The Valuation of a Close Corporation: Glimpses of Objectivity in an Inflationary Period

James E. Cushing, Jr.
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INTRODUCTION

The valuation of stock of a close corporation is among the most perplexing problems in the law.1 Ideally, a public market composed of willing and informed buyers and sellers provides an accurate indication of the value of a corporation's stock.2 This rarely occurs, however, in the case of a close corporation. Instead, the legal and corporate characteristics of a close corporation discourage the formation of a public market, thereby preventing an objective and equitable valuation.3

1. A close corporation is generally characterized as being owned by a small number of shareholders, usually consisting of members of the same family, with a lack of a public market for the transfer of shares, and perhaps with ownership and management vested in the same persons. F. O'NEIL, CLOSE CORPORATIONS § 1.02 (2d ed. 1971) (hereinafter cited as O'NEIL).

2. This description of valuation is based upon a common definition of value used for estate tax purposes: "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b) (1965).


The lack of a public market for the transfer of a close corporation's stock is frequently due to restrictions placed upon the transferability of the stock. The owners of a close corporation, while seeking the advantages of a corporate structure, such as limited liability, deferral of individual income, and the availability of pension and other benefit plans, also attempt to preserve control over the operations of the business by imposing restrictions on transferability. These restrictions, including buy-sell agreements, stock repurchase plans, corporate call options, and options of first refusal, are usually created by the corporation's shareholders. They are imposed to avoid the transfer of stock to shareholders with personalities or corporate goals incompatible with current ownership. See generally Comment, Valuations of Shares in a Closely Held Corporation, 47 Miss. L.J. 715, 716-17 (1976).

The number of shareholders is also limited through these restrictions in order to gain advantageous tax considerations. For example, a corporation can have no more than 25 shareholders in order to qualify as a Subchapter S corporation for federal tax purposes. I.R.C. § 1371(a)(1). For a discussion of the advantages of qualifying under the Subchapter S election see Daly, Operations of Subchapter S Corporations, 53 TAXES 495 (1975).

Other statutory incentives, outside the tax area, also encourage limited transferability of stock. State laws often require restrictions on the transfer of stock in order for a corporation to qualify under a state's close corporation act. E.g., Del. Code Ann. tit. 8, § 342 (1974); Ill. 107
The absence of a public market necessitates the development of alternate methods for determining the value of the stock of a close corporation. Although these methods do provide specific valuation amounts, they are not without their disadvantages. The primary disadvantage is the inability to reflect the actual or fair market value of a close corporation's worth, particularly when subject to high rates of inflation.

This article will examine the problem of valuation of the stock of a close corporation. Initially, it will discuss the special need for

REV. STAT. ch. 32, ¶ 1203 (1979). Furthermore, the expenses and complexities of compliance with federal and state securities laws can often be avoided by remaining outside the public market. Illinois, for example, permits the transfer of securities, without registration, if the stock of a corporation is offered for sale to no more than 70 persons. ILL. REV. STAT. ch. 121 1/2, ¶ 137.4(G) (1979). See also DEL. CODE ANN. tit. 6, § 7309(b)(9) (1979).


There is no doubt that the value of the closely held corporation is an elusive quarry. The determination of the value of a corporation is, at least, an art and not a science, at worst, pure conjecture." Silton, Valuation of Closely Held Corporations, 116 Trusts & Estates 82,82 (1977) (hereinafter cited as Silton).

The difficulties of valuing a close corporation are compounded because of its unique characteristics. These characteristics include control by a family or a relatively small number of shareholders who often provide specialized goods or services. These characteristics, in turn, affect the method of valuation selected. For example, the method selected for valuing the stock of a manufacturing corporation will likely differ from the method selected for valuing the stock of a service corporation. A service corporation providing specialized services primarily performed by a key employee-shareholder may possess little value upon the death or retirement of that employee-shareholder. The eventual loss of expertise and resulting loss in value to the corporation would thus be considered in the selection of a valuation approach. On the other hand, a manufacturing corporation with large investments in its fixed assets is likely to have consistent and predictable earnings, regardless of its ownership. A manufacturing corporation's underlying assets, however, may be subject to significant changes in value due to technological advancements and inflation. See notes 106-15 infra and accompanying text for a proposed valuation method which reflects changes in value due to technological advancements and inflation.

A Delaware court, ruling upon the value of the stock of minority shareholders, considered the nature of the corporation's business. In the Matter of General Realty & Util. Corp., 29 Del. Ch. 480, 52 A.2d 6 (1947). The court ruled that the "mere possession of the assets [rather than] . . . the caliber of the corporate management" was a factor properly considered in a valuation formula established by a court appointed appraiser. Id. at 483, 52 A.2d at 8.

The nature of a business has also been deemed important and relevant by the Tax Court and the Internal Revenue Service in the valuation of a close corporation for tax purposes. See generally Silton, supra this note, at 82.

These valuation problems of a close corporation become even more formidable when considering the estimate that approximately 1.7 million close corporations exist in the United States. Englebrecht, Valuation of Closely Held Oil and Gas Corporations for Estate and Gift Tax Purposes, 25 Oil & Gas Tax Q. 273, 273 (1977) [hereinafter cited as Englebrecht].
stock valuation in a close corporation. The various methods used for valuation will be surveyed with special emphasis upon the book value approach, the most common method of valuation. Finally, this note will propose and analyze an alternative method for solving the problem of valuation. This proposal, although based upon book value, incorporates into the valuation process recent inflation accounting techniques developed by the accounting profession.

USES OF VALUATION

Transfers of stock of a close corporation do occur despite difficulties in valuation. These transfers include voluntary sales of stock, involuntary squeeze-outs from corporate ownership and the transfer of shares upon the death of a shareholder. Each of these situations require the valuation of the transferred stock of a close corporation. The performance of this difficult task requires the informed planning of an attorney or the insightful exercise of judi-

5. The valuation of the stock of a close corporation is also necessary if insurance is taken out upon the life of a key employee-shareholder, payable to the corporation upon the death of the shareholder. This insurance is designed to provide the corporation with funds for purchasing the shares from the decedent's estate. See Page, Setting the Price in a Close Corporation Buy-Sell Agreement, 57 Mich. L. Rev. 655, 660 (1959). The valuation of a close corporation may also be necessary in order to comply with statutes which require a positive capital amount in the corporation before a dividend can be paid. E.g., Del. Code Ann. tit. 8, § 170 (1974); Ill. Rev. Stat. ch. 32, ¶ 157.41a(d) (1979). This requirement imposes a duty upon the corporation's directors to determine the corporation's value. Morris v. Std. Gas & Elec. Co., 31 Del. Ch. 20, 63 A.2d 577 (1949); Randall v. Bailey, 23 N.Y.S.2d 173, 182 (1940) (value of the assets, and not necessarily their costs, is important for meeting the statutory requirement). See also Comment, Valuation of Close Corporate Shares in Oregon, 57 Ore. L. Rev. 309, 309-10 (1978) for a listing of other uses for valuations of close corporations.

6. An attorney performs an important role in the valuation of the stock of a close corporation. The duties of an attorney often include the drafting of restrictive shareholder stock agreements and the counseling or selection of the appropriate valuation method. An attorney's choice of a method, without first developing a sufficient understanding of the various valuation methods and of the nature of the particular corporation, "can be the source of confusion, disputes and often litigation." Page, supra note 5, at 655.

"This question concerning the extent of lawyer participation in the valuation decision... will depend on many factors including the size and financial experience of the client, the lawyer's familiarity with financial matters and problems of the industry involved, and the relationship between the lawyer and the client." Baum, Buying and Selling Small Corporations: The Legal and Financial Problems, in Buying and Selling Small Businesses 6-1 (1972).

Attorneys are increasingly being called upon to understand the complexities of valuation methods. Accordingly, some commentators believe that an attorney practicing in this area of law should possess an understanding of "at least some elementary finance theory in order to represent clients capably." Schreir & Joy, Judicial Valuation of "Close" Corporation Stock: "Alice in Wonderland" Revisited, 31 Okla. L. Rev. 853, 857 (1978) [hereinafter cited as Schreir & Joy].

Principles of accounting are also involved in valuation methods. It may likewise be "nec-
cial discretion in determining an appropriate valuation method.

**Buy-Sell Agreements**

Varying methods of stock valuation are most often utilized when determining the transfer price in a buy-sell or a stock purchase agreement. Buy-sell agreements and stock purchase provisions impose certain duties and obligations upon a corporation and its shareholders. They also frequently impose restrictions on the transferability of stock. These agreements, generally established during the amiable period of a corporation’s formation, maintain corporate ownership among existing shareholders.

The risk of adverse ownership exists as the result of a number of contingencies, including irreconcilable disputes among owners and the retirement or death of a shareholder. Restrictions in a buy-sell agreement aim at eliminating this risk by requiring a shareholder or the administrator of a decedent’s estate to sell the stock only to the corporation or to the remaining shareholders. As a result, the existing shareholders retain corporate control.

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9. It has been estimated that the average family business survives only 25 years. The break-ups are due primarily to disagreements among family members. Bonner, *Small Business*, Chi. Sun-Times, Feb. 13, 1981 at 83.

10. An employee, for example, may be granted stock in the corporation. Buy-sell agreements are often entered into when this occurs. The corporation may retain the right to purchase that stock when the employment relationship is terminated. *E.g.*, Systematics, Inc. v. Mitchell, 253 Ark. 848, 491 S.W.2d 40 (1973); Jones v. Harris, 63 Wash. 2d 559, 388 P.2d 539 (1964).


12. *E.g.*, Am. Bank & Trust Co. of Pa. v. Lied, 487 Pa. 333, 409 A.2d 377 (1979). Such restrictions imposed for the purpose of maintaining control have been held not to be unconscionable or contrary to law or public policy. Ginter v. Palmer, 39 Colo. App. 221, 222, 566
The transfer of shares in accordance with the provisions of a buy-sell agreement frequently requires the selection of a fair price to be paid in the transfer. The selection of a fair purchase price, however, is difficult because of the unique characteristics of a close corporation and the absence of a public market for its shares. Diverse shareholder motives also impede the selection of an objective valuation. The buy-sell agreement will therefore typically provide, with the mutual consent of the parties, for a provision specifying a purchase price for the stock or a valuation method from which a price can be determined.

The valuation method contained in a buy-sell agreement is often a source of dispute among shareholders when enforcement of the terms is sought by one of the parties. This is particularly true when the transfer price, as determined in accordance with the valuation method specified in the agreement, fails to reflect the actual value of the corporate stock. Many courts confronted with this difficulty have upheld the selected valuation method and resulting price. In these decisions, courts recognize the buy-sell agreements as contracts and accord them similar judicial deference. Assuming the parties were free to establish a transfer price, their intentions, as reflected in the agreement, are upheld.


The provisions of buy-sell agreements may also work to the advantage of shareholders. Most notably, buy-sell agreements may provide a departing shareholder or the estate of a decedent shareholder with an available purchaser of the shares of a close corporation. See Page, supra note 5, at 655.

13. Some shareholders may prefer a valuation method which establishes a high price for the transfer of the stock. This provides assurance that a shareholder's heirs would be amply provided for upon the shareholder's death. The problem with a high valuation, however, is the risk that this high value may be used as a part of an estate tax valuation. See notes 24-26 infra and accompanying text. Conversely, a valuation method which establishes a low price may be preferred. This would increase the likelihood that the corporation or remaining shareholders would have the necessary funds to purchase the shares, thereby retaining the desired control of the corporation.

14. See notes 81-93 infra and accompanying text.


16. "Obviously in such a serious agreement involving the transfer of many thousands of dollars of stock, the parties must have intended by this provision to establish a fairly stable and predictable valuation basis." Aron v. Gillman, 309 N.Y. 157, 163, 128 N.E.2d 284,288 (1955).
Disputes among shareholders, including disputes over the valuation of stock, often lead to corporate ownership battles. These battles may lead to the oppression of minority shareholders by those possessing majority control of the corporation. The majority may place itself in positions of exclusive power and control of the corporation. In a close corporation this can result in the loss of a minority shareholder's employment or the imposition of other hardships.

The relief available to minority shareholders is limited. In a close corporate setting the minority will most likely be unable to sell their interest at a fair price. Few buyers are willing to purchase a minority interest in a close corporation, even with a price discount. The only possible buyers, therefore, may be the oppressive majority shareholders of the corporation. Given the hostility of the majority to the minority shareholders, a fair valuation of the minority stock becomes a necessity.

Corporate ownership battles create economic hardship upon the majority shareholders as well. The minority shareholders are often in a position to employ obstructive tactics capable of disrupting business operations and causing pecuniary loss to the majority shareholders. Some states have responded to these problems with statutory solutions. To avoid a destructive ownership battle, states allow a specified percentage of the majority shareholders to squeeze the minority shareholders out of ownership. In addition, some state statutes provide minority shareholders with the right to

17. O'Neil, supra note 1, at § 7.24a.
18. E.g., Homer v. Crown Cork & Seal Co. of Balt., 155 Md. 66, 141 A. 425 (1928) (majority shareholders proposed a corporate resolution that required the minority shareholders to terminate their interest in the corporation at a price dictated by the majority shareholders).
19. These disruptive practices of disputing minority shareholders or their elected directors include the withholding of votes necessary for the authorization of important business decisions and the frequent disruption of shareholder or director meetings through constant procedural maneuvers. Because these practices endanger the efficient operation of the corporation, the occurrence of these disputes weakens the confidences of third parties in the corporation. The result may be the loss of business or a reluctance by financial institutions or other creditors to risk doing business with the embattled corporation. O'Neil, supra note 1, at § 9.02.
sell their interest to the corporation in the event of irreparable disputes with majority shareholders.\textsuperscript{21}

Although these statutes provide relief to the disputing owners of a close corporation, they fail to adequately address the additional problem of valuing the stock of the minority interests.\textsuperscript{22} The statutes generally require only that the purchase price be set at a “fair” amount,\textsuperscript{23} leaving to the shareholders, and eventually to the courts, the determination of value. Thus, the valuation problem remains unresolved.

\textit{Estate Tax Valuation}

The death of a corporate shareholder presents another situation for which the valuation of stock is necessary. The death of a shareholder is certain to require a valuation of the decedent’s stock for estate tax purposes. Section 2001 of the Internal Revenue Code\textsuperscript{24} imposes a tax upon the transfer of assets of a decedent at the time of death. This estate tax is based upon the value of the decedent’s estate.\textsuperscript{25} The valuation of the estate is determined by the “fair market value” of its assets.\textsuperscript{26} This determination of the fair market value of a decedent’s assets, however, becomes especially difficult when the estate includes shares in a close corporation.\textsuperscript{27}

Early court decisions concerning the tax valuation of a close corporation recognized the difficulty of stock valuation in the absence of a market price.\textsuperscript{28} The courts considered various factors and formulas in determining the corporation’s value.\textsuperscript{29} In response to the resulting “bewilderment,”\textsuperscript{30} the Treasury Department in 1959 issued a Revenue Ruling attempting to provide certainty to the

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\item \textsuperscript{21} E.g., Del. Code Ann. tit. 8, § 262 (1979); Ill. Rev. Stat. ch. 32, ¶ 1214(b) (1977).
\item \textsuperscript{22} E.g., Ahlenius v. Bunn & Humphreys, 358 Ill. 155, 192 N.E. 824 (1934); Application of Del. Racing Ass’n, 42 Del. Ch. 406, 213 A.2d 203 (1965).
\item \textsuperscript{23} E.g., Del. Code Ann. tit. 8, § 262 (1979); Ill. Rev. Stat. ch. 32, ¶ 1214(b) (1977). The various statutes also granted the minority shareholders the right to petition the court for a determination of value if the minority and majority shareholders are unable to agree on a “fair value.” E.g., Del. Code Ann. tit. 8, § 262(c) (1979); Ill. Rev. Stat. ch. 32, ¶ 157.73 (1977). \textit{See generally} Note, Appraisal Statutes, \textit{supra} note 20.
\item \textsuperscript{24} I.R.C. § 2001.
\item \textsuperscript{25} I.R.C. § 2031.
\item \textsuperscript{26} Treas. Reg. § 20.2031-1(b) (1965). For pertinent language, \textit{see} note 2 \textit{supra}.
\item \textsuperscript{27} \textit{See} Englebrecht & Davison, \textit{A Statistical Look at Tax Court Compromise in Estate and Gift Tax Valuation of Closely Held Stock}, 55 \textit{Taxes} 395 (1977) \textit{[hereinafter cited as Englebrecht & Davison]}.
\item \textsuperscript{28} Couzens v. Commissioner, 11 B.T.A. 1040 (1928).
\item \textsuperscript{29} \textit{Id}.
\item \textsuperscript{30} Schreier & Joy, \textit{supra} note 6, at 870.
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problem of valuation of close corporations.\textsuperscript{31} Recognizing the fact that the valuation of a close corporation depends upon the particular facts involved, however, the Ruling did not require the use of a specific valuation formula.\textsuperscript{32} Instead, the Ruling listed various factors to be considered in the valuation of a close corporation.\textsuperscript{33}

The issuance of the 1959 Revenue Ruling ended neither the disputes nor Internal Revenue Service challenges concerning valuation.\textsuperscript{34} Rather, the valuation of a close corporation for estate tax purposes continues to be a question of fact, dependent upon the particular corporation involved.\textsuperscript{35} No one valuation method has become a panacea.\textsuperscript{36}

\section*{Methods of Valuation}

The various situations dependent upon accurate valuation, as discussed, highlight the need for an accurate and reliable method of determining the value of a close corporation. The optimum valuation situation - the determination of value by willing and in-
formed buyers and sellers - is unlikely to occur. A valuation formula or method is therefore needed to determine the value of a close corporation.

**Shareholder Assigned Value**

One method for determining value requires shareholders to periodically assign a value to the stock. This "flexible" method requires the shareholders to meet on a regular basis for the purpose of reviewing the current operations and anticipated performance of the corporation. The value assigned to the corporation is based upon the shareholders' estimation of the corporation's value. Ideally, the end result of this valuation method is a fair and reliable price upon which the shareholders mutually agree.

A significant weakness in this method is its dependence upon the continuing amity of the shareholders. This disadvantage is particularly important where the valuation of stock becomes relevant in a shareholder dispute. Discord is likely to prevent the shareholders from agreeing on a valuation. Their failure to assign a value may thus result in the continued use of a price no longer indicative of subsequent changes within the corporation or the economy. As a result, one of the purposes of the valuation, to provide a fair price to a selling shareholder in the event of a dispute, will be defeated.

Another weakness in this valuation method is that the shareholders may have little knowledge or expertise in valuing the corporation. Mere conjecture may instead prevail. Shareholders may

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37. Page, supra note 5, at 675.
38. Such an approach was examined in Krebs v. McDonald, 266 S.W.2d 87 (Ct. App. Ky. 1953) (price of stock to be determined by the corporation's shareholders at an annual meeting). See also Milston & Cohn, Personal and Business Aspects of Stockholders Agreements, 124 J. Accy. 41, 42 (1967) [hereinafter cited as Milston & Cohn].
39. "Certainty, of course, results from stating a fixed price in the agreement upon which all parties can rely without potential for a disputed interpretation, and fairness lies in the capacity for revaluation at intervals based upon possible appreciation or depreciation of the business interest." Matsen, supra note 34, at 135-36.
40. Other weaknesses include the possibility that the shareholders may fail, or simply forget, to meet on a periodic basis.
41. Page, supra note 5, at 677.
42. It may thus be advisable to provide alternative methods of valuation in contemplation of the possibility that the shareholders will fail to agree upon a price. O'Neill, supra note 1, at § 7.24b. For example, a previously approved adjustment may be applied to the last agreed upon value. Milston & Cohn, supra note 38, at 42. Of course, this adjustment would not necessarily reflect the actual change in the corporation's value.
also have differing motives for determining value. Instead of reflecting the fair value of the corporation, the selected valuation may merely reflect the particular motives of a shareholder. The problems of valuation will thus be perpetuated.

Shareholder valuations determined in this manner have been challenged as being inequitable and as imposing unreasonable restraints upon alienation of a corporation's shares. Courts nonetheless have generally upheld the valuation as conforming to the intentions of the shareholders. The shareholders' failure to periodically review the purchase price, however, may render the price unenforceable.

**Appraisal**

The disadvantages of the previous method may be remedied by the use of an appraiser. Under the appraisal method a person skilled in the techniques of valuing a business is employed to render an opinion on the worth of the corporation. This employment of an independent person to determine the value reduces the risk that the value will be influenced by self-serving motivations.

The appraisal method of valuation is not without disadvantages. The shareholder assigned valuation method attempts to gain the agreement of all shareholders, yet the appraisal method may pro-

43. "The most serious shortcoming [of this method]. . . is its susceptibility to abuse by a shareholder who expects to be a survivor." Page, supra note 5, at 676.

44. In Krebs v. McDonald, 266 S.W.2d 87 (Ct. App. Ky. 1953) the court upheld the shareholders' $100 per share valuation as the price at which the estate of the decedent shareholder was required to offer the stock to the surviving shareholders. The price was recognized by the court as "not sensitively reflect[ing] the fluctuations in real or actual value. . . .", as evidenced by a $218 per share value determined for tax purposes. Id. at 89. Nonetheless, the price was enforced because it was in accordance with the shareholders' express intentions. Accord, Baron v. Royal Paper Corp., 36 A.D.2d 112, 318 N.Y.S.2d 327 (1971); Meyers v. S. Nat'l Bank of N.C., 21 N.C. App. 202, 204 S.E.2d 30 (1974); In re Mather's Estate, 410 Pa. 361, 189 A.2d 586 (1963) (Valuation of shares at one dollar per share was enforced even though the actual value was $1,060 per share. The price was held to be consistent with the shareholders' intention of keeping the business in the family by permitting surviving family shareholders to inexpensively purchase the shares).

45. See Systematics, Inc. v. Mitchell, 253 Ark. 848, 491 S.W.2d 40 (1973) (ruling that the price violated an Arkansas statute requiring shareholder restrictions to include a "fair price" provision. Ark. Stat. Ann. § 64-211 (Repl. 1966)); Collins v. Universal Parts Co., 260 So. 2d 702 (Ct. App. La. 1972) ("It was obviously not intended that the value of a shareholder's interest be frozen. . . .") Id. at 704).

46. Utilization of appraisers is widespread. Courts, for example, frequently appoint appraisers for resolving valuation disputes. A corporation or its shareholders also frequently employ appraisers pursuant to shareholder or other corporate agreements. See Note, Appraisal Statutes, supra note 20, at 1453-54, and note 47 supra and accompanying text.

vide a valuation agreeable to none.\textsuperscript{48} The parties may instead be bound by the unpopular valuation opinion of a third-person. In addition, the appraisal method requires subjective judgments by an appraiser.\textsuperscript{49} Thus, no guarantee exists that the appraiser’s value in fact reflects actual value.\textsuperscript{50}

The unique characteristics of a close corporation also present appraisal valuation problems. The underlying value of a close corporation is often based upon certain individuals, products or methods of operation that may prove difficult to value, even by an experienced appraiser. The employment of an appraiser is also often prohibitively expensive for a close corporation, particularly if the valuation involves only a small percentage of the corporation’s shares.\textsuperscript{51}

\textit{Capitalized Earnings}

Another common valuation approach, the capitalization of earnings method, requires neither periodic shareholder meetings nor expensive opinions from appraisers. The value of the corporation is determined by projecting future earnings, using past corporate performance as a guide. A dollar value is determined by multiplying the average earnings of selected past years by an assigned factor.\textsuperscript{52} The resulting sum is intended to approximate the earnings which can be expected in the immediate future. This amount is viewed as equivalent to the corporation’s value, that is, the amount

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\item \textsuperscript{48} The appraised valuation may in turn create additional friction among shareholders rather than providing a solution to the valuation problem. Milston & Cohn, \textit{supra} note 38, at 42.
\item \textsuperscript{49} An appraiser must often determine the actual significance of various valuation factors. An appraiser must also estimate the market price of assets, based upon their value in light of the particular industry involved and given industry trends as interpreted by the appraiser.
\item \textsuperscript{50} In \textit{Std. Int’l Corp. v. McDonald Printing Co.}, 159 N.E.2d 822 (Ct. C.P. Ohio 1959) the board of directors sold stock at $37.50 per share appraised value even though another offer to purchase the shares at $40 per share was made by a willing buyer. The court allowed the sale at the appraised value despite the offer of a higher price.
\item \textsuperscript{51} Page, \textit{supra} note 5, at 659, 674; Note, \textit{Appraisal Statutes, supra} note 20, at 1471.
\item \textsuperscript{52} The multiplication factor reflects the number of years after which time the anticipated future earnings are expected to provide a return of the purchase price of the corporation, given an assumed investment risk. As an illustration, if the risk of the investment in the corporation requires a 20% return on investment, then the multiplication factor would be 5 (100% ÷ 20% = 5). The capitalized earnings value of the corporation would thus be the anticipated future earnings, of for example $500,000 per year, multiplied by the factor of 5, or a $2,500,000 capitalized earnings value of the corporation. The assumed 20% return of investment on the $2,500,000 capitalized earnings value of the corporation would provide the anticipated $500,000 earnings ($2,500,000 × 20% = $500,000).
\end{itemize}
a willing buyer will pay in return for anticipated future earnings.

The major criticism of the capitalization of earnings method is that it is based upon the assumption that the corporation's past performance is indicative of future corporate earnings. For a close corporation this may be an invalid assumption. A close corporation's employee-shareholders, for example, may allow themselves lucrative compensation. The corporation's past salary expenses may thus be excessive, understating actual past earnings. Similarly, a key employee-shareholder may have contributed significantly to the past success of the close corporation. The past earnings may not be indicative of the corporation's future performance following the sale of stock by, or death of, that employee-shareholder.

Another disadvantage of the capitalization of earnings method lies in the subjective process of selecting the factor to be used for multiplying average past earnings. The selection of this factor may in itself lead to disputes and litigation. Other subjective decisions are also involved, such as a decision to delete the past earnings of certain years not considered representative of the corporation's past performance.

**Formula Method**

A combination of various valuation methods can also be used to determine value. Under this approach three factors defining corporate value, the market value, investment (or earnings) value, and net asset value, are often combined. The factors are determined

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53. See generally O'Neil, supra note 1, at § 7.24d.
54. It is generally more advantageous to an employee-shareholder to have earnings of the corporation distributed in the form of salary rather than as a corporate dividend. For example, pension benefits may be based upon wage amounts. Similarly, salary is a tax deductible expense of the corporation. Dividends are not. There are, however, limitations on the corporate earnings that can be paid as salary. E.g., Charles Schneider & Co., Inc. v. Commissioner, 500 F.2d 148 (8th Cir. 1974).
55. "Any [factor]... selected by the draftsman, though based on sound judgment and authority, will be no more than an intelligent guess." Page, supra note 5, at 670.
56. Besides the formula method described, other combinations of valuation methods can be used. For example, in Krebs v. McDonald, 266 S.W.2d 87 (Ct. App. Ky. 1953), the shareholders' assigned value, as agreed upon at periodic shareholder meetings, was applied. The shareholders were also required to use the book value method as a guide for determining value.

In addition, one valuation method may be designated as the primary method, with a second method designated as a substitute if the primary valuation cannot be made or is in dispute. The shareholders' assigned value method, for example, may be used while providing for the "use of arbitration in the event of a dispute..." Matsen, supra note 34, at 135.
separately and then combined pursuant to a formula. Each factor receives a weighted percentage; the total of the three assigned percentages equals 100 per cent.  

This approach is commonly adopted by courts determining the value of minority interests following a dispute among corporate shareholders. A court-appointed appraiser frequently determines the value of the three factors and assigns the weighted percentages. The resulting valuation, supported by the formula computation, is then submitted for court approval.

Although this approach has the appearance of certainty, two significant disadvantages exist. First, the assignment of the percentages to the various factors requires a subjective judgment. No rigid standards apply. Instead, courts have ruled that the percentages assigned to each factor should be based upon the ability of each factor to reflect actual value, demonstrating the factor's reliability, under the particular circumstances involved.

Second, this method requires a determination of the value of each of the three factors used in the formula. This in turn requires the employment of other valuation methods to determine value for each of the three factors. The result is that the disadvantages inherent in these other valuation methods now exist in the formula method.

The disadvantages of the formula method are particularly apparent when a close corporation is involved. This is due, in part, to the general inapplicability to a close corporation of the three valuation factors. For example, close corporations are without available

57. See, e.g., In re Valuation of Common Stock of Libby, 406 A.2d 54, 69 (Me. 1979). The court there approved a formula which assigned 40% to the market value, 40% to the investment value and 20% to the net asset value, totalling 100%. In Delaware, the percentages assigned to each factor must actually be stated. See Note, Appraisal Statutes, supra note 20, at 1469.


59. E.g., Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980).

60. “The elements of value must be weighed in different proportions, depending on the nature of the particular firm, the industry in which it operates, general economic conditions, and other similar variables.” Note, Appraisal Statutes, supra note 20, at 1457.

61. The determination is “more akin to an artistic composition than to a scientific process,” with reliability of a particular approach serving as the primary factor. In re Valuation of Common Stock of Libby, 406 A.2d 54, 60 (Me. 1979). See also Bell v. Kirby Lumber Corp., 413 A.2d 137, 143 (Del. 1980).

62. For example, the appraisal method is commonly used to determine net asset value. See note 69 infra. As a result, the disadvantages inherent in the appraisal method (see notes 48-51 supra and accompanying text) would also exist in the formula method.
markets for the exchange of their stock. It is therefore difficult to determine the market value factor. Likewise, the unique characteristics of a close corporation may prevent a valid forecast of future earnings. This would therefore diminish the reliability of the investment (or earnings) value. As a result, the remaining approach, net asset value, would be heavily weighted.

The net asset value is based upon a hypothetical value being assigned to each of a corporation’s assets as though the corporation was being liquidated. The methods for determining this net asset value are many, with an appraisal of the assets being the most common. The book value method is also used in determining the net asset value.

**Book Value**

The most common method of valuation is the book value method; its widespread use is most often attributed to its simplicity. A close corporation’s value is determined under this method by reference to the value of the corporation as reflected in its accounting books and records. The books and records are es-

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63. See notes 3 and 4 supra and accompanying text.
64. “Where market value is not reliable, a reconstructed market value must be considered if one can be formulated.” In re Creole Petroleum Corp., 3 Del. J. Corp. L. 606, 611 (Del. Ch. 1978).
65. See note 4 supra.
67. Although all three factors should be considered and assigned a weight, in an unusual situation courts may rely more heavily upon one factor at the expense of the others. E.g., In re Creole Petroleum Corp., 3 Del. J. Corp. L. 606 (Del. Ch. 1978). The court there assigned a 100% weight to net asset value. The corporation being valued was an oil refiner doing business in Venezuela. The unusual circumstances surrounding the valuation was due to the nationalization of the assets of the corporation by the government of Venezuela.
69. See Note, Appraisal Statutes, supra note 20, at 1470-71.
70. O’NEIL, supra note 1, at § 7.24a. The book value method is commonly used both in shareholder agreements and in estate valuations. A study of 19 factors used in a multiple regression model concluded that book value was the “most significant variable” in the valuation of closely held stock in 67 selected Tax Court decisions. Englebrecht, supra note 4, at 279.
71. The book value method is “most applicable” to corporations whose underlying value is primarily located in its fixed assets rather than to corporations whose value is deprived primarily from the performance of services. Milston & Cohn, supra note 38, at 42. Courts and the Internal Revenue Service have generally recognized this distinction and have similarly applied the book value method. Silton, supra note 4, at 83.
72. “[W]hat is meant is a value disclosed by a statement that reveals the money measure of assets and liabilities as they are shown on the books of the company.” Corbett v. McClintic-Marshall Corp., 17 Del. Ch. 165, 169, 151 A. 218, 222 (1930).
tablished and maintained in accordance with generally accepted accounting principles. These principles require that the assets of the corporation be recorded on the books at the purchase cost of each of the individual assets. These historical costs are then depreciated over the estimated lives of the assets, thereby reflecting a theoretical decline in the assets’ values over their lives. The resulting book value as of a particular date should thus provide the value of the corporation on that date. The valuation of a single share of stock can be determined by dividing the number of outstanding shares into the book value.

The apparent simplicity of the book value calculation makes it attractive to persons selecting a valuation method. This simplicity allows the parties to understand readily the process of computing book value. Shareholders are also able to quickly and inexpensively calculate the value of their own stock.

Objectivity is another attractive feature of this method. The books of a corporation are frequently maintained in accordance with generally accepted accounting principles, an objective set of rules and principles used in general practice or specifically promulgated by the accounting profession. As a result of these principles, few subjective factors enter the book value process. The objectivity inherent in the accounting principles allows the underlying books and records of the corporation to be subjected to independent verification. The credibility of the book value process can thus be assured through an audit of the corporation’s financial

73. In Aron v. Gillman, 309 N.Y. 157, 128 N.E.2d 284 (1955), the court reviewed a shareholder agreement which provided for the corporation’s shares to be valued at the book value. The court noted the requisites of the book value method as indicated by “the better reasoned authorities: (1) the book value must be correct and complete, and not made to defeat an outstanding claim, and (2) accepted accounting principles should not be entirely disregarded,..." Id. at 160, 128 N.E.2d at 286.

74. It is often noted that the purpose of depreciation is not actually to reflect a gradual decline in asset values. Rather, the purpose is to periodically distribute the cost of the assets as an expense against the earnings of the corporation. Consequently, the net asset figures on the books would not necessarily reflect value. Hackney, supra note 6, at 805.

75. This information would be frequently useful to a shareholder even if the shareholder is not contemplating the sale of stock. For example, the value of stock holdings would be of importance for such purposes as retirement planning, adequacy of insurance reviews, and estate and gift tax planning.

76. Subjective determinations nonetheless do exist in the book value process. For example, many different approved depreciation methods can be used for determining the depreciation of an asset. The selection of a particular method requires a judgment by management. The application of the selected depreciation method will determine the adjusted basis of the corporation’s assets. See generally DeCapriles, Modern Financial Accounting, 37 N.Y.U. L. Rev. 1001 (1962) [hereinafter cited as DeCapriles].
statements by independent certified public accountants.\textsuperscript{77}

The many advantages of the book value method, however, pale in light of the major disadvantage of this method: the inability of book value to reflect the fair market value of the assets of a corporation.\textsuperscript{78} This is particularly true during periods of inflation.\textsuperscript{79} During inflationary periods the dollar amounts representing historical costs no longer accurately portray the current value of an asset. Gross disparities may therefore exist between the actual value of a corporation and the determined book value. This disparity is the crux of the valuation problem.\textsuperscript{80}

The problems of book value create frequent disputes and litigation when the book value method is applied in the various situations previously discussed. Shareholder agreements, for example, frequently provide for an assessment of the corporation at its book value. Courts confronted with the disparity between book value and actual value have responded in various ways.\textsuperscript{81} Some courts have strictly construed book value even where the book value significantly differed from actual value.\textsuperscript{82} Such courts, rejecting equitable considerations, strictly enforced the intentions of the parties

\textsuperscript{77} The very purpose of an audit is to verify and reconcile the book entries of a business according to proper accounting practice, and to see that they are accurate.” Aron v. Gillman, 309 N.Y. 157, 161, 128 N.E.2d 248, 287 (1955).

\textsuperscript{78} The fact that book value fails to reflect actual value is universally recognized. See Fabacher v. United States, 17 AFTR2d ¶ 401,403 (S.D. Miss. 1965); Corbett v. McClintic-Marshall Corp., 17 Del. Ch. 165, 169, 151 A. 218, 222 (1930); In re Valuation of Common Stock of Libby, 406 A.2d 54, 67 (Me. 1980); Homer v. Crown Cork & Seal Co. of Balt., 155 Md. 66, 82, 141 A. 425, 432-33 (1928) (“[A]lthough a balance sheet is worked out to the last penny and has the form and the appearance of impregnable accuracy, it may actually be far from a true presentation of the actual financial condition.”); O’Neil, supra note 1, at § 7.24a; Banks, The Accounting Balance Sheet as a Guide to Stock Value, 1978 DET. C.L. REV. 241, 257; Page, supra note 5, at 666; Schreier & Joy, supra note 6, at 861; Silton, supra note 4, at 85; Note, Appraisal Statutes, supra note 20, at 1457.


\textsuperscript{80} “There would be no valuation ‘problem,’ of course, if balance sheets reported market values. But, except in special cases . . . , they do not.” Schreier & Joy, supra note 6, at 858.

\textsuperscript{81} The frequent suits and divergent judicial approaches have diminished the advantages of predictability and simplicity of the book value method.

\textsuperscript{82} See Ginter v. Palmer & Co., 39 Colo. App. 221, 223, 566 P.2d 1358, 1359 (1977), rev’d on other grounds, ___ Colo. ___, 585 P.2d 583 (1978) (enforcement of book value at $1.91 per share even though the value claimed to be greater than $20 per share); Jones v. Harris, 63 Wash. 2d 559, 388 P.2d 539 (1964) (book value calculation, as required in the shareholder agreement, of $37,000 was enforced rather than $92,000 market value determined by a lower court).
as expressed in the selection of a valuation method.\textsuperscript{83} Although book value does not necessarily fairly reflect actual value, courts have held that the shareholders nonetheless considered book value to be fair and reasonable.\textsuperscript{84} Absent fraud in the determination of the value, courts have held that the expressed intent of the shareholders should be enforced.\textsuperscript{85}

Other courts, similarly enforcing shareholder agreements have assumed that the shareholders knew at the time of the agreement's execution that the book value would not necessarily equal actual value.\textsuperscript{86} The shareholders, in fact, may have intended for the book value method (with its frequent low valuation) to serve as a restriction on the transferability of stock.\textsuperscript{87} The intended book value determinations have thus been enforced, the disparity between book value and actual value notwithstanding.

Some decisions have held that the term "book value" is a question of law and therefore subject to judicial interpretation.\textsuperscript{88} This has provided courts with the opportunity to define "book value" in a manner more closely resembling actual value. Accordingly, several courts have ruled that the market value of the corporation should be considered in determining the "true book value" of the stock of the corporation.\textsuperscript{89} The term "book value", in its "narrow

\textsuperscript{83} The contract cannot be said to have been unfair or inequitable \textit{when it was made}, and now is too clear to admit of interpretation to include and emphasize equities, nonexistent at the inception of the contract, but which have evolved and now seem persuasive. Many close corporations have similar buy-out provisions, and the courts would do a disservice to business practice by substituting an "appraisal" or "market value" formula when hindsight shows the "book value," as originally conceived, has become unrealistic with the passing of time. Jones v. Harris, 63 Wash. 2d 559, 562, 388 P.2d 539, 541-42 (1964). Accord, Ginter v. Palmer & Co., 39 Colo. App. 221, 223, 566 P.2d 1358, 1360 (1977), \textit{rev'd on other grounds}, --- Colo. ---, 585 P.2d 583 (1978), \textit{Contra}, Aron v. Gillman, 309 N.Y. 157, 167, 128 N.E.2d 284, 290 (1955) (Desmond, J., dissenting) ("It is entirely beside the point that the use of such figures turned out to be 'unfair' to one or the other. As our courts have long ago noted, a sale at book value is always 'unfair' . . .[citations omitted].")


\textsuperscript{85} \textit{Id}.

\textsuperscript{86} This is particularly true if the shareholders were also officers of the corporation, familiar with the actual and book values of the business. Fabacher v. United States, 17 AFTR 2d 1 401,403 (S.D. Miss 1965); Succession of Warren, 126 La. 649, 655, 110 So. 891, 893 (1926); Jones v. Harris, 63 Wash. 2d 559, 562, 388 P.2d 539, 541 (1964).

\textsuperscript{87} Krebs v. McDonald, 266 S.W.2d 87, 89 (Ct. App. Ky. 1953).

\textsuperscript{88} \textit{E.g.} Area Inc. v. Stetenfeld, 541 P.2d 755, 762 (Alaska 1975).

\textsuperscript{89} Steeg v. Leopold Weil Bldg. & Improvements Co., 126 La. 101, 111, 52 So. 232, 235 (1910) ("by 'book value' we understand, not any arbitrary or fictitious value that may be entered on the books of the company, but the value as predicated upon the market value of
technical sense" has been disregarded, replaced in some cases with an approach which considers all of the circumstances concerning value. Technical variations to the book value approach have also been approved, even though the result differed from a strict "book value" calculation.

The great disparity between actual value and book value has also led to a judicial refusal to enforce the book value. Instead, equitable concepts of fairness and reasonableness have been employed in an attempt to prevent the enforcement of a book value which failed to reflect actual value.

Despite the disadvantage of the book value method in frequently failing to reflect actual value, it nonetheless is a commonly used valuation approach. Its simplicity, for example, makes it an attractive valuation method to use in buy-sell agreements. The book value method is also used occasionally as a method for determining the value of shares held by distributing minority shareholders.

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the assets of the company, after deducting its liabilities.


91. For example, the North Carolina Supreme Court ruled in Gurley v. Woodbury, 177 N.C. 70, 76, 97 S.E. 754, 756 (1919) that a more liberal definition of book value was necessary and that "the book value was to be ascertained from the books and records, and not from the books alone." The books presented a value of $125 per share, whereas supporting records indicated that the corporation was worthless.


93. Aron v. Gillman, 309 N.Y. 157, 163, 128 N.E.2d 284, 288 (1955). The court refused to enforce a book value price because it was considered "manifestly unreasonable from both a practical and theoretical point of view."

94. E.g., S.C. Pohlman Co. v. Esterling, 211 Cal. App. 2d 466, 27 Cal. Rptr. 450 (1962); Hollister v. Fielder, 22 N.J. Super. 439, 92 A.2d 52, 47 (1952). In addition, the parties are likely to place confidence in the derived values since they are based upon the corporation's own records.

95. The net asset value, one of the three factors typically used in the valuation of these shares, can be derived from the book value of a corporation. See notes 67-69 supra and accompanying text. Although the book value is generally disfavored as a method of determining net asset value due to its inability to reflect actual value (e.g., Levin v. Midland-Ross Corp., 41 Del. Ch. 276, 283, 194 A.2d 50, 54 (1963); Ahlenius v. Bunn & Humphreys, 358 Ill. 155, 169, 192 N.E. 824, 830 (1930) (use of book value for determining value of minority shares generally considered "unsound."); courts have allowed the use of book value if it is reliable under the particular facts. Stewart v. D.J. Stewart & Co., 37 Ill. App. 848, 855, 346 N.E.2d 475, 480-81 (1976). Similarly, if no other reliable factor exists, then book value will
And the role of book value in estate tax valuations is indeed significant. The author of a study of estate valuations reached the "astounding" conclusion that the book value was the "most significant variable" affecting the tax valuation.

INFLATION ACCOUNTING: AN ANALYSIS OF A NEW TOOL FOR REFLECTING VALUE

The inability of the book value method to reflect actual value undermines that method's usefulness as a means of valuing a close corporation. Yet the simplicity and other advantages of the book value method make it the most prevalent means of valuation. What is needed, therefore, is a valuation method which possesses the advantages of the book value method and yet also produces a valuation more closely approximating actual value.

New accounting methods, designed to reduce value distortion caused by inflation, may aid in solving this problem. These new methods offer a novel means of presenting the financial position of a corporation which more closely reflects actual value. Accordingly, financial information prepared under these new inflation accounting techniques may become a useful tool in future valuations of

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96. It is, for example, among the valuation factors suggested by the Internal Revenue Service. 1959 Revenue Ruling, supra note 31, § 4(c). See note 33 supra. The valuation is often determined by using book value as an important, but not exclusive, factor. E.g., Diefenthal v. United States, 343 F. Supp. 1208 (E.D. La. 1972).

Although courts have criticized the book value method (e.g., Fabacher v. United States, 17 AFTR2d ¶ 401,403 (S.D. Miss. 1965); Righter v. United States, 439 F.2d 1204,1210 (Ct. Cl. 1971)), it has also been recognized as having a pervasive effect upon estate tax valuations of close corporations. Englebrecht, supra note 4.

Book value has also been recognized as a preferred method of valuation by various courts. E.g., Estate of Davis, 37 T.C.M. (CCH) 1978-69 at ¶ 78-347. The particular factual situation is often the determinative factor in the judicial decision. Diefenthal v. United States, 343 F. Supp. 1208, 1210 (E.D. La. 1972).

97. Englebrecht, supra note 4, at 280. The study was performed by using 19 selected valuation factors in a multiple regression model. The significance of each of these factors was compared to the Tax Court's determination of value. Sixty-seven Tax Court valuation decisions rendered from 1950 through 1974 were analyzed. The study concluded that book value was the most significant factor:

Relative to the other beta coefficients in the model, it was the most important in explaining the variation assigned to closely held stock. Furthermore, the net regression coefficient for book value indicated a change of .9506 in the price of closely held stock which would be associated with a one unit change in book value. Id. at 279 n.12. The author noted the ability to verify the book value, as well as its objectivity, as likely factors contributing to its widespread use. Id. at 280.

98. See note 70 supra.
close corporations.\textsuperscript{99}

The failure of the book value, and its underlying accounting records, to reflect actual value is due in large part to the rampant inflation occurring after World War II.\textsuperscript{100} As a result, the usefulness of the book value method as a reliable financial tool for valuing a corporation has declined.\textsuperscript{101} Instead of presenting a summary of a corporation’s current financial value, the financial statements now serve merely as accumulators of the historical costs of a corporation’s assets, ignoring the changes in market or replacement values of depreciable assets.\textsuperscript{102}

The effects of inflation and its resulting distortion of financial statements cause concern in many foreign countries. Many of these countries have responded to the problems of inflation by developing new accounting systems.\textsuperscript{103} The United Kingdom, for example, has adopted a current cost accounting approach which allows for a restatement of the accounting books in order to reflect inflationary changes in the British monetary unit.\textsuperscript{104} Similar approaches have been employed in other countries.\textsuperscript{105}

Although inflation in the United States has not been as severe as that in many foreign countries, the inflation rates of the 1970’s produced concern. The initial American response came from the Securities and Exchange Commission (SEC), which was concerned with the inflationary distortion of the financial statements being

\textsuperscript{99} These techniques may become increasingly important to attorneys and courts in their attempts to solve the problem of valuing a close corporation. “[L]awyers must be diligent to examine, analyze, publicly criticize, and otherwise contribute...” to the development and use of accounting principles. Hackney, supra note 6, at 823.

\textsuperscript{100} See Block, supra note 79, at 29.

\textsuperscript{101} “It is not surprising that book value gathers dust on the back row of the analyst’s set of tools, to be used only in cases of utter desperation.” Id.

\textsuperscript{102} Hackney, supra note 6, at 803-4. See this article generally for a thorough discussion of modern accounting principles and their emphasis on income recognition and not necessarily on valuation. The result is the “distortion of the balance sheet.” Id. at 805. See also DeCapriles, supra note 76.

\textsuperscript{103} Many countries have likewise adjusted their income tax schedules to reflect changes in a consumer price index. Rosenn, Adjusting Taxation of Business Income for Inflation: Lessons from Brazil and Chile, 13 Tex. Int’l L.J. 165, 189 n. 86 (1978).

\textsuperscript{104} See Bowie, Legal Implications of the Introduction of Current Cost Accounting, 127 New L.J. 95 (1977) [hereinafter cited as Bowie]. This article contains an excellent discussion of the British approach and its possible legal ramifications. The author suggests that the new inflation information may in the future be used in determining the “true and fair view” of a company’s financial position, as required by the British Company Act, 1948, § 149(1).

\textsuperscript{105} See generally Bowie, supra note 103.
disclosed to the investing public. Pursuant to its rule making powers, the SEC issued regulations which required the disclosure to investors of supplemental information describing the impact of inflation on the corporation. This additional information was designed to adjust the historical cost of a corporation's assets for inflation and to provide financial information which more reasonably approximated current economic value. A "constant dollar" formula was to be employed, revaluing assets in accordance with changes in the consumer price index. The SEC regulations also required a restatement of the assets of a corporation to reflect their replacement costs.

The distortions of value resulting from inflation also came to the attention of the Financial Accounting Standards Board (FASB), the rule promulgating body of the American accounting profession. The FASB responded in 1979 by issuing Financial Accounting Standard Number 33. This release requires corporations of a specified size to disclose supplemental information reflecting the effects of inflation.

The FASB suggests two methods of valuation for inflation accounting: the constant dollar method and the current cost approach. Specifically, the constant dollar method revalues assets in accordance with general inflation, as reflected in changes to the

107. 17 C.F.R. § 210.4-08 (1980). The requirements were imposed only on large corporations - generally, corporations with consolidated balance sheets of at least $100 million.
108. "These proposals were designed to enable investors to obtain more relevant information about the current economics of a business enterprise in an inflationary economy than that provided solely by financial statements prepared on the basis of historical cost." SEC Acctg. Ser. Release No. 190 (March 23, 1976), Fed. Sec. L. Rep. (CCH) ¶ 72,212 at 62,504.
110. Id.
111. FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 33, FINANCIAL REPORTING AND CHANGING PRICES (1979) [hereinafter cited as FAS No. 33]. The FASB considered this statement to be among its most important projects ever undertaken. Kretchman, Giroux & Grossman, Accounting for the Impact of Inflation: The Experience of the Oil Companies, 29 OIL & GAS TAX Q. 331,332 (1980). The SEC was well satisfied with the results of the FASB project and withdrew its own guidelines. "FAS 33 has the effect of law as evidenced by the Commission's withdrawal of its replacement cost rule in deference to FAS 33." SEC Letter, Firestone Tire & Rubber Co. (Dec. 12, 1979).
112. Generally, the requirements apply to enterprises with inventory and other fixed assets of at least $125 million. FAS No. 33, supra note 111 at ¶ 23. Although only large corporations are currently affected, it is anticipated that the use of this information will become more widespread. See notes 119-21 infra and accompanying text.
Consumer Price Index.\textsuperscript{113} The second method, "generally preferred" by the users of financial information,\textsuperscript{114} presents financial information reflecting the current cost of replacing an asset of similar productive capacity.\textsuperscript{115} This method, in effect, represents an approximation of the current value of the particular assets of a corporation.

Although inflation accounting\textsuperscript{116} is still in its developmental stages,\textsuperscript{117} it has already received general acceptance as a viable means of combatting the problem of value distortion.\textsuperscript{118} Accordingly, the advantage of FAS No. 33, basing value upon current costs rather than historical costs, is likely to result in increased usage of these new techniques.\textsuperscript{119} Inflation accounting may some-

\textsuperscript{113} This method has been criticized for failing to reflect the changes in value of a particular corporation. See note 137 infra. Instead, only general inflationary changes to the entire economy, as reflected in changes to the Consumer Price Index, are considered. Accordingly, this constant dollar method would be of little use for determining the particular fluctuations in value of a particular corporation. The second method, however, the current cost approach, does reflect these individual changes in value and would thus provide a greater means for solving the valuation problems of a close corporation. See Norby, \textit{A Conceptual Framework for Inflation Accounting}, 35:6 Fin. Analysts J. 16, 16-17 (1979) for the advantages of the current cost approach.


\textsuperscript{115} The current cost of inventory . . . is the current cost of purchasing the goods concerned or the current cost of the resources required to produce the goods concerned . . .

The current cost of property, plant and equipment . . . is the current cost of acquiring the same service potential (indicated by operating costs and physical output capacity) as embodied by the asset owned; . . . reflect[ing] whatever method of acquisition would currently be appropriate in the circumstances of the enterprise.

FAS No. 33, supra note 111, at ¶ 57-58. It has been recognized that "current value accounting could naturally evolve out of the replacement cost method of inflation accounting." Norby, supra note 113, at 76. See Deloitte, Haskins \& Sells, Accounting Practices 1978 at 267 for examples of how corporations are presenting this information. See also Grossman, Kratchman \& Giroux, \textit{Inflation Accounting for the Small Company}, 150:5 J. Accy. 94 (1980) for an example of the application of these techniques to a close corporation's books.

\textsuperscript{116} The term "inflation accounting" describes both the constant dollar and the current cost methods. See FAS No. 33, supra note 111. However, because the current cost method is potentially a more valuable tool for valuation purposes, that method is the intended method being described in this article under the generic term "inflation accounting." See note 113 supra.


\textsuperscript{118} See Berliner \& Gerboth, \textit{FASB Statement No. 33 "The Great Experiment"}, 149:5 J. Accy. 48 (May, 1980).

\textsuperscript{119} For instance, these methods may be used in determining whether a corporation has sufficient capital to pay dividends. See Randall v. Bailey, 23 N.Y.S.2d 173, 182-83 (1940) (review made of cases from various states which have upheld corporate directors' payments
day replace the historical cost method as the primary financial statement of corporations. This development may lead to the use of inflation accounting in the books and records of close corporations.

The adoption by a close corporation of inflation accounting techniques provides a powerful tool for the valuation of a close corporation. Instead of basing value upon the most common valuation method, the traditional book value method, value is based upon an inflation adjusted book value. Rather than using historical cost accounting records, the inflation adjusted information serves as the basis for the valuation. At the very least, this approach more closely approximates actual value than the traditional historical cost book value method. Ideally, it provides a viable alternative to the perplexing problem of valuing a close corporation.

One example of the possible application of inflation accounting is in the valuation provision of a buy-sell agreement. The selection of the inflation adjusted book value as the valuation method of a buy-sell agreement provides the parties with a method more apt to reflect actual value than the traditional book value approach. Likewise, if the intentions of the parties is to provide for a valuation which reflects actual value, the selection of this inflation method reduces the likelihood of disputes and litigation over buy-sell agreement valuations.

of dividends based upon unrealized appreciation of assets.)


122. The FASB has expressly recommended experimentation with inflation accounting. FAS No. 33, supra note 111, at ¶¶ 13-14.

123. The court in Corbett v. McClintic-Marshall Corp., 17 Del. Ch. 165, 151 A. 218 (1930) discussed such a hypothetical alternative valuation based upon “another statement of assets and liabilities as shown by a revision of the books for the particular [valuation] purpose. . . .” Id. at 169, 151 A. at 222. The court, however, rejected this alternative basis as not being within the provisions of the corporation’s charter.


125. The widespread adoption of these new techniques, with the possible “replacement” of historical based accounting, may also affect the provisions in existing buy-sell agreements. Many of these existing agreements provide for the valuation to be based upon the corporation’s books as kept in accordance with generally accepted accounting principles. Generally accepted accounting principles are not absolute; they are, rather, the procedures adopted and generally accepted by the accounting profession. The experimental use of inflation accounting techniques has already been adopted and with widespread acceptance these techniques may in turn become generally accepted accounting principles. They may thus serve as the basis for valuations under those existing buy-sell agreements which require the appli-
The inflation accounting techniques may also serve as a reliable and therefore useful aid in the valuation of stock of minority shareholders involved in corporate ownership squeeze-outs. Specifically, these techniques could be used to determine the net asset value, one of the three valuation factors used in determining the value of minority shares. Courts valuing minority shares have generally expressed preferences for asset valuations which reflect "reproduction cost rather than original cost." Inflation accounting techniques provide a means of basing values upon the replacement cost of a corporation's assets. These techniques, therefore, provide a more reliable approach toward the valuation of minority shareholder's stock.

The proposed valuation method will also aid in resolving valuation problems arising in the estate tax area. The valuation of a close corporation for estate taxes is ostensibly based upon a multitude of factors. The Tax Court, however, has historically shown a strong reliance upon the book value of a corporation in its determination of value. Thus, it is to be expected that information similarly derived, but more closely reflecting fair market value, would become a significant factor in the valuation of close corporations.

Treasury Department guidelines dictate that all relevant factors affecting fair market value, including all available financial data, should be considered in valuing a close corporation for estate tax purposes. Inflation adjusted values provide such additional re-
vant financial information. This information, moreover, evidences a good faith attempt at determining the elusive tax value of a close corporation.\footnote{133. The showing of good faith may be important to an estate's asserted valuation if an Internal Revenue Service challenge is made, particularly if the value is derived from a buy-sell agreement. \textit{E.g.}, Estate of Davis, 37 T.C.M. (CCH) 1978-69 at ¶ 78-347.}

Inflation accounting in the United States is still in an experimental stage. Accordingly, the SEC has cautioned against the simplistic use of this information.\footnote{134. This method would at least present a reasonable valuation. "In most cases, the need is not for a definitive answer. . . but for a value determination within a reasonable range." \textit{Silton, supra} note 4, at 82.} One court reviewing the use of inflation accounting rejected it as a means of valuing the shares of dissenting shareholders.\footnote{135. SEC Acctg. Ser. Release No. 190 (March 23, 1976), \textit{Fed. Sec. L. Rep.} (CCH) ¶ 72,212 at 62,507-08. \textit{In accord Bowie, supra} note 104, at 97 ("valuation [even under current cost accounting] is inherently an uncertain science.").} Inflation accounting valuation was rejected, in part, because of a lack of judicial precedent for this approach to valuation.\footnote{136. \textit{In re Valuation of Common Stock of Libby}, 406 A.2d 54 (Me. 1979).} As increased experimentation occurs, how-

The showing of good faith may be important to an estate's asserted valuation if an Internal Revenue Service challenge is made, particularly if the value is derived from a buy-sell agreement. \textit{E.g.}, Estate of Davis, 37 T.C.M. (CCH) 1978-69 at ¶ 78-347.

This method would at least present a reasonable valuation. "In most cases, the need is not for a definitive answer. . . but for a value determination within a reasonable range." \textit{Silton, supra} note 4, at 82.


The particular nature of a corporation may also affect the possible application of these techniques. For example, a service corporation's value may lie in the expertise of its personnel, and not in its assets. These techniques would therefore have little applicability to those corporations. See Rustigan, Lentz & Olsen, \textit{Problems in Valuing Stock of a Close Corporation: A Panel Discussion}, 23 N.Y.U. Inst. Fed. Tax. 1261 (1965). See note 4 supra.

\textit{In re Valuation of Common Stock of Libby}, 406 A.2d 54 (Me. 1979).

The Maine court based its rejection of inflation accounting on three grounds. The first was the lack of judicial precedent. Anticipated widespread experimentation and usage, of course, may negate this basis for rejecting inflation accounting as a valid valuation tool.

Secondly, the court noted that a "generally accepted treatise on accounting practices specifically cautions against the use of such techniques for appraisal purposes. Deloitte, Haskins & Sells, \textit{Accounting Practice} 876 (1978)." The court appears to have been misguided. The cited publication is a treatise providing \textit{examples} of how various accounting topics are disclosed by various large institutions. In fact, the cited reference is to a sample footnote to the financial statement of a large oil company, a company not even involved in the \textit{Libby} litigation. The preface to the treatise notes that the examples presented are for illustrative purposes and do not "necessarily represent authoritative support. . . ." \textit{DELOITTE, HASKINS & SELLS, supra} note 115, at iii. Reference is instead directed to FASB pronouncements.

The third basis for the court's rejection is, however, supported by various authorities. "There is no reason in logic to support the contention that the particular mix of property owned by Libby appreciated or depreciated in step with changes in general average price levels." \textit{In re Valuation of Common Stock of Libby}, 406 A.2d 54, 69 (Me. 1979).

The inflation accounting rules, FAS No. 33, \textit{supra} note 111, presents two different approaches. The constant dollar approach, involved in this case, is based upon a restatement of historical cost in accordance with changes in the general price index. The use of this method as a valuation tool has been rejected for the reasons stated by the court. \textit{See Norby, supra} note 113, at 16-17.

The other inflation accounting technique, the current cost approach, has received greater support and has been recognized as a potentially useful aid to financial analysts. \textit{Id.} at 16-17.
ever, courts will become more familiar with this approach and its attributes. Also, increased experimentation may perfect this method’s ability to narrow the gap presently existing between historical cost book value and actual current value.138

The most common valuation approach, the historical cost book value method, provides many advantages to its users, particularly close corporations.139 These advantages are likely to be preserved in a valuation based upon the inflation adjusted book value method. General acceptance and increased usage of inflation accounting will encourage close corporations to maintain accounting records in accordance with these techniques.140 Once this occurs, an inflation adjusted book value can be easily determined. The simplicity of this method thus provides a close corporation with a relatively inexpensive method for determining the value of its stock. This method, however, may be economically practical only for those corporations which have already adopted inflation accounting as a management aid for other accounting or business decisions.141

Furthermore, an inflation adjusted book value is based on rules and principles promulgated by the accounting profession. Adherence to these rules and principles in the calculation of an adjusted book value will provide its users with the desired element of objectivity. Periodic audits will verify that these principles are properly followed.142 This ability to verify the accuracy of the valuation pro-

and 76. Rather than adjusting the value of assets for the general effects of inflation, the current cost approach revalues individual groups of assets, taking into account the particular circumstances pertinent to a particular corporation. See note 115 supra. In this manner, adjustments are made for the effects of inflation on particular assets of a particular corporation. It is this approach that may serve as an effective means of valuing corporations in the future. See generally note 113 supra.

138. SEC Acctg. Ser. Release No. 190 (March 23, 1976), Fed. Sec. L. Rep. (CCH) ¶ 72,212; Grossman, Kratchman & Giroux, supra note 115, at 100 (these techniques can provide a close corporation with a “good approximation of how the operations of the company look after inflation is taken into account.”)

139. See notes 75-77 supra and accompanying text.

140. Close corporations are generally not required to prepare and issue financial statements. See note 3 supra. The maintenance of books and records in accordance with inflation techniques may nonetheless provide useful internal information to a close corporation’s management. See Grossman, Kratchman & Giroux, supra note 115, at 100.

141. For a small close corporation that has not otherwise maintained inflation accounting data, the cost may be prohibitive to prepare separate records in accordance with these techniques. Valuations based upon such inflation data would thus be economically impractical for those corporations.

142. New auditing procedures have already been developed for use with inflation accounting information. Berliner & Gerboth, supra note 118, at 52, 54.
cess will further insure the reliability and integrity of the inflation adjusted book value.

**CONCLUSION**

A precise valuation of the stock of a close corporation is impossible due to the absence of a public market for the exchange of shares. Consequently, various formulas and methods must be employed in an attempt to approximate value. In this presently imperfect state of valuation, consideration should be given to valuation methods which more closely reflect current values.

The valuation of a close corporation is required in many situations. In each of these situations the inflation adjusted method should be considered. This method may better serve the needs of shareholders and may provide a more effective solution to shareholder disputes concerning the valuation of a close corporation. Its potential application will increase as this method is perfected and its use becomes more widespread.

The accounting profession recommends increased experimentation with inflation adjusted information. The multiple problems inherent in the valuation of close corporations require that the legal profession similarly experiment with and begin to utilize inflation adjusted information for solving the valuation quandary.

JAMES E. CUSHING, JR.