



The State of the Fair Value Standard in Divorce

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The State of the Fair Value Standard in Divorce

By John Stockdale Jr., Esq.*

Many states' courts apply the fair market value standard when appraising the value of closely held businesses in divorce cases.¹ These courts generally define fair market value by reference to tax guidance: the price a willing buyer and a willing seller would agree upon when neither is under any compulsion and both are knowledgeable of the business.²

However, the argument for replacing fair market value with fair value as the standard of value in divorce cases has grown increasingly prevalent in recent years. Most statutory schemes define fair value as the pro rata share of the business as a going concern without reference to discounts for lack of marketability or for minority interests (lack of control).³ Courts' reactions to requests to adopt the fair value standard have been mixed.

This article will first address the rationale for applying fair value rather than fair market value in the divorce context. The second part will discuss several landmark cases that considered the issue in depth, and the final section will distill several general rules from these cases.

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Analogy to dissenters' rights

As early as 1989, attorneys for the non-business owning spouse began arguing that fair market value is not the appropriate standard of value in divorce. They claim that denying the non-operating spouse a pro rata share of a marital business inequitably enriches the operating spouse and denies the non-operating spouse the fruits of his or her contributions to growing the business during the marriage. By analogy, the proponents of fair value point to the dissenting shareholders' rights and remedies under the applicable state business corporation act.

The analogy is largely based on the Delaware Supreme Court's landmark decision in *Cavalier Oil Corp v. Harnett*,⁴ which reviewed a case originally decided by the Delaware Chancery Court that denied discounts for lack of marketability and lack of control in calculating fair value in dissenting shareholder actions. The application of discounts at the shareholder level was contrary to the fair value mandate to value the business as a going concern, the higher court held, and cited three reasons:

- 1) fair value does not assume a hypothetical sale of the minority's interest, but assumes that the minority will maintain his or her investment in the business;
- 2) applying discounts at the shareholder level injects speculation into the appraisal process; and
- 3) discounts penalize dissenting shareholders for enforcing their rights while providing majority shareholders a windfall by cashing out the minority at a discounted price.

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The Delaware Supreme Court found this result “undesirable.”

Applying fair value analogy to divorce

Only a handful of state courts have addressed the issue of fair value as the standard of value in divorce in a meaningful way. As discussed below, these states include North Dakota, New Jersey, Florida, and Washington. By contrast,

courts in states such as Arkansas have refused to entertain the notion as contrary to established law.⁵

1. *North Dakota*. The North Dakota Supreme Court first considered whether fair value was the appropriate standard of value in the divorce context in *Kaiser v. Kaiser*,⁶ which assessed a wife’s 9.2% interest in a family-owned oil business. The husband argued that no discount for minority interest should apply because the wife’s family owned the stock and had no plans to sell the stock to unrelated, unknown buyers. The wife’s expert claimed that a minority discount ranging from 25% to 40% was appropriate. The lower court applied an 11.3% minority discount and no discount for lack of marketability.

On appeal, the Supreme Court affirmed the application of a reduced discount, explaining that North Dakota’s business corporation act provided sufficient protection to the wife under the dissenters’ rights statutes. Further, the court reasoned that the wife’s family owned all the remaining stock in the subject business and was not contemplating sale to unrelated third parties.

The same court revisited the issue in *Fisher v. Fisher*.⁷ In this case, the husband started the business but transferred ownership and control to the wife, to take advantage of minority-owned business contracts. Both parties owned stock in the business (the husband a minority interest), but shortly after filing for divorce the wife demoted the husband and removed him from the board of directors. The trial court valued the parties combined 88% interest at \$9,094.74 per share and reallocated the interests 51% to the husband and 37% to the wife, based on the husband’s proposal and desire to maintain control in the firm. To balance the unequal split of stock, the court ordered the husband to pay \$2,365,070.34 in cash to the wife within 90 days after entry of judgment.

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The wife appealed to the state Supreme Court. She argued that because of the husband's post-divorce oppression, she would have to sell her interest or petition for dissolution of the business. Further, if she sold her interest she would realize much less than the value the trial court accorded to the stock, because it did not apply a minority interest discount.

The Supreme Court disagreed, finding that the trial court had properly valued the stock without reference to a marketability discount. Moreover, a minority business interest might be worth less to a potential purchaser, but this was not sufficient reason to discount her minority shares in the marital dissolution proceedings when the wife's corporate rights provided adequate remedies. For example, the wife could petition for dissolution of the business, the court noted, or enforce her dissenters' rights and obtain the stock's fair value. It further reasoned that in assessing fair value, other courts (including the Delaware Supreme Court in *Cavalier Oil Corp.*) have declined to discount minority stock interests because the discount was too speculative; the discount penalized the dissenter by denying the dissenter his or her pro rata share of the value; and it enriched the majority shareholders by allowing them to repurchase the dissenter's stock at a discounted price. By applying the fair value analogy from corporate cases, the *Fisher* court thus affirmed the denial of the minority interest discount in divorce.⁸

2. *New Jersey*. In *Brown v. Brown*,⁹ the husband received a 47.5% gifted interest in a closely held wholesale florist. (His brother held the remaining interest.) The husband was actively involved in the business during the marriage while the wife was otherwise employed. At trial, the parties' experts took divergent views regarding discounts: The wife's expert did not apply any discounts while the husband's expert applied a 25% discount for lack of marketability and 15% minority interest discount. The trial court adopted the wife's position and declined to apply the discounts.

The appellate division affirmed. For purposes of equitable distribution, it was not appropriate to apply discounts to the husband's interest in the business. The court considered the then-recent New Jersey Supreme Court cases that denied, absent a showing of wrongful conduct by the dissenter or oppressed shareholder, discounts for lack of marketability and minority interest in dissenting and oppressed shareholder cases.¹⁰ These cases effectively adopted the *Cavalier Oil Corp.* rationale: the discounts were speculative; application contravened the purposes of the dissenters' rights and oppression statutes; and discounts would provide the majority shareholders with a windfall.

The court reasoned that the application of discounts in the equitable distribution context resulted in similar unfairness. The husband and his brother were the only shareholders; they did not contemplate a sale and they would continue to operate the business in the same manner for the foreseeable future. The dissenters' rights and oppression statutes also protected the husband, allowing him access to fair value. In the absence of extraordinary circumstances, the court concluded that there was no reason to allow one spouse to minimize the marital estate at the expense of the other spouse.

3. *Washington*. In *Baltrusis v. Baltrusis*,¹¹ the husband and the wife held individual minority interests in a bank holding company owned by the wife's family. At trial, only the wife introduced valuation testimony, which included a 33% marketability discount in determining the fair market value of the stock. The trial court generally adopted the wife's valuation but declined to apply the lack of marketability discount.

The Washington Court of Appeals affirmed the denial of the discount. The court stated that the husband was akin to a dissenting shareholder, because he was an "unwilling seller with no bargaining power." He was under a court-ordered compulsion to sell, the only market was his ex-

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wife's family, and his ex-wife was in a position to fully enjoy the benefits of ownership. Since a marketability discount was inappropriate in the dissenters' rights context, the court reasoned that it was inappropriate in this context as well.

4. *Florida*. More recently, in *Erp v. Erp*¹² the parties owned equal shares in the majority interest in a recreational vehicle dealership. (Their children owned the remaining interests). Both parties vied for control over the dealership and presented valuation experts at trial. In awarding the majority interest to the husband (and an equalization payment to the wife), the trial court rejected a minority discount but applied a marketability discount. The wife appealed. Citing the analogy of dissenting shareholder cases, she argued that a marketability discount was never appropriate where one spouse was purchasing the stock of the other.

The appellate court rejected the wife's analogy. Her position did not resemble a dissenting shareholder, since the wife was not the victim of oppressive behavior and was not avoiding a fundamental change in the corporation. Instead, the court found that her position was more akin to a shareholder seeking dissolution of the business for corporate deadlock under Florida's business corporation act. Because Florida gave courts the discretion to apply marketability discounts in the dissolution of a business scenario, divorce courts should have the same discretion. Further, the best way to address the application of the discount is through expert witness testimony.

Argument for application of fair value

Several general rules emerge from these cases. First, when the spouses hold stock in a closely held business—particularly one that is majority-owned and controlled by one of their families—discounts for lack of marketability and lack of control (minority interest) may not be appropriate under the analogy of the divorce to dissenters' and oppressed shareholders cases. The "outside" spouse is akin to the oppressed/

dissenting shareholder, subject to a forced sale of his or her interest to the "inside" spouse, who would receive a windfall by acquiring the stock at a discount. At the same time, the inside spouse enjoys recourse to the corporate appraisal statutes, which require application of the fair value standard should post-divorce, intra-family dealings go awry.

The facts in *Erp* and *Fisher* illustrate a corollary rule: When both spouses are actively involved and own shares in the business, a discount for lack of marketability and lack of control may be appropriate as within the discretion of the court. This situation positions the parties more like deadlocked shareholders who petition the court for dissolution of the business.

While these rules may be distilled in a general way from these cases, they by no means apply beyond the jurisdictions that have adopted them. Legal authorities and commentators need to develop broader support regarding the application of fair value principles to marital dissolution statutes and equitable distribution schemes. Given equity's emphasis on fairness to the parties and consistency of outcomes, state legislatures and courts are urged to apply fair value principles to the disposition of business interests in divorce.

This article is an excerpt from the Fair Value in Marital Dissolution chapter of BVR's recently-updated *Guide*, entitled *BVR's Guide to Fair Value in Shareholder Dissent, Oppression, and Marital Dissolution*. For more information on this *Guide*, visit www.BVResources.com/Publications.

1. See generally Jay E. Fishman, Shannon P. Pratt, William J. Morrison, *Standards of Value* (2007).
2. See generally I.R.S. Rev. Rul. 59-60.
3. Model Business Corporation Act §13.02 (1999).
4. 564 A.2d 1137 (Del. 1989).
5. *Layman v. Layman*, 780 S.W.2d 560, 562 (Ark. 1989) (rejecting fair value over dissent); *Crismon v. Crismon*, 34 S.W.2d 763, 765 (Ark. App. 2000) (same).

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6. 555 N.W.2d 585 (N.D. 1996).
7. 568 N.W.2d 728 (N.D. 1997).
8. However, the court reversed the lower court's decision awarding shares to both parties. "[A] corporate remedy should be implemented concurrently with this divorce to avoid multiplying litigation and to achieve judicial economy. If [the parties] cannot get along as husband and wife, the courts cannot expect them to get along as business associates."
9. *Brown v. Brown*, 792 A.2d 463, 470 (N.J. Super. A.D. 2002).
10. *Balsamides v. Protameen Chemicals, Inc.*, 734 A.2d 721 (N.J. 1999); *Lawson Marden Wheaton, Inc. v. Smith*, 734 A.2d 738 (N.J. 1999); and *Casey v. Brennan*, 780 A.2d 553 (N.J. 2002).
11. 113 Wash. App. 1037 (2002)(unpublished).
12. *Erp v. Erp*, 976 So.2d 1234 (Fla. 2008).

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