Valuation: Minimizing the Impact of Subsequent Events

By Peter Gampel, CPA, ABV, ASA, CBV, CA

Hindsight gained from events after a valuation date does not provide an appropriate starting point to determine value, but thorough analysis of subsequent events strengthens defense against valuation challenges. Author Peter Gampel explores relevant factors in valuation and economic damages disputes based on subsequent events.

If a business sells at a price much higher than the value placed on it in an earlier appraisal, the disparity can put the valuation at risk during a court challenge. Disputes concerning taxes and business damages, for example, may hinge on information unavailable at the valuation date, but later deemed relevant to the appraisal.

Whether events subsequent to the valuation date were foreseeable or unforeseeable at the valuation date is a key question in these cases.

No Crystal Ball

What is a foreseeable event? Crystal balls are no more available to valuation experts than to anyone else. But a valuation report that considers all pertinent factors affecting company value can go a long way in establishing whether a subsequent event was foreseeable.

Foreseeable events are potential or actual post-valuation developments that are relevant to the value at the valuation date. In contrast, unforeseeable events after the valuation date — such as the unexpected death of a key employee or a natural disaster — are generally inadmissible in determining value.

Disputes often develop in the gray area of contingent events, developments that were known to be possible at the valuation date, but not in a quantifiable form.

Hindsight and Foresight

Unless hindsight can be used to test the validity of judgments at the valuation date, it is usually not relevant in a challenge. On the other hand, if intervening events that contribute to the change in value were known — or foreseeable — on the valuation date, the courts may place greater weight on subsequent events than on pre-valuation circumstances.

For example, *Mark Boyce v. Soundview Technology Group Inc.* (No. 05-1685-CV 2nd Cir. Sept. 29, 2006), a lawsuit involving stock options in an employment contract, challenged a valuation made before the company issued an initial public offering (IPO). The court said that the post-IPO value of the options applied to the employee's options, even though he had been terminated before the IPO.

The ruling hinged on filings with the Securities and Exchange Commission (SEC) shortly after the effective date of the valuation. The court said that the filings included financial information anticipating relevant future conditions that should have been considered in the valuation.

A Reasonable Time Frame

What constitutes a reasonable time frame after valuation for consideration of a post-valuation event? Tax court cases are showing increased willingness to consider events well after the valuation date.

In *Estate of Helen M. Noble v. Commissioner* (T.C. Memo 2005-2), for example, the court found a transaction more than 13 months after the valuation date more indicative of value than a transaction two months before the valuation date.

The key to this reading was the size of the block of stock involved in each transaction. The quantity of shares in the later transaction was closer to the quantity subject to valuation than was the block in the earlier transaction.

Premium for Synergies

Thorough understanding of the subsequent event providing the basis of a valuation challenge can offer an effective defense, if the premium in value demonstrated in the later development grows out of operational synergies or controlling interest not foreseeable at valuation.

For example, in an estate tax case settled before trial, *Estate of Joseph R. Coulter v. Commissioner*, (T.C. Docket 17458-99), the Internal Revenue Service (IRS) contested the valuation of shares in a privately held company that were part of the estate. The challenge was based on the company's sale 21 months after the valuation date at a per-share price approximately four times that in the valuation report.

But the company hadn't been up for sale at the time of the estate valuation, and no indication had been given that management was considering a sale. The estate maintained that the sale was not foreseeable at valuation date.

Compromise Settlement

The IRS argued that the company's sale price and specific interest under consideration was disproportionate to the earlier value when nothing had changed. The IRS asked for an upward adjustment of the valuation by as much as three times the figure submitted by the estate.

But the estate was able to demonstrate that the substantial change in value in the 21 months between the valuation and the sale had not been foreseeable. The defense relied on the impact of synergies of operations the buyer anticipated from the acquisition.

Because it was in the same field, the purchaser expected to trim the acquired company's work force substantially after the acquisition and to reduce research and development spending along with several other costs.

The IRS and the estate agreed to a compromise somewhat higher than the original valuation but substantially below the figure sought by the IRS.

Relevant Transactions

In considering the relevance of transactions — either before or after the valuation date — the courts look for evidence that parties are at arm's length, without any special relationship between buyer and seller that might influence price.

Other important considerations are the number of relevant transactions in the period surrounding the valuation date and the size of those transactions relative to the size of the holdings subject to valuation.

The greater the number of transactions, the better indication of value represented by those transactions. Sales of shares representing 1 percent blocks would not be as relevant to valuation of a 35 percent block as would sales of a block representing a 15 percent or 20 percent share. Larger blocks are disproportionately valuable because they can confer additional benefits of increased control over company decisions.

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Evaluating Indicators

Evaluating the relative merits of indicators before and after the valuation date requires assessing both the relevance of the pre-valuation factors and the irrelevance of the post-valuation activity.

Some cases involve indicators occurring both before and after the valuation date. Some involve only pre-valuation factors, and some are based exclusively on post-valuation indicators.

In *Morton v. Commissioner* (T.C. Memo 1997-166), the court considered valuation of a noncontrolling interest made nine months after the valuation date and a private placement memorandum six months later more germane to appraisal than activities before the date.

The ruling said that activities before the valuation date were less relevant because of the size of the transactions. The earlier activities concerned a much smaller quantity of shares than the number in dispute, while the later actions involved a block comparable in size to the subject holding.

The Role of Uncertainty

Uncertainty that an event contemplated before the valuation date will be completed can reduce the influence of a subsequent event in a challenge.

Regardless of whether a transaction materializes — or whether it occurs soon after or well after the valuation date — doubt about its completion at the valuation date minimizes its impact in setting valuation.

Even if the transaction is completed, the subsequent price is not the appropriate starting point to determine value at the earlier valuation date.

Considering All Factors

Potential or actual subsequent events are not determinative of value as of the valuation date, but they may be probative. Thorough analysis of all relevant factors minimizes the risks associated with valuation challenges based on subsequent events.

Peter Gampel is an executive in financial advisory services specializing in valuation and forensic services with Crowe Chizek and Company LLC in Fort Lauderdale, Fla. He can be reached at 954.202.8619 or pgampel@crowechizek.com.