for the 25% undivided interest was \$3,340,000, after adding an unrealized gain for the buildup of inventory due to the saw timber management philosophy. Interestingly, the opinion never explains the origin of Petitioner's value of \$4,750,000.

Valuation-Court. The Court did not accept any of the experts' opinions. Respondent's expert's valuation was never addressed because of the change of argument on brief. The Court ruled out Pinkowski's opinion based on his use of a single year's income to project earnings.

(Continued on Page 4)

Table 2

Yr	Income	Partition Costs	Partition Payment	Total	Present Value
1	\$293,000	\$165,625	\$0	\$127,375	\$115,795
2	\$293,000	\$165,625	\$0	\$127,375	\$105,268
3	\$293,000	\$165,625	\$0	\$127,375	\$95,699
4	\$293,000	\$165,265	\$10,250,000	\$10,377,375	\$7,087,887
				Total	\$7,404,649

The year on which his calculations were based was abnormally high, due to harvesting to increase earnings to pay taxes. While the Court did not specifically reject Ebner's valuation, it was not satisfied with his income capitalization because it did not consider the option of partition.

The Court's valuation was based on the assumption that a potential purchaser of the interest would force partition of the real property because of disagreement with the timber management philosophy. Thus, valuation should be based on a present value of the cash flow expected under Partnership management for the period until partition (less partition costs) plus the value of the interest on partition.

Based on expert opinion, the Court considered that a contested partition would take two to five years and cost

approximately \$1.15 to \$1.5 million. The Court determined a partition action in this case would take four years at a cost of \$1.325 million. The Court determined that the appropriate discount rate was 10% after it rejected Petitioner's argument that the rate was 14%.

Petitioner supported this argument with the statement that "a minimum rate of return for this type of investment was 10%, exclusive of investment risks. The evidence in this case clearly indicates that there are many risks inherent with the ownership of this type of property. Therefore it is reasonable ... to accept 14%." The Court indicated that Petitioner has not sufficiently proven a discount rate greater than 10% was appropriate.

The Court calculated the value of the land at partition to be \$41 million. This total was the stipulated value of \$40 million in 1987 plus the appreciation in value of the timberland of approximately \$1 million over the period of partition. Thus, a 25% undivided interest would be worth \$10,250,000.

The court's determination of fair market value is set out in Table 2.

Comments. This case highlights several items of interest. First, the

court required more analysis by the experts, rather than accepting vague defenses for their positions. For instance, the court rejected the choice of income projections used by Petitioner's expert. This rejection emphasizes the fact that appraisers using income projections, and valuation methodologies incorporating such projections, must carefully analyze them before use in valuations. The appraiser must consider the source of the projections as well as the reasonability of the projections in light of historical performance and industry trends. In addition, the court required significantly more support for a higher discount rate before accepting it. Simply arguing that there were inherent risks in Barge's lumber business was insufficient analysis of the particular factors in this case.

Second, the court validates the notion that discounts are appropriate for fractional interests in real estate. Real estate appraisers are not always willing to opine to appropriate discounts for fractional interests. This case outlines a methodology for valuing a fractional interest that does yield a discount of approximately 20% from the value of the property as a whole. ♦

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