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When can an expert consider subsequent events?

Often, financial experts encounter evidence of events that occurred after the valuation or damage date that may have a bearing on their conclusions. But to what extent can they consider this evidence when valuing an asset or calculating damages?

Unfortunately, there's a great deal of confusion about the role of such evidence, also known as *ex post facto* data. Here's a quick summary of the "rules." But keep in mind that courts may deviate from these guidelines to achieve an equitable result.



Known or knowable

To understand the impact of subsequent events on business valuation, it's important to understand the meaning of "fair market value." It's commonly defined as the price at which property would change hands between a willing buyer and a willing seller when neither is under any compulsion to buy or sell, and both parties have reasonable knowledge of relevant facts.

Business value is generally based on facts that are "known or reasonably knowable" on the valuation date, even if subsequent events alter that value. But that doesn't mean all evidence of subsequent events is irrelevant. Valuers and the courts also make a distinction between events that *affect* business value and those that *reflect* — that is, provide an indication of — value. In many cases, it's appropriate to consider the latter.

A case in point

The former type of subsequent event is often excluded from consideration when valuing a business, however. *Okerlund v. U.S.* is a well-known

example of subsequent events that *affect* value. In this case, the founder and president of a large, privately held food company transferred stock to several family members. Shortly after this, the founder died — and a while later, a salmonella outbreak significantly impaired the company's stock price. The stock recipients sought to reduce the amount of gift tax on their transfers, arguing that the court should consider the stock's actual performance following the gifts.

The court rejected this argument, explaining that value must be determined as of the valuation date and must rely primarily on information known, or reasonably knowable, at that time. In this case, the valuator had listed "reliance on a key management figure" and "risk of food contamination" as foreseeable, albeit unlikely, risks on the valuation date.

The most common example of a subsequent event that *reflects* business value is a sale of the same or a similar business interest within a reasonable time after the valuation date. In fact, the courts generally view actual arm's-length sales within a reasonable time *before* or *after* the valuation date as the

best evidence of fair market value. (See “Redstone v. Commissioner: Timing is critical when relying on arm’s-length stock transactions” on page 5.)

Fairness considerations

Despite the general rule against considering subsequent events that affect value, courts sometimes deviate from that guideline in the interest of fairness. Suppose, for example, that divorcing spouses agree to use the filing date as the valuation date for all marital assets, including a business owned by one of the spouses. What if the business’s offices are destroyed in a fire after the filing date but before the court date?

It’s likely that the court would consider the impact of the fire on value in equitably dividing the marital estate or setting the amount of support payments, even though it wasn’t known or knowable on the filing date.

What about lost profits?

Subsequent events are often considered in calculating lost profits damages. Business valuation is based on the perceptions of hypothetical buyers and sellers about the business as of a certain date. Lost profits, on the other hand, are designed to compensate plaintiffs through recovery of the net profits they *would have earned in the past and potential future lost profits*, but for the defendant’s wrongful conduct.

Evidence of a business’s actual postinjury performance — or the postinjury performance of its competitors — is often relevant in calculating historical lost profits and projecting future lost profits or lost business value.

Keep your experts informed

It’s not unusual, during the course of a valuation or litigation proceeding, for attorneys to learn about events that may provide an indication of value — or potentially alter damages or business value calculations. Be sure to inform your experts of these events so they can consider the relevance, if any, in their opinions. ■

Accounting for subsequent events

Subsequent events may have an impact on a company’s financial statements. For example, what happens if an event affecting the company’s financial condition occurs after the balance sheet date but before financial statements are issued?

Current accounting principles consider two types of subsequent events:

1. Recognized subsequent events. These reflect conditions that exist on the balance sheet date — for example, if a major customer subsequently files for bankruptcy and is likely to default on all or part of its outstanding receivables.

2. Nonrecognized subsequent events. These reflect conditions that arise after the balance sheet date but didn’t exist at the balance sheet date, such as a natural disaster that severely damages the business.

Generally, the effects of the former must be recorded in the financial statements and the details must be disclosed in the footnotes. The latter aren’t required to be recorded, but they may have to be disclosed in the footnotes.

Regardless of how they’re classified, subsequent events are often revealed when experts review the company’s disclosures. So, it’s important to provide your valuator with a complete copy of the company’s financial statements.



The ins and outs of control and marketability

Valuation discounts and premiums are one of the most subjective — and contentious — issues when valuing a business interest for litigation purposes. For one thing, they may sometimes be embedded (fully or partially) in the expert's methodology. Moreover, their size can vary significantly, depending on the facts and circumstances of the case.

Who's the boss?

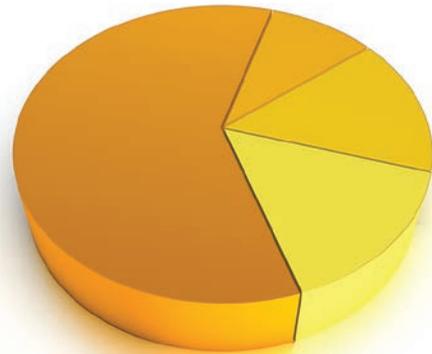
Investors generally pay premiums to have majority control of businesses. Conversely, they expect discounts for being unable to assert control. Prerogatives of control include the rights to appoint management, pay dividends, direct business strategy, set compensation and divest assets.

The most common control adjustment is the discount for lack of control (DLOC). Valuers consider many factors when quantifying DLOC, such as ownership distribution, block size and state laws. To quantify DLOC, valuers sometimes use control premium studies of public company acquisition prices to compute implied minority discounts. Small interests with the power to block the prerogatives of control may warrant a swing vote premium. Alternatively, owners who lack voting rights may require an additional discount.

Why does marketability matter?

Marketability refers to how quickly an investment can be liquidated at minimum cost and maximum certainty about price. Minority interests in private business generally sell more slowly and unpredictably than publicly traded stocks. Discounts for lack of marketability (DLOM) may apply when public data is used to value private firms.

Valuators support DLOM with empirical evidence. They may use restricted stock studies, which compare public stock prices to private placements of



restricted stock. The restricted and unrestricted shares are identical, except that the former are subject to a minimum holding period of one year.

They also may use pre-IPO studies to compare companies' private transactions before going public to initial public offering (IPO) prices. In general, pre-IPO studies generate higher average (or median) discounts than do restricted stock studies.

Finally and most recently, valuers have been using put option models. A major component of marketability is the risk that an investment will decrease in value over time. Put options provide a measurement of the cost to hedge this risk and are used as an indication of the marketability discount.

An empirical study's average discount is just a starting point. Valuers customize the underlying data — by size, performance and other factors — to support their DLOM estimates. They also analyze more than one type of DLOM study and reconcile conflicting evidence or case law.

All these empirical studies apply exclusively to *minority* interests. *Controlling* interests may warrant a discount for lack of liquidity. However, illiquidity discounts are highly subjective and may be difficult to support, since there is little evidence available.

What is the basis of value?

Discounts and premiums are meaningless unless the valuator clearly defines the basis of value that his or her preliminary analysis generates. The valuator also needs to define the desired basis of value.

For example, suppose an appraiser uses the guideline transaction method to value a business. He adjusts the company's earnings for discretionary items, such as above-market owner's compensation and related-party transactions. The appraiser concludes that his preliminary analysis has generated a controlling basis of value. The desired basis of value is minority, nonmarketable.

To arrive at the appropriate basis of value, the appraiser applies discounts for lack of control (15%) and lack of marketability (25%). The effects of these discounts aren't additive (equaling 40%) but multiplicative (totaling 36.25%).

Are there exceptions?

Discounts and premiums aren't universally applicable. Discuss the issues of control and marketability with your valuation expert to make sure that you understand how they've been handled based on the facts and circumstances of the case at hand. ■

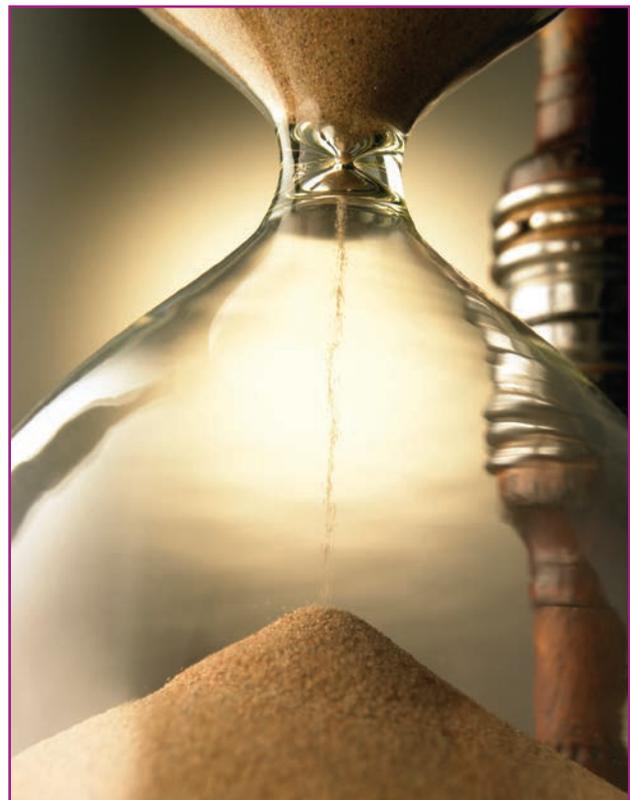
Redstone v. Commissioner

Timing is critical when relying on arm's-length stock transactions

An arm's-length transaction involving the subject company's stock that occurs before or after the valuation date can provide a meaningful indication of fair market value. In *Redstone v. Commissioner*, the U.S. Tax Court held that the best evidence of the stock's value for gift tax purposes was the price the company had paid to redeem another shareholder's stock three weeks before the valuation date. The valuation prepared by the petitioner's expert was found to be unreliable, because it was based on a stock redemption 12 years after the valuation date without accounting for changes in market conditions.

All in the family

The company at the center of this dispute was National Amusements Inc. (NAI), a family business that built and operated drive-in movie theaters throughout the Northeast. Mickey Redstone, who owned it with his two sons, Edward and Sumner, established the business. Although Mickey contributed nearly twice as much capital as each of



his sons, the company's 300 shares of stock were divided among them equally. In 1968, Mickey transferred 50 shares of his stock to a trust established for the benefit of his grandchildren.

In 1971, Edward decided to leave the company and a dispute arose over his entitlement to his 100 shares, ultimately resulting in litigation. After a year of negotiations, the parties settled in June 1972. The settlement provided that the company would redeem $66 \frac{2}{3}$ of Edward's shares for \$5 million (approximately \$75,000 per share) and that the remaining $33 \frac{1}{3}$ shares would go into a trust for the benefit of his two children.

Three weeks later, in July 1972, Sumner, who wasn't a party to the litigation, also transferred $33 \frac{1}{3}$ of his shares to trusts for the benefit of his children. Although he didn't file a gift tax return that year, Sumner testified in unrelated litigation that the transfer had been voluntary.

In 1984, NAI redeemed $83 \frac{1}{3}$ shares held by the trusts that Mickey and Edward had established. The aggregate redemption price was roughly \$21.4 million, or approximately \$257,000 per share.

In 2011, the IRS determined that Sumner's 1972 transfer was a gift and assessed more than \$700,000 in gift taxes. Although Sumner claimed the transfer wasn't a gift, the Tax Court disagreed, based on Sumner's conflicting testimony and other evidence.

Conflicting valuations

The Tax Court also addressed the proper valuation of the $33 \frac{1}{3}$ shares Sumner transferred in July 1972. The IRS expert valued the shares by referencing the price NAI had paid three weeks earlier to redeem Edward's $66 \frac{2}{3}$ shares — approximately \$75,000 per share. The expert viewed the redemption as a "private transaction for a minority interest," establishing NAI's per-share value "on a minority, non-marketable interest basis." He also applied the direct capitalization and guideline company methods (using a 34% discount for lack of marketability), resulting in values of approximately \$2.4 million and \$3 million, respectively.



Sumner's expert used the so-called "grafting" method. Starting with the 1984 redemption price, he computed pricing multiples based on the company's average net income for 1981 to 1983 and the book value of shareholders' equity in 1984. Applying those multiples to similar data from 1972, he arrived at a valuation of approximately \$22,000 per share.

Petitioner Sumner's valuation unreliable

Noting that the best evidence of value is an actual arm's-length stock sale within a reasonable time before or after the valuation date, the Tax Court accepted the IRS expert's valuation. The court suggested that the 1984 redemption relied on by Sumner's expert was likely too remote in time to be probative: "Petitioner has cited no case in which a court employed, as its principal valuation metric, a stock sale that occurred as many as 12 years after the valuation date."

But the court based its decision on the fact that the expert had failed to make adjustments to reflect changes in economic, industry-specific and company-specific factors over the 12-year period — or to offer a rationale for not doing so.

Timing is everything

This case shows how events at or near the time of the valuation date generally are the most reliable indicators of value. Further, it shows that subsequent events — particularly those that are remote in time — may have no bearing on the analysis for a host of reasons. ■

Valuing synergy: When a risk-based approach works

In a merger and acquisition (M&A) context, valuers may be called on to value potential synergies — that is, benefits to a specific strategic buyer that are expected to make a combined company more valuable than the sum of its parts. Valuing synergies is a challenge, given the substantial uncertainty, in many cases, over whether they'll be achieved. A recent study of investment bankers' valuation techniques demonstrates a trend toward valuing synergies separately in light of the inherent risks.

In a 2014 article in the *Journal of Applied Finance*, "Company Valuation in Mergers and Acquisitions: How is Discounted Cash Flow Applied by Leading Practitioners?" the authors reported the results of interviews with 11 major investment banks about how they value business enterprises. They found that, while leading practitioners routinely use discounted cash flow (DCF) methods in M&A valuations, how they apply the DCF method "is often far from 'routine.'" All but one of the

investment banks said they take specific separate steps to address the value of synergies. This represents a significant change from a similar 1998 study, in which only half of financial advisors made special adjustments to value synergies differently.

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The steps vary from bank to bank. For example, some assign different types of synergies into separate "buckets" and assess them separately according to risk. Others use a higher discount rate, such as the cost of equity, for synergies. Still others give synergies a "haircut" — that is, they reduce synergy-related cash flow projections to reflect the risk they won't be achieved.



The approach depends in part on the nature and risk of the synergies. For example, easily achieved cost synergies — such as those derived from eliminating redundant management — might not require a separate valuation. But revenue synergies, such as those derived from cross selling to a new customer base or sharing distribution channels, might need to be treated separately, given the higher risk involved. ■

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Valuations

At some point, your business-owner clients will need to have a valuation of their company stock – whether for gifting, estate settlement, settling a legal dispute, securing financing, or succession planning purposes. Our accredited analysts are experienced in providing a comprehensive approach that is recognized and accepted by regulatory institutions including the Internal Revenue Service and the Department of Labor.

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