

Economic Crisis Raises Questions About Business Valuation Standards

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As the daily news media continues to report, the country's economy is tumbling to unprecedented levels and numerous companies have declared bankruptcy or been seized by government agencies. In addition to the collapse of several major banking institutions, the United States has seen major retailers and other businesses face insolvency. Housing prices have fallen to numbers not touched in years, retail sales have declined, and consumer prices have dropped to lows not seen since 1955.

The current global economic crisis, in combination with the body of accepted professional standards and case law on business valuation, has led to uncertainty over the current application of business valuation standards. In particular, uncertainty exists concerning what kinds of company-specific events directly resulting from the crisis can be addressed in a valuation report. Specifically, it is unclear when events that have occurred after a particular valuation date, but before the preparation of the valuation report for that period, should be included in such a report. Now more than ever, business valuation professionals and those seeking the services of such professionals, such as ESOP fiduciaries, need clarification.

A Complex Standard Applied to New Circumstances

Most of the universally accepted business valuation standards and IRS Revenue Rulings support the notion that events occurring *after* the valuation date shall not be considered in the valuation itself. For example, IRS Revenue Ruling 59-60 states, "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." Similarly, the Institute of Business Appraisers' Business Appraisal Standards state, "An appraisal shall be based upon what a reasonably informed person would have knowledge of as of a certain date Information unavailable or unknown on the date of valuation must not influence the appraiser or contribute to the concluding opinion of value."

Despite these straightforward standards, there have been several instances in which courts have allowed postvaluation-date information to be used in determining the value of a company's securities. These cases set forth a standard that is based on whether the subsequent event is "known or foreseeable" as of the date of the valuation. Some of these cases go even further by attempting to determine which events, even if not foreseeable, are evidence of fair market value. Although most of these cases pertain to the subsequent sale of stock in the estate context, the standards invoked by the courts in these cases are indicative of what valuation professionals should be considering when conducting valuations.

For example, in *Estate of Noble v. Commissioner*, T.C. Memo 2005-2 (2005),¹ the court was tasked with determining whether a sale of the decedent's company stock 14 months after the valuation date could be considered in determining the stock's value as of the date of the valuation. The court held that "[a]n event occurring after a valuation date may affect the fair market value of property as of the valuation date if the event was reasonably foreseeable as of that earlier date." *Id.* at 10. However, "[a]n event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical buyer would have paid a hypothetical willing seller for the subject property as of the valuation date." *Id.* As a result, although the court determined that the subsequent sale was unforeseeable, the court concluded that the sale should still be considered in the valuation because of its use as evidence of the stock's value.

Similarly, in *Estate of Jung v. Commissioner*, 101 T.C. 412 (1993), the court elected to use the price in a subsequent sale of stock and liquidation of the company after the decedent's death as evidence of what the value of the decedent's stock was as of the valuation date. There, the court acknowledged the propriety of the "known and foreseeable" standard, but then went on to distinguish between later-occurring events which *affect* the fair market value as of the valuation date and later-occurring events which may be taken into account as *evidence* of the fair market value. The court noted that "[w]hen viewed . . . as evidence of value rather than as something that affects value[,] later-occurring events are no more to be ignored than earlier-occurring events." *Id.* at 432. As a result, the court held that the subsequent sale and liquidation should be considered in the valuation because each was evidence of fair market value even though such events were not foreseeable. Thus, while the courts in both *Estate of Noble* and *Estate of Jung* cited the "known and foreseeable" standard and concluded that the subsequent events at issue in each were not foreseeable, both still found a way to look to these unforeseeable events under the guise that such events were evidence of value. Although this assessment of subsequent events as evidence of value appears to be limited to the estate context at this time, business valuation professionals need to be aware that such a standard may eventually be imposed in other contexts as well.

Until the use of subsequent events as evidence of value is adopted on a broader basis, the "known or foreseeable" standard—which the American Institute of Certified Public Accountants adopted for the valuation of businesses, business ownership interests, securities, and intangible assets with the implementation of its Statement on Standards for Valuation Services 1 (June 2007)—raises a new critical question in light of the current economic situation: Was the extensive fallout from the economic crisis foreseeable? More specifically, if the downturn has had a particularly onerous effect on a certain industry or business, was that effect foreseeable and should it be included in a valuation?

Although it is clear that unforeseeable subsequent events such as natural disasters or the death of a critical employee cannot be taken into account for valuation purposes, valuation professionals need guidance as to whether certain subsequent events directly resulting from the economic crisis are truly foreseeable and therefore required to be included in business valuations.

New Questions

Whether the turmoil within many companies resulting from the crisis should be taken into account will depend on the specific circumstances surrounding each business in question. Some industries and particular companies felt the effects of the crisis much earlier than others, and some have been impacted

1. While Tax Court memos are not binding precedent, they can provide insight into how courts may decide similar cases in the future.

more severely than others. The answer to the question of how much of this was foreseeable for a particular company as of a certain valuation date may depend on what that company or industry was facing at that certain point in time. For example, if a retailer's revenues had declined prior to the valuation date as the result of the drop in consumer spending, and the retailer filed for Chapter 11 protection after the valuation date, was the bankruptcy filing foreseeable and should the valuation professional include it in his or her report for that period? Valuation professionals are clearly required to take the economic climate into account, but whether specific events resulting from the economy should be taken into account is a much more uncertain matter.

Determining what was in fact foreseeable for a particular company as of the valuation date will undoubtedly require careful evaluation of a variety of factors, including all potential legal implications. Valuation professionals must come to a clear understanding of what should and should not be included in each instance, as holders of equity interests in failing businesses and the businesses themselves may argue that such subsequent events should not be used if they will lead to what they consider to be a premature decrease in their stock's value.

Morgan Lewis Can Provide Assistance

The effects of the economic crisis continue to be felt by a wide variety of businesses. As a result, the holders of equity interests in such businesses and the business valuation professionals servicing these holders must understand the law and how the law can affect the valuation of the business. The attorneys at Morgan Lewis have experience in assisting a variety of clients—from ESOP fiduciaries to financial advisors—on the legal framework surrounding business valuations.

For more information on how Morgan Lewis can help, please contact any of the following attorneys:

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