KTS, INC.
VALUATION ISSUES™

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Featured Article – Part II

FAIR VALUE VERSUS FAIR MARKET VALUE AS USED IN CALIFORNIA CORPORATIONS CODE SECTION 2000, SECTION 17707.03 AND SECTION 15908.02

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FMV VS FAIR VALUE (AS UTILIZED IN VALUATION SUBJECT TO CALIFORNIA CORPORATIONS CODE SECTION 2000, SECTION 17707.03, AND SECTION 15908.02).

As discussed in Part 1, our focus is on the discounts applicable (if any) for a fractional interest in a corporation, Limited Liability Company, and/or Partnership in an action subject to the previously mentioned state codes. The starting point prior to determining the discount is to value 100% of the subject business.

Our prayers are with everyone who has been impacted by the devastating fires and is facing unimaginable loss and challenges.

We are deeply grateful to ALL those combating the fires, and those who are working tirelessly to provide support to those affected by this heartbreaking tragedy.

Stay safe!
Klaris, Thomson & Schroeder, Inc. ("KTS")

Generally, Corporate valuations (C or S) consist of operating companies. The Operating Companies would be companies that sell or manufacture products or provide services to the public. The market and/or income approaches are normally utilized on these type of corporate entities, whereas the Net Asset Value approach (NAV), a subset of the cost approach, is generally utilized on Real Estate or investment holding companies which are typically held in Limited Liability Companies and/or Partnerships.

In valuing a Corporation (operating company), a Limited Liability Company (LLC) and a Partnership (PTR) (investment holding companies), one generally employs conventional valuation techniques in the analysis of those factors and considerations that are encompassed in U.S. Internal Revenue Ruling 59-60. This ruling is most commonly

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prescribed as a guide for the valuation of closely held businesses and their securities. Revenue Ruling 59-60 states that all relevant factors should be considered, including the following:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earning capacity of the business.
5. The dividend-paying capacity.
6. Whether or not the enterprise has goodwill or other intangible value.
7. Sales of the stock and the size of the block of stock to be valued.
8. The market price of stocks of guideline companies engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or "over the counter."

With respect to the valuation of investment or holding companies (such as LLC's or PTR's), Revenue Ruling 59-60 states the following:

> "Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.
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> The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market value of the assets of the Company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity."

After concluding on the 100% value of the business, the discounts for lack of control ("LOC") and/or lack of marketability ("LOM") are considered and applied if applicable. Section 2000 disputes, subject to fair value, generally do not allow any discount for LOC, however, it is less clear on the LOM discounts.

The prevailing opinion, based on my experience, is a small discount for Lack of Marketability is accepted. This would be in the range of 5 to 10 percent, based on facts and circumstances. The word "liquidation" in the Fair Value definition lends some credibility to a small LOM discount.

For example, if the value of the entire entity (business) is $1,000, 50% or ½ would be $500. However, a 50% interest, under section 2000, could be $475 with a 5% LOM discount.

Using the same example subject to a dispute under section 17707.03 and/or section 15908.02 would be different because the statute calls for Fair Market Value (FMV), which allows for the consideration of discounts for Lack of Control and/or Lack of Marketability.

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FAIR VALUE VERSUS FAIR MARKET VALUE AS USED IN CALIFORNIA CORPORATIONS CODE SECTION 2000, SECTION 17707.03 AND SECTION 15908.02 *(continued from page 2)*

In the above example, assuming the total value (100%) is $1000, the pro rata 50% value (before discounts) would be $500. However, after a discount, of say 10%, for Lack of Control and 15% for Lack of Marketability (which is an overall discount of 23.5% when applied sequentially), the resulting value for a 50% interest would be $382.50 versus $475 under section 2000.

We point out that if we were valuing a less than 50% interest, such as a 25% interest, under section 17707.03 (LLC) or 15908.02 (PTR), the discounts would most likely be higher than previously discussed. In a relatively recent case, "Cheng vs. Coastal" (LLC case), which was affirmed on appeal to the California Court of Appeals, concluded an overall discount of 27%.

We conclude with a few thoughts on the above-mentioned case, "Cheng vs. Coastal". I was one of the 3 court appointed appraisers. The assignment was to value a 25% Interest in a LLC which held Real Property. The standard was FMV, so the real property needed to be valued and inserted on the balance statement for the book value of the Real Property. The current assets were added to the real property and the liabilities were deducted to conclude the Net Asset Value (NAV), which represents 100% of the LLC equity value. The next step would be to determine the applicable Lack of Control and Lack of Marketability discounts. However, because one (1) of the 3 appointed appraisers did not use a discount, a unanimous opinion was not possible. Therefore, the two remaining appraisers concluded a majority opinion. The discount concluded by the two appraisers after the review of each other's appraisals was 27%, which was accepted by the trial court and affirmed by the appeals court. ❏

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Abraham Lincoln

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