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# American Society of Appraisers Business Valuation Committee Special Topics Paper #4 The "Willing Buyer" and the "Willing Seller" in Fair Market Value[a]

*The* International Glossary of Business Valuation Terms, *June 2001, developed jointly by the American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, and Institute of Business Appraisers, defines fair market value as "The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms-length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." The discussion in this technical paper focuses on areas the valuation analyst must consider when characterizing the willing buyer and willing seller for a determination fair market value.*

## Introduction

In considering the hypothetical "willing buyer" and hypothetical "willing seller" in determining fair market value (FMV) as defined and developed by the major business valuation standards-promulgating organizations, the valuation analyst must perform the valuation analysis consistent with the assumptions inherent in this standard of value.

FMV is defined as follows:

> The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms-length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.[1]

In identifying the respective characteristics of the willing buyer and willing seller, the first step is to consider the market in which they would notionally transact. This market may be either the *notional market* or the *open* (real-world) *market*.

## The Notional Market versus the Open Market

As a fundamental principle, when FMV is determined absent arm's length, *open-market* (real-world) negotiations, the hypothetical transaction is assumed to occur in a *notional market*.

The *notional market* contemplates that a market exists and that any statutory, contractual, or other restrictions that would or could influence the marketability of the subject property or business interest are momentarily lifted to facilitate a sale in such a *notional* market. However, this assumption does not completely disregard such restrictions. Rather, the hypothetical purchaser is assumed to assess the value of the business interest such that any prevailing restrictions are accounted for by applying an appropriate discount to the value otherwise determined on the basis that such purchaser will be subject to the very same restrictions following acquisition.

Therefore, when considering the "buyer" and "seller" in the context of the *notional* market, the valuation analyst draws a careful distinction between the notional market and the *open market*. The characteristics of each of the markets may be outlined as follows:

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[a]This technical paper is for education purposes and should not be considered to be authoritative. It has been provided as a discussion of a concept and is not being offered as professional advice. Each set of circumstances may require a different analysis to be performed.

[1] *International Glossary of Business Valuation Terms*, June 2001, developed jointly by the American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, and Institute of Business Appraisers.


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| "Fair Market Value" (*Notional* Market) | "Price" (*Open* Market, which can include possible restrictions) |
|---|---|
| ***Assumptions in Determining FMV*** | ***Facts in Determining Price*** |
| Transaction assumed to be at most probable price obtainable | Transactions may not be at highest price obtainable (can be unrealistic or uneconomic) |
| Market is open and unrestricted; restrictions are assumed to be lifted | Any restrictions are assumed to be enforceable |
| Parties are equally informed and knowledgeable of relevant information | Parties may have different levels of knowledge regarding relevant information |
| Each party is equally uncompelled to transact; distress sales are excluded | One party may be forced to transact (e.g., distressed or anxious) |
| Parties have equal negotiating abilities | Negotiating abilities of each party might differ |
| Parties have equal financial strength | Often parties have different financial strengths |
| Market is consistent and not the result of a "transient boom" or "sudden panic" in the marketplace; market not "spasmodic" or "ephemeral" | Market could include "transient booms" or "sudden panics"; could be "spasmodic" or "ephemeral" |
| Parties act prudently | A party might be imprudent |
| Parties are dealing at arm's length | Parties might be related |
| The property is properly exposed in marketplace for a reasonable period | The property might not have been exposed in marketplace for a reasonable period |

The buyer in the *notional market* is not the same buyer who is in the *open market* (as can be seen from the chart above), as each buyer typically has different characteristics.

As Professor Bonbright of Columbia University stated in his 1937 treatise:

> [FMV] represents, not what the property could presently be sold for, but what, in the appraiser's judgment, the property *would* sell for, were the market composed of intelligent individuals who were interested in buying and selling the property only by reference to its investment merits. Often it is called "true value" as distinct from the market prices that are thought of as "fictitious," More properly, it is to be regarded as a *hypothetical* market value, since it represents the market prices that would prevail under conditions other than those that actually exist. (emphasis added)[2]

*Valuing a Business* summarizes the distinction as follows:

> In most interpretations of fair market value, the willing buyer and willing seller are hypothetical persons dealing at arm's length, rather than any particular buyer or seller. In other words, a price would not be considered representative of fair market value if influenced by special motivations not characteristic of a typical buyer or seller."[3]

## Judicial Background

The courts have addressed the distinction between the *notional* market and the *open* market when considering the FMV standard of value (e.g., in taxation disputes), assuming the existence of a *notional marketplace* in which no possible purchaser is excluded. The lack of marketability that may arise from any restrictions on share transfer contained in the articles of incorporation, shareholders' agreement, or other agreements would be taken into consideration by the hypothetical purchaser through the application of an appropriate discount to the value otherwise determined.

Some earlier U.S. cases have commented on the respective characteristics of the "willing buyer" and "willing seller":

> Assumed existence of a notional market that refers "not to actual buyers and sellers but to hypothetical vendors and vendees of a vaguely described state of mind.[4]
>
> In speaking of fair market value . . . as a concept which may reflect more than market price, we place emphasis on the hypothetical willing buyer and seller and the assumed free and open market.[5]

The principles relating to FMV determination have been considered for more than a century by the English courts.

In *Mountview Estate* v. *London Borough of Enfield,* an English case, the court emphasized the following:

> Neither are we concerned with the personal characteristics of the parties even if we could ascertain what they were. Whether . . . (he) was rich or poor, wise or foolish, easygoing or obstinate—these personal characteristics are as irrelevant

[2] J. C. Bonbright, *The Valuation of Property*, 2 vols. (New York: McGraw-Hill, 1937), 27.

[3] S. P. Pratt and A.V. Niculita, *Valuing a Business*, 5th ed. (New York: McGraw-Hill, 2007), 42.

[4] *Westchester County Park Commission* v. *U.S.,* 143 F 2d 688 (2nd Cir. 1944).

[5] *Martignette* v. *Sagamore Manufacturing Co*., 163 NE 2d 9. (Mass. 1959).

> as whether he is black or white. For the purpose of the hypothetical exercise the parties are to be conceived as two persons on the Clapham omnibus, devoid of prejudice or eccentricity, who in any given circumstances might have been expected to behave reasonably.[6]

### The Willing Buyer

In *Inland Revenue Commissioners* v. *Clay*, the U.K. Court of Appeal stated:

> A value ascertained by reference to the amount obtainable in an open market, shews an intention to include every possible purchaser. The market is to be the open market, as distinguished from an offer to a limited class only, such as the members of the family. The market is not necessarily an auction sale.[7]

The willing buyer had also been considered in the U.K. decision in *Findlay's Trustees*. The appellate court stated:

> In estimating the price which might be fetched in the open market, it must be assumed that the transaction takes place between a willing seller and a willing purchaser and the willing purchaser is a person of reasonable prudence who has informed himself with regard to all the relevant facts such as the history of the business, its present position, its future prospects and the general conditions of the industry.[8]

### The Willing Seller

When the *open* market is being considered for *notional* FMV purposes, the personal position of the owner of the property cannot be taken into account. A common characteristic of all hypothetical sellers is that of being the owner of the subject property, which includes being a reasonable person who is willing to sell the asset at the best possible price.

In *Salomon* v. *Commissioner of Customs and Excise*, the willing seller in the notional marketplace is not necessarily identified as the person who owns a particular asset, but is a hypothetical seller, being:

> an imaginary person with no personal characteristics, positive or negative, except a deemed desire and a full facility to take the property in question into the open market and sell it for the highest price obtainable.[9]

In *Hinchcliffe* v. *Crabtree,* Lord Justice Harmer stated that the personal position of the owner of the shares cannot be taken into account:

> [b]ut, of course, we must forget that this block of shares happened to be owned by the taxpayer, who was a director and knew all the about the negotiations. We must assume a shareholder with the same block who knew nothing about them." (emphasis added)[10]

In *Lynall* v. *Inland Revenue Commissioners*, Lord Justice Harmer stated*:*

> one must not envisage a vendor who is a director as well as a shareholder. Of course, the hypothetical vendor may be a director but he equally well may not be a director. One must, therefore, only endow him with the characteristic which must necessarily belong to all hypothetical vendors, namely that of owning the block of shares in question.[11]

In *Findlay's Trustees,* the appellate court stated, with respect to the hypothetical seller:

> I would emphasise here the use of the indefinite article. Too often the would-be valuer assumes that the shares are being sold by the person who owns them.[12]

### Other Considerations

In considering the willing buyer and willing seller in the notional market, the valuation analyst must pay particular attention to the subject matter of the valuation (shares, a business, etc.). For example, if the FMV of voting or nonvoting classes of shares is being determined, the difference in their respective values must be calculated. The value of voting rights of shares in closely held companies has been considered in a number of cases. It has also been addressed in various studies of transactions involving both voting and nonvoting shares.

While the cases referred to earlier in this technical paper held that the owner (willing seller) of the shares need not be identified or considered, the valuation of the shares would take into account the fact that, in a notional sale, the shares might be sold together with another class of shares of the company to realize the best price. For example, in *Curry Estate* v. *U.S.* the Court of Appeals held:

> In our view, both the law and common sense compel the conclusion that the fair market value of the non-voting stock in the hands of an estate with sufficient shares of voting stock to ensure the estate's control of a corporation cannot be less than the value of the Estate's voting stock.[13]

In reaching this conclusion, the appellate court appeared to have followed the decision in *Ahmanson Foundation* v. *U.S.*[14] where the court emphasized the block purchaser's power to fully guard the interests of his nonvoting shares through control of corporate policy.

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[6] (1969) EG 165.
[7] [1914] 3 KB 466.
[8] (1938) 22 A.T.C.
[9] [1914] 3 KB 466.
[10] [1971] 2 All ER 104; aff'd [1972] AC 707 (HL).
[11] (1971) 3 WLR 759.
[12] (1938) 22 A.T.C.
[13] 706 Fed. 2d. 1424 (US 7th Cir. 1983).
[14] 674 Fed. 2d. 761 (9th Cir. 1981).


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In valuing the shares, the assumption can nonetheless be made that the shares would likely be sold together with another class of shares of the same company.

These decisions are consistent with that of the U.K. Privy Council in *Attorney-General of Ceylon* v. *Mackie*.[15] In that case, the deceased held two classes of voting shares, neither of which was sufficient, in and of itself, to provide voting control, but when combined, afforded the holder voting control. The Privy Council affirmed the decision of the lower court and held that the deceased's shares were to be valued at the same price that a controlling interest would fetch. As regards publicly traded shares, empirical studies regarding voting shares versus nonvoting shares have found there could be value differences of 2% to 7% between the voting and nonvoting classes. There are also studies showing that where a small number of shares are voting and a large number of shares in the company are nonvoting, a block of voting shares having the power to control the company has a FMV considerably in excess of that of the nonvoting shares.

## Summary

Even though it is not necessary to identify the parties to a hypothetical transaction in the notional marketplace, the willing buyer and willing seller are assumed to take into account all relevant circumstances, including the other shareholdings in the company, which, when added to the subject shareholding, could produce additional value to the stand-alone, intrinsic value of the subject shares being valued.

[15] [1952] 2 All ER 775.