Business Valuation Review

Back to the Future

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The future ain't what it used to be.
-Yogi Berra

Introduction. Imagine if you had the ability to see the future perfectly. Suppose you could go out months or years into the future and know exact details of events that were yet to happen. Would that change anything for you? If you had the *Money and Investing* section of *The Wall Street Journal* dated one month from today would you be tempted to call your broker and make a few investments? How about next month's copy of *Sports Illustrated*? Tempted to call your bookie and place a few bets? I am no financial genius but I believe that given this ability and a modest amount of cash, I could retire to my private island in the Caribbean in a relatively short period of time.

Michael Paschall

Of course, in the real world, nobody has this kind of ability. Yet, in some business valuation contexts, certain business appraisers would have us believe that this kind of time travel is not only possible, but is actually appropriate in determining the value of a privately-held company. In particular, I am referring to the use of market data information (usually merger and acquisition data) that has occurred *after* the valuation date of the appraisal. This article will examine various opinions on the use of data subsequent to the valuation date. Resources reviewed include revenue rulings, business valuation standards, business valuation textbooks, and court cases. As will be shown, an overwhelming majority believes that such time travel into the future is best left to H.G. Wells or Michael J. Fox and not to business appraisers.

Standard of Value. Before we begin our experiment in time travel, we need to examine the definition of value. Definitions of value can come in many shapes and forms. Investment Value, for example, is the value of a company to a particular buyer. Fair Value usually is a judicially-determined concept that may have a wide range of definitions from jurisdiction to jurisdiction. For purposes of this analysis, we will focus on the most common standard of value: Fair Market Value. Fair market value is defined by the Internal Revenue Service as "the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have knowledge of the relevant facts."

Knowledge of the relevant facts. As seen above, one of the key elements to the definition of fair market value is that both the willing buyer and the willing seller "have knowledge of the relevant facts." Of course, barring any clairvoyant ability by either the willing buyer or seller, neither the willing buyer nor the willing seller would have any knowledge of facts (such as the sale of similar companies) in the future. Yet some business appraisers incorrectly utilize sales data from transactions that occur after the valuation date as if such information were available to the willing buyer and willing seller as of the valuation date.

Revenue Ruling 59-60. To begin our tour of the possibility of time travel, we first look to the "gold standard" of business valuation – Revenue Ruling 59-60. In Section 3.03 (approach to valuation), RR 59-60 states that "Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal." This statement echoes the phrase noted above in the definition of fair market value: "facts available *at the required date of appraisal,*" not

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facts in the future that are unknown as of the required date of appraisal. RR 59-60 notes that valuation is a "prophesy" which Webster's defines as "to utter by or as if by divine inspiration" or "to predict with assurance or on the basis of mystic knowledge." Business valuators who use transaction data occurring after the valuation date are imputing this "divine inspiration" and "mystic knowledge" onto ordinary, mortal buyers and sellers who of course possess no such supernatural powers.

Given this foundation of the prohibition against time travel in RR 59-60, we now turn to examination of the business valuation standards of some of the leading credentialing bodies in business valuation, including the American Society of Appraisers (ASA) and the Institute of Business Appraisers (IBA). Also, the Uniform Standards of Professional Appraisal Practice (USPAP) will be examined.

American Society of Appraisers. Section II of the ASA's *Business Valuation Standards* deals with the appropriate definition of the assignment. Under II.B.1.b.(2), an appraisal has the following qualities: "It considers all relevant information as of the appraisal date available to the appraiser at the time of performance of the valuation." In the definitions section, "appraisal date" is defined under "valuation date" as the "specific point in time as of which the valuator's opinion of value applies (also referred to as 'Effective Date' or 'Appraisal Date')." Of course, it is impossible for subsequent transaction data to be relevant information "as of the appraisal date."

Institute of Business Appraisers. Section 1.20 of the IBA's *Business Appraisal Standards* also prohibits the use of subsequent data, stating:

> "An appraisal shall be based upon what a reasonably informed person would have knowledge of as of a certain date. This shall be known as the appraisal's 'date of valuation' or 'effective date' and accordingly reflect the appraiser's supportable conclusion as of that date. Information unavailable or unknown on the date of valuation *must* not influence the appraiser or contribute to the concluding opinion of value."

Uniform Standards of Professional Appraisal Practice. USPAP offers a conflicting and confusing view on the use of data subsequent to the valuation date as one part of USPAP appears to allow the use of subsequent data while another part of USPAP appears to prohibit it.

USPAP Allowing Subsequent Data. In USPAP *Statement on Appraisal Standards No. 3*, the issue is retrospective value opinions for real and personal property valuations. The *Statement* reads, in part, as follows:

> "Retrospective appraisals (effective date of the appraisal prior to the date of the report) may be required for property tax matters, estate or inheritance tax matters, condemnation proceedings, suits to recover damages, and similar situations.
>
> A retrospective appraisal is complicated by the fact that the appraiser already knows what occurred in the market after the effective date of the appraisal. Data subsequent to the effective date may be considered in developing a retrospective value as a confirmation of trends that would reasonably be considered by a buyer or seller as of that date. The appraiser should determine a logical cut-off because at some point distant from the effective date, the subsequent data will not reflect the relevant market. This is a difficult determination to make. Studying the market conditions as of the date of the appraisal assists the appraiser in judging where he or she should make this cut-off. In the absence of evidence in the market that data subsequent to the effective date were consistent with and confirmed market expectations as of the effective date, the effective date should be used as the cut-off date for data considered by the appraiser."

Thus, USPAP in its *Statement on Standard 3* condones the use of after-the-fact data, however, this practice is fraught with subjectivity. How do you determine the "trends that would reasonably be considered by a buyer or seller as of that date?" Can a buyer and seller really see actual transactions in the future as a confirmation of current trends? What is a "logical cut-off" date for the consideration of subsequent data? USPAP recognizes the difficulty of this, noting that this "is a difficult determination to make." Furthermore, if the evidence is

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inconclusive, USPAP also offers the fall-back position that the effective date (or valuation date) should be the cut-off date for data considered.

USPAP Prohibiting Subsequent Data. In addition to recognizing the inherent subjectivity of allowing subsequent transactions, USPAP also appears to be inconsistent in its allowing the use of after-the-fact data. *Standards Rule 3-1* deals with developing an appraisal review. In outlining the procedures for an appraisal review, *Standards Rule 3-1* states:

> "The appraisal review must be conducted in the context of market conditions as of the effective date of the opinion in the work being reviewed. Information available to the reviewer that could not have been available to the appraiser as of or subsequent to the date of the work being reviewed must not be used by a reviewer in the development of an opinion as to the quality of the work under review."

It is also noted that this *Standards Rule 3-1* (which prohibits the use of subsequent data) contains the language that "This Standards Rule contains binding requirements from which departure is not permitted." The *Statement on Standard 3* (which allows the use of subsequent data) contains no such language. Although *Statement on Standard 3* has been adopted by the Appraisal Standards Board and thus has the full weight of a Standards Rule, the fact that it does not have the strong prohibitive language of *Standards Rule 3-1* may imply that *Standards Rule 3-1* (which prohibits the use of subsequent data) is the "stronger" rule. Also, it should be noted that both *Standards Rule 3-1* and *Statement on Standard 3* deal with real property and personal property appraisals and not business valuation. Standards 1 through 8 of USPAP deal with real and personal property appraisals. Standards 9 and 10 of USPAP deal specifically with business valuation appraisals. Therefore, if relying solely on USPAP, the business appraiser is left with little guidance as to the appropriateness of the use of subsequent data.

Textbook Opinions. Now that we have examined the various business valuation standards, we will turn to an examination of the appropriateness of the use of subsequent data in various business valuation books.

Valuing a Business. Originally written by Shannon Pratt and now co-authored by Pratt, Robert Reilly and Robert Schweihs, *Valuing a Business* was first published in 1981 and is now in its fourth edition. Pertinent excerpts in *Valuing a Business* as to the consideration of events and data after the valuation date are as follows:

> "The date, or dates, at which the business is being valued is critically important because circumstances can cause values to vary materially from one date to another, and the valuation date directly influences data available for the valuation. Every day, observers of the public stock markets see sudden and substantial changes in the value of a particular company's stock. In many court cases, especially those involving tax litigation, significant changes in value over very short time spans have been justified because of changes in relevant circumstances. See, for example, *Morris M. Messing*, 48 T.C. 502 (1967), *acq.* 1968-1 C.B. 2. Even though the company made a public offering at over $36 shortly after a gift of stock, the court upheld a value of $13 for gift tax purposes as of the date of the gift. (p. 26).
>
> In most business valuations, the opinion of value will be based at least partly on other, similar transactions, such as the prices at which stock in the same or a related industry are trading in the public market relative to their earnings, assets, dividends, or other relevant variables, if such data are available. It is important to know the valuation date when using guideline companies in the valuation so that the guideline transaction data can be compiled as of the valuation date, or as near to it as is practically possible." (pp. 26-27).

As seen above, *Valuing a Business* states that because "circumstances can cause values to vary materially from one date to another" and the valuation date "directly influences data available for the valuation," it is "critically important" to adhere to a specific valuation date and not go beyond that date. *Valuing a Business* does note, however,

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certain court cases where the sale of the private company itself after the valuation date was considered as evidence of the value of the company as of the valuation date. This line of cases is discussed in more detail later in this article.

***PPC Guide to Business Valuations*.** Shannon Pratt also co-authored the *PPC Guide to Business Valuations* along with Jay Fishman, Clifford Griffith, and Keith Wilson. Section 401.3 of the *Guide* states:

> "It is important to note that valuation consultants should only gather data that was available or discernable as of the valuation date. Although the valuation process is concerned with the future benefits of ownership, the consultant must approach the engagement from the perspective of the valuation date. That means the consultant can only use information that was available or determinable as of the valuation date. However, this may not be entirely true in estate and gift tax matters, as discussed in Section 1002."

Thus, in the *PPC Guide*, we also see a clear prohibition of the use of subsequent data, except in certain estate and gift tax matters. Section 1002 in the *PPC Guide* also mentions the various case law noted in *Valuing a Business* that has allowed the use of subsequent data in very limited situations (see discussion later).

Analysis of Case Law. Most case law on this subject does not permit the consideration of subsequent data. As noted above, a line of various cases has allowed for the use of transaction information subsequent to the valuation date, however, the use of subsequent data has been in very limited situations and with very specific requirements. The subsequent data allowed in these cases has been only of the sale of the actual private company being valued and has only been in the gift and estate tax context. Some of these cases allow the consideration of the later transaction of the subject company only if such a transaction was "reasonably foreseeable" as of the valuation date. Other cases do not require any foreseeability at all but state that the later sale of the private company provides useful "evidence" of the value of the business as of the earlier valuation date. We will first examine a sample of the cases that do not allow subsequent data and then look at those cases that do allow subsequent data.

Long-standing Proposition. The proposition that subsequent information should not be considered in the valuation context has been around for a long time. The decedent in *Ithaca Trust Co. v. United States, 279 U.S. 151 (1929)* died on June 15, 1921, and left the residue of his estate to his wife for the duration of her life. Upon his wife's death, the remainder of the estate went to various charities. The estate was eligible to deduct a certain amount for the gifts made to charity, based on the life expectancy of the wife. When the wife died unexpectedly six months after the decedent's date of death, the value of the gifts to charity became much larger and the estate attempted to take a larger deduction for those gifts. The United States Supreme Court held that the known fact of the wife's unexpected death six months later was irrelevant and the allowable deduction for the estate must be based on the wife's expected mortality as of the date of death. Justice Oliver Wendell Holmes delivered the opinion of the Court:

> "The first impression is that it is absurd to resort to statistical probabilities when you know the fact. But this is due to inaccurate thinking. [T]he value of the thing to be taxed must be estimated as of the time when the act is done. Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true. Tempting as it is to correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done, but that the value of the wife's life interest must be estimated by the mortality tables."

Justice Holmes' holding in *Ithaca Trust* is cited in numerous later cases for the proposition that it is inappropriate to consider subsequent data for the simple reason that such data was not available to a willing buyer and willing seller as of the valuation date. The logic of Justice Holmes is sound: "The value of the thing to be taxed must be estimated as

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of the time when the act is done. The value is no less real at that time if later the prophecy turns out false than when it comes out true." This is true even when the result is unfavorable for the taxpayer, as in *Ithaca Trust*.

Approach is Prospective, not Retrospective. Although it is better known for its impact on ESOP valuations, *Foltz v. U.S. News & World Report, 663 F.Supp. 1494 (1987), affirmed 865 F.2d 364 (1989)* also dealt with the consideration of subsequent data. In *U.S. News*, the company's annual profit sharing plan and stock bonus plan valuation had ranged from $65 to $470 per share over the 1973 to 1981 period. In 1984, the company was acquired by a purchaser who paid $2,842 per share. Prior employees of the company, who had been cashed out at the much lower values, sued to attempt to receive the much higher value received by shareholders as a result of the acquisition. The Court held that the prior appraisals were properly done on a minority basis and the company had no liability to those employees cashed out at the earlier, lower values.

The annual profit sharing plan and stock bonus plan appraisals valued the stock on a going-concern basis, taking into consideration only facts and circumstances as they were known or knowable as of each valuation date. The plaintiffs argued that prospects for future changes, such as those that would be instituted by a strategic buyer of the company (and thus imputed into the price that a buyer would be willing to pay for the company), should have been considered and reflected in the annual appraisals. The Court disagreed, noting:

> "[T]he approach to be used is not retrospective, but prospective. One must look at the situation as of the time that each employee separated from the company. Therefore, the appropriate inquiry is whether the company was property valued during the class period, not whether former employees become eligible for a greater share of benefits upon the contingency of a subsequent sale."

This is a far more reasonable position due to the uncertainty of forecasting "prospects for future changes" as was argued by the plaintiffs. Also, unless an acquisition of the company by a "strategic buyer" is guaranteed, it makes no sense to use a control-level value for a minority interest. See the *Mueller* case below for the proper treatment of an acquisition scenario.

Cases Allowing Subsequent Transaction Data. As noted above, some cases do allow the consideration of subsequent transaction data of the private company itself. One subset of these cases (illustrated by *Ridgely* and *Gilford* below) requires "reasonable foreseeability" as a condition for the use of subsequent data. Another subset of these cases (illustrated by *Jung* and *Cidulka* below) has no such reasonable foreseeability requirement but allows subsequent transactions as "evidence" of the value of the private company on the valuation date. An analysis of the "reasonable foreseeability" cases is followed by those cases that have no foreseeability requirement.

Radically Different Circumstances. Some situations involve an unexpected windfall subsequent to the valuation date. The decedent in *Ridgely v. U.S., 20 AFTR 2d 5946 (1967)* died January 11, 1962. The estate valued the decedent's 368-acre farm at $372 per acre. In the fall of 1961 and early 1962 (prior to and shortly after the decedent's death), decedent and her family tried to sell 40 acres of the farm to the local school board. The original offering price was $3,000 per acre, later reduced to $2,000 per acre and then $1,000 per acre. The school board eventually declined to purchase the tract at any price because of its undesirable location. In February 1962, General Foods began looking for land for a new Jell-O plant. On May 11, 1962, General Foods purchased 112 acres of the farm for $2,700 per acre. Although the IRS claimed that the farm was worth $2,700 per acre, the Court did not consider the post-death transaction with General Foods as an indication of value:

> "There is no doubt that evidence of a sale taking place after a valuation date has probative force bearing on the value as of the earlier critical date – where there has been no material change of conditions or circumstances in the interim. Here, by contrast, the record conclusively demonstrates that the circumstances present at the time General Foods decided to purchase 116 acres of Eden Hill Farm at $2,700 per acre

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> were radically different from those prevailing at the date of decedent's death and could not have reasonably been foreseen as of the date of decedent's death."

Ridgely is a good analysis and good result. Neither a willing buyer nor a willing seller could have foreseen the Jell-O plant as of the date of death. Furthermore, as of and subsequent to the valuation date, there were no buyers for a portion of the property at even $1,000 per acre. There was nothing to indicate that the sale of a 116-acre tract at $2,700 per acre was imminent. Because of this difficulty in selling the property, a willing buyer and willing seller would have transacted based on a much lower value as of the valuation date.

No Reasonable or Intelligent Expectation of a Sale. Similar to *Ridgely* above, some cases have required that there be some reasonable or intelligent expectation of a sale before a subsequent event will be considered. The decedent in *Estate of Gilford, 88 T.C. 38 (1987)* died unexpectedly on November 17, 1979, owning a 22.9% interest in a company whose stock was actively traded in the over-the-counter market. The decedent was Chairman and CEO of the company. On November 27, 1979, the board of directors met and decided not to solicit any offers for the company. On January 2, 1980, the board hired an investment bank to investigate financial alternatives. During March 1980, the board considered selling the company and on May 30, 1980, the company was sold for $24 per share. The estate return used a value of $7.35 per share based on the actual trading price of the stock less a discount for blockage and the fact that the stock was restricted. The IRS claimed a value of $24 per share based on the May 1980 transaction, however, the Tax Court found no evidence that the subsequent transaction was foreseeable and held for the taxpayer:

> "In general, property is valued as of the valuation date on the basis of market conditions and fact available on that date without regard to hindsight. However, we have held that postmortem events can be considered by the Court for the 'limited purpose' of establishing what the willing buyer and seller's expectations were on the valuation date and whether these expectations were 'reasonable and intelligent.' The rule that has developed, and which we accept, is that subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation. On November 17, 1979, there was no reasonable or intelligent expectation that a merger of Gilford or a sale of petitioner's block of stock between a willing buyer and a willing seller for $24 per share would take place. The valuation of stock by hindsight analysis is especially inappropriate where there is an active market. To rule for respondent in this case would reject the few strands of clarity in this murky world of valuation. This we refuse to do."

Gilford is also a good analysis and a good result. Even though a much higher price was realized a relatively short time after the date of death, there was no "reasonable and intelligent" evidence that this price was achievable on the date of death. This situation is similar to the analogy of discovering oil on a property after its purchase: while the property is undoubtedly much more valuable now, the existence of oil was unknown as of the transaction date and a willing buyer and willing seller would not have factored this unknown issue into the transaction price.

No Foreseeability Required. In contrast to the "reasonably foreseeable" requirement of the *Ridgely* and *Gilford* cases above, the *Jung* and *Cidulka* line of cases have no such requirement. The *Jung* and *Cidulka* line of cases introduce the concept of subsequent transactions as "evidence" of the value as of an earlier date. Under the *Jung* and *Cidulka* reasoning, a subsequent transaction can come from out of the blue – neither the willing buyer nor the willing seller need have had any inkling such a value was obtainable. *Jung* and *Cidulka* therefore represent time travel in its purest form.

The *Jung* Case. The decedent in *Estate of Jung, 101 T.C. 412 (1993)* died on October 9, 1984, owning an approximate 21% minority interest in Jung Corp. Although Jung Corp. had received letters of inquiry as to an acquisition of the company since 1979, formal discussions with a buyer

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did not begin until mid-1986 and the company was ultimately sold (to Kendall Co.) at the end of 1986. The Court noted that on the date of the decedent's death, this sale was not foreseeable, however, the Court nonetheless considered the December 1986 sale of Jung Corp. as evidence of the value of the decedent's stock on October 9, 1984. The Court stated as follows:

> "A distinction may usefully be drawn between later-occurring events which *affect* fair market value as of the valuation date, and later-occurring events which may be taken into account as *evidence* of fair market value as of the valuation date.
>
> If a prospective October 9, 1984, buyer and seller were likely to have foreseen the 1986 sale to Kendall, and the other activities leading to the liquidation, then those later-occurring events could affect what a willing buyer would pay and what a willing seller would demand as of October 9, 1984. We conclude, and we have found that, on October 9, 1984, Jung Corp. was not for sale, the sale to Kendall was not foreseeable, and the liquidation was not foreseeable. Accordingly, we conclude that those later-occurring events did not affect the October 9, 1984, fair market of decedent's stock.
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> However, we have stated that 'for purposes of determining fair market value, we believe it appropriate to consider sales of properties occurring subsequent to the valuation date if the properties involved are indeed comparable to the subject properties.'
>
> Of course, appropriate adjustments must be made to take account of differences between the valuation date and the dates of the later-occurring events. For example, there may have been changes in general inflation, people's expectations with respect to that industry, performances of the various components of the business, technology, and the provisions of tax law that might affect fair market values between October 9, 1984, and the sales and liquidation some 2 years later. Although any such changes must be accounted for in determining the evidentiary weight to be given to the later-occurring events, those changes ordinarily are not justification for ignoring the later-occurring events (unless other comparables offer significantly better matches to the property being valued).
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> When viewed in this light – as evidence of value rather than as something that affects value – later-occurring events are no more to be ignored than earlier-occurring events. Accordingly, we do not consider the sales and eventual liquidation as affecting the October 9, 1984, value of Jung Corp., but we do consider these events as evidence of the October 9, 1984, value."

Criticism of the *Jung* rationale follows the even more egregious *Cidulka* case below.

A Bigger Leap into the Future. Whereas the *Jung* court had enough gas in its time machine to go a little more than two years into the future, the Court in *Estate of Joseph Cidulka, T.C. Memo 1996-149* cranked up an even larger and more powerful time machine that allowed for time travel nearly four years into the future. In *Cidulka*, the decedent made a number of gifts of a closely-held company stock (SOAI), the latest of which was on January 25, 1982. On December 31, 1985, nearly four years after the last gift, SOAI was acquired by another company. The *Cidulka* court held, in part, that:

> "While 4 years in some instances might be considered too remote to have a real bearing on the valuation of the stock at the earlier date, the multiplier used for the 1986 sale gives an indication of how the value of all the SOAI assets might be determined for a sale at fair market value at an earlier date. This is particularly true where, as here, some asset sales of other companies are shown to have been made near the January 25, 1982, valuation date at a multiplier of around the multiplier at which SOAI's assets were sold in 1986. The record also contains one sale within a year of the SOAI asset sale at a multiplier slightly greater than the multiplier determined for the SOAI sale. Therefore, in our view, the sale by SOAI in January 1986 of all its assets has relevance in determining an appropriate multiplier to determine the fair market value of SOAI's assets on January 25, 1982."

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Problems with *Jung* and *Cidulka* Reasoning. The courts in *Jung*, *Cidulka* and similar cases have taken the use of subsequent transactions into dangerous territory that is so subjective it is unnavigable. One key problem with the *Jung* and *Cidulka* reasoning is quantifying the following issue (as stated by the *Jung* court): "Of course, appropriate adjustments must be made to take account of differences between the valuation date and the dates of the later-occurring events. For example, there may have been changes in general inflation, people's expectations with respect to that industry, performances of the various components of the business, technology, and the provisions of tax law that might affect fair market values between October 9, 1984, and the sales and liquidation some 2 years later." The problem with this directive is that making such "appropriate adjustments" reaches a degree of subjectivity that is entirely unworkable.

Night and Day. For example, in the *Cidulka* case, the valuation date was January 25, 1982, and the subsequent transaction date was December 31, 1985. On January 25, 1982, the Dow Jones Industrial Average closed at 843 and the prime interest rate was 15.75%. On December 31, 1985, the Dow Jones Industrial Average closed at 1547 and the prime interest rate was 9.5%. This represents an 83% increase in the stock market and a 40% decline in interest rates. Remember the vast difference between the late-Carter-early-Reagan recession of the early 1980s and the tremendous economic boom and bull market that began under Reagan in the mid-80s? These represent two vastly different economic situations – how in the world is a business appraiser supposed to objectively adjust for these radically opposite market environments?

To Infinity and Beyond! In addition to the impossibility of making the "appropriate adjustments" suggested by the *Jung* court, these cases also create an equally subjective problem in regards to the degree of time travel allowed. If you are going to use transaction data that is in the future, how far into the future can you go? Six months? One year? Five years? Or should all valuations be "open-ended" and subject to infinite change due to the possibility that additional transactions may occur in the industry? Suppose that none of your gift and estate tax planning, equitable distribution, shareholder disputes, business damages cases, or transactions of private companies were ever settled as the option always existed to adjust the value derived based on transactions that may happen in the future. This would be the equivalent of business valuation anarchy, yet such a result is not out of the realm of possibility under *Jung* and *Cidulka*. All you need is a powerful enough time machine to beam you far into the future. Imagine the subsequent transaction data Charlton Heston could have found in *Planet of the Apes*!

A Glimpse of Reason. Ironically, the *Cidulka* court states the rational solution to the subsequent transaction issue in its opinion above. The *Cidulka* court unfortunately does not specify if the sales of other companies "near" the January 25, 1982, valuation date were before or after the valuation date, however, assuming there were sale multiples on or before the January 25, 1982, valuation date, why not use those multiples and stop there? Isn't that the information a willing buyer and willing seller would have had available to them on January 25, 1982? If you have a reasonable sample of multiples as of the valuation date, why do you need to go into the future to observe additional multiples? The findings of the *Cidulka* court begs the question: what if the 1986 sales multiple had been vastly different from the multiples observed "near" the January 25, 1982, valuation date? Do you disregard the actual multiples observed in the industry as of the valuation date in favor of the multiple that occurred four years into the future?

Apples and Oranges. Another serious problem arises with the relationship between a back-to-the-future market approach and other valuation approaches. A business valuation frequently requires the use of other components that are measured or observed as of the valuation date. For example, the use of a capitalization of earnings method or a discounted cash flow method necessitates the development of a capitalization or discount rate. These rates are determined by utilizing market interest rates (usually some form of "risk-free" rate) in the overall derivation of a capitalization or discount rate. For example, a business appraiser may use a "build-up" method in developing a capitalization or discount rate whereby the appraiser

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takes a "risk-free" rate (such as a U.S. Treasury rate) and adds to that rate an equity risk premium and a specific company risk premium.

Of course, the "risk free" rate changes daily as the yields on U.S. Treasury instruments change daily. It is therefore critical for a business appraiser to adhere to the appropriate valuation date and utilize the "risk free" rate as of that date. Also, equity risk premiums (as measured by various entities such as PricewaterhouseCoopers or Ibbotson) change from year to year and it is equally important for the business appraiser to utilize the appropriate study available as of the valuation date in the selection of the appropriate equity risk premium.

A business appraiser who (under the income approach) carefully develops a capitalization or discount rate using data as of the valuation date but then (under the market approach) uses transaction data that has occurred after the valuation date has used an apples and oranges approach. If a business appraiser is going to use transaction data that occurred after the valuation date, why should he be so careful in developing his capitalization or discount rate using a risk free interest rate and equity risk premium data as of the valuation date? If a business appraiser is willing to consider transaction data after the valuation date, does it really matter that he develop his capitalization or discount rate as of the valuation date? Why not go out into the future to some random date to develop the capitalization or discount rate? Or why not mix and match the risk free rate and the equity risk premium as of different dates in the future?

Open the Pod Bay Door, HAL. Another serious problem with the *Jung* and *Cidulka* line of reasoning occurs when the subsequent "transaction" is not really a transaction at all. As seen above, the Courts in *Jung* and *Cidulka* used time machines that were able to go out two and four years into the future, capture a subsequent transaction, and successfully return back to the valuation date. In contrast, *First National Bank of Kenosha v. United States, 763 F.2d 891 (7th Cir., 1985)* illustrates the unfortunate situation where a time machine heads off into the future but then malfunctions, failing to capture a subsequent transaction and return back to the valuation date. In *Kenosha*, the decedent's estate returned a value of the family farm of $405,000. An option agreement on the farm was executed 21 months after the date of death, giving the optionee the opportunity to buy the property for $1 million. The optionee never exercised the option because of an economic downturn and the farm remained unsold. The jury found a value of $1 million for the farm and the Court of Appeals affirmed, despite noting that "the limited partnership agreement did not evidence a completed sale. It could best be characterized as an option to purchase the property and, in fact, the option was never exercised."

This is an *incredibly* bad result. How can the fair market value of the land be $1 million when no transaction ever happened at that price? An option to purchase is not the same thing as a sale transaction. The only thing the facts of this case prove is that the property definitely was not worth $1 million at *any* time. This case illustrates yet another one of the many problems with using subsequent data to justify the value as of an earlier date.

A More Intelligent Approach. In contrast to the horrible decision in *Kenosha* above, the Court in *Mueller v. Commissioner, T.C. Memo 1992-284* reached a far more rational decision in regards to an uncertain sale in the future. On March 21, 1986, the board of directors of Mueller Company approved a merger of the company with an acquiror. Three days later, the decedent died. Sixty-seven days later, the merger was consummated at $2,150 per share. The estate valued the stock at $1,550 per share. The IRS claimed a value of $2,150 per share. Although the sale had been approved as of the date of death, there were various uncertainties surrounding the eventual close of the sale. The Court applied an arbitrage discount to account for the fact that a willing buyer would not have paid the full $2,150 merger price as of the date of death. The Court determined a value of $1,700 per share.

In contrast to *Kenosha*, *Mueller* is good analysis and a good result. Here, the subsequent transaction was approved by the board of directors prior to the valuation date so any argument that the subsequent transaction was not "reasonably foreseeable" is without merit. This transaction was very

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foreseeable and certainly more foreseeable than the "transaction" in *Kenosha*. However, just because the *Mueller* transaction was approved by the board of directors did not mean the sale would actually close. The Court appropriately analyzed and determined the discount that a willing buyer would place on the shares, considering the very real possibility that the deal would not close.

Willamette Management Associates was the valuation firm hired by the IRS in *Mueller* and Shannon Pratt was the valuation expert who testified on behalf of Willamette. The *Mueller* Court found fault with Dr. Pratt's use of subsequent transaction data:

> "We conclude that Willamette's 'discounted effective merger price' methodology is flawed…because it relies on information (the exact day the deal would close) *that could not have been known on the valuation date* (emphasis added)."

Although Dr. Pratt has made innumerable contributions to the field of business valuation, his support of the use of subsequent data (particularly as articulated in the March 2002 issue of *Shannon Pratt's Business Valuation Update*) is dead wrong. Interestingly enough, Dr. Pratt's colleague and co-author of *Valuing a Business*, Robert Reilly, co-authored an article in the Spring 2002 issue of *Insights* (Willamette's quarterly newsletter) that strongly *supports* the position that subsequent information is to be ignored. In commenting on the recent *McMorris* decision, Mr. Reilly states:

> "With this decision, the Tenth Circuit upheld a valuation principle that has been accepted by numerous federal courts – including the U.S. Court of Appeals for various other circuits. That principle is that events that occur after the appropriate valuation date…should be ignored."

It will be interesting to see how these two co-authors reconcile these dramatically opposite positions in the next edition of their book.

Narrow Application. Finally, in addition to the numerous shortcomings of the *Jung* and *Cidulka* cases noted above, there are two important distinctions to make with this line of cases:

1. The approved use of subsequent data involves transactions *only of the subject private company itself*. The approved use of subsequent data in these line of cases does not involve transactions of other companies in the private company's industry (see discussion below).
2. All of these cases are in the *gift and estate tax context*. None of these cases are in a litigation, equitable distribution, or dispute resolution context.

Therefore, it appears that if one were to follow the faulty *Jung* and *Cidulka* line of reasoning, it would have to be limited to the narrow context of: (1) a subsequent sale of the private company itself that is (2) in the gift and estate tax context only.

A Weak Argument. As concerns the first point above, the *Jung* court did cite a footnote in *Estate of Thompson v. Commissioner, 89 T.C. 619 (1987), revd. on other grounds 864 F2d 1128 (4th Cir. 1989)* in implying that transactions other than that of the subject private company could be considered:

> "[F]or purposes of determining fair market value, we believe it appropriate to consider sales of properties occurring subsequent to the valuation date if the properties involved are indeed comparable to the subject properties."

The weight of this statement, however, is very weak. First of all, the cite is from a footnote in the *Thompson* case, not the body of the opinion. Footnotes are *not* the law – they are merely explanations or suggestions and are not a part of the holding of a case. If a court feels strongly enough about an idea, it makes it a part of the written opinion. Anything less is demoted to a footnote. Secondly, the *Thompson* case was later reversed on other grounds by the United States Court of Appeals. This raises at least the possibility that the *Thompson* holding at the Tax Court level should be thrown out in its entirety. In any event, the legal support for the proposition that subsequent transactions of other companies should be considered is on very shaky ground at best. From a practical standpoint, the use of subsequent

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transactions of other companies adds yet another subjective layer to what is already an impenetrable morass of ambiguity.

IRS Concern is Valid. Although the *Jung* and *Cidulka* line of cases are poorly reasoned, it is recognized that the IRS has a valid interest in the situation where a company is valued at $1 million on an estate tax return and then sold one year later for $10 million. Generally speaking, a "miss" this big usually can be attributed to one (or a combination) of the following factors:

1. Something unforeseen and extraordinary happened at the company or in the industry (similar to the discovery of oil in your backyard). In this instance, the logic of *Ridgely* and *Gilford* (see above) should prevail. As seen above, the key analysis in *Ridgely* and *Gilford* is that the subsequent transaction must have been "reasonably foreseeable" to be considered. Of course, something unforeseen and extraordinary will not have been "reasonably foreseeable," therefore barring the subsequent transaction from consideration. This is the correct result as neither the willing buyer nor the willing seller would have had knowledge of the unforeseen and extraordinary event when the deal was struck on the valuation date. Neither business appraisers nor the courts should be in the position of trying to correct for future events that were unforeseen or were not the result of fraud or deception by one of the parties. Conversely, if the subsequent transaction is "reasonably foreseeable," an analysis such as in *Mueller* is the appropriate approach to employ.

2. Management at the company withheld or distorted vital information during the information gathering and interview process. The issue of a potential subsequent sale of the company should be addressed during the normal valuation process. Basic questions to management and ownership during the valuation process include inquiries as to whether the company is marketing itself for sale or has been approached by potential acquirors. Additional research should uncover whether there is acquisition activity in the industry and whether the company would be an attractive target for an acquiror. If the business appraiser believes that enough tangible interest has been shown in a company (including reasonable terms and prices for a deal), the appraiser must incorporate this into his valuation of the company. If an owner tells the business appraiser that his company is responding favorably to the inquiries of numerous potential acquirors as of the valuation date, the later sale of the company may come as no surprise and could have been very foreseeable as of the valuation date. This data must be incorporated into the valuation report. The degree to which this data impacts the ultimate opinion of value is left to the judgment of the business appraiser, however, if the evidence is strong enough, it cannot be ignored.

3. The business appraiser is inexperienced, professionally incompetent, unscrupulous, or suffers from some other shortcoming that prohibits the delivery of a reliable valuation product.

Conclusion. No matter how you slice it, the use of subsequent data in valuation reports is wrong. It is shoddy valuation practice and may be an indicator of other serious problems with the valuation report. It is intellectually without merit and flies in the face of common sense for the following reasons:

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Back to the Future *(continued)*

1. A willing buyer and willing seller have no knowledge of future events as of the valuation date. Time travel exists only in books and movies. Business valuations are no place for such science fiction.
2. Even if such time travel were possible, there is no way to effectively determine how far out into the future one should be allowed to go. With each successive day's voyage into the future, the quality of information deteriorates and the degree of subjectivity increases. At some point in the future, the information obtained is so subjective it is meaningless.
3. The use of other approaches that are specifically tied to the valuation date results in a mismatch when paired with a back-to-the-future market approach.
4. Time travel is prohibited under the definition of fair market value and by Revenue Ruling 59-60. Nearly all of the professional standards and widely-read valuation textbooks prohibit the use of subsequent data. About the only consistent support for the use of subsequent data is found in a limited line of cases that are poorly reasoned and have a very narrow application. The only redeeming quality of these cases is their recognition of the subjectivity and potential problems with this method.

Beware of the business valuation "expert" who uses subsequent transaction data in his report. The use of such data may indicate either a professionally incompetent appraiser or one who is seeking and selecting whatever useful data he can find to justify a pre-determined value. In either case, the result is a meaningless valuation report.

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