Case Western Reserve Law Review

Volume 14 | Issue 2

1963

Valuation of Securities Generally

John H. Butala Jr.

Recommended Citation

John H. Butala Jr., *Valuation of Securities Generally*, 14 W. Res. L. Rev. 179 (1963)

Available at: https://scholarlycommons.law.case.edu/caselrev/vol14/iss2/7

on an assumed market is totally disregarded.[37] The market price of notes, like the above-mentioned insurance policies, apparently is not considered a fair representation of value since the holder may wish to retain them until maturity, rather than sell them. Consequently, the rule applied is that the value of a note is *presumed* to be the unpaid principal amount, plus interest.[38] This is apparently deemed to be its intrinsic worth, at least where the note is likely to be paid in full at maturity.

From the above examples, one is led to the conclusion that the element of fairness is of far more significance where a "market," in the popular sense of the word, is limited or non-existent; that is, where the putative or assumed market is based on limited sales and a restricted number of willing and knowledgeable buyers and sellers.

II

VALUATION OF SECURITIES GENERALLY

John H. Butala, Jr.

The valuation of securities, other than those of closely-held corporations, appears on the surface to be a rather simple process. Yet even this field is developing its own underbrush of technicalities and complexities, and a review of these may be rewarding and useful. The following discussion will be in the nature of a survey of the subject.

LISTED SECURITIES

The Estate Tax Regulations[1] and Gift Tax Regulations[2] set forth surprisingly precise rules for the valuation of listed securities. At a given valuation date, the value of a listed stock or bond is determined by the mean between the highest and lowest selling prices on that date. If no sales were made on the valuation date, reference may be made to sales within a reasonable period of time before and after the valuation date. The value is then determined by an inverse weighted average based upon the number of stock exchange trading days intervening between the sales and the valuation date.[3] If the valuation cannot be determined by reference to sales, it may be established by the mean between the bid and asked prices on the valuation date. This proceeds upon the same basis. Quotations are first considered as of the valuation date. In the absence

37. Reg. §§ 20.2031-4, 25.2512-4 (1958).
38. *Ibid.*

of these, quotations within a reasonable period of time before and after the valuation date may be used. If a valuation is not produced by these rules for want of available sales or quotations, resort may be made to a sale or quotation *either* before or after the valuation date.

OVER-THE-COUNTER SECURITIES

The valuation of over-the-counter stocks is determined by the Regulations[4] in essentially the same manner as that used in the valuation of listed stocks. Value is determined by the mean between high and low selling prices or between bid and asked prices, first on the valuation date and, secondly, within a reasonable period of time before and after that date. This identity of treatment is open to serious question. Unlike listed securities, sales of over-the-counter securities usually do not involve a broker's commission. A broker issues quotations consisting of a bid price (at which he will buy the security) and an asked price (at which he will sell the security), the latter being somewhat higher than the bid price. The spread between the bid and asked prices represents the broker's profit on the transaction and may be regarded as the equivalent of a commission on the sale of a listed security. It may be argued that, inasmuch as the seller of an over-the-counter security can never realize more than the bid price, the bid price should represent the fair market value of the stock. On the other hand, if the spread is the equivalent of a commission on the sale of a listed security, a valuation determined by the mean between the bid and asked price in effect permits a valuation reduction of one-half of a commission on over-the-counter stocks while denying any commission reduction in the case of listed securities.[5]

A bid and asked mean may be justified as a valuation measure on the ground that it represents an averaging device. Several brokers, all quoting slightly different bid and asked prices, may be in the market with respect to any given security, and use of the mean of the published bid and asked prices may be a reasonable method of averaging the various quotations available. However, even this tenuous theory becomes unsupportable when the valuation of open-end mutual funds is involved.[6]

1. Treas. Reg. § 20.2031-2 (1958) [hereinafter cited as Reg. §].

2. Reg. § 25.2512-2 (1958).

3. The following example is contained in the Regulations: A sale is made at $10 per share two days before the valuation date and another sale is made at $15 per share three days after the valuation date. The fair market value of the stock is $12 per share determined by the formula (3 x 10 plus 2 x 15) ÷ 5. Reg. §§ 20.031-2(b), 25.2512-2(b) (1958). Previous Regulations required a proration of the difference between sales prices before and after the valuation date upon the basis of actual days rather than stock exchange trading days intervening.

4. Reg. §§ 20.2031-2, 25.2512-2 (1958).

5. For a discussion of the estimated commission expense as a factor in determining fair market values, see at 183 *infra*.

6. For a discussion of the valuation of open-end mutual funds, see at 181 *infra*.

The prevailing practice of Internal Revenue Service personnel of employing newspaper quotations may create further distortions. Many of the published bid and asked quotations are weighted on the asked side. Such quotations are supplied by brokers who inflate the asked quotation to ensure that the following day's asked quotations to their customers are within the published range. In defense of this practice, it should be noted that such published quotations are invariably designated as being "approximate." In view of this practice, the valuation of a substantial number of over-the-counter shares, as a matter of precaution, should be based upon quotations checked directly with brokers, and preferably with several brokers at that.

Even the use of the mean between the highest and lowest selling prices on a valuation date may not yield an accurate valuation, at least in the precise terms outlined in the Regulations. Again, this situation results from the basic difference in trading practice between over-the-counter and listed securities. An over-the-counter securities broker may deal in either of two capacities: as an agent arranging a transaction between two individuals, or as a principal buying or selling for his own account. A purchase for a broker's inventory is equivalent to a bid price; a sale from his inventory is equivalent to an asked price. Accordingly, if the only sales on a valuation date are all either for a broker's inventory or from his inventory, a valuation based upon such sales may in effect be an average of bid prices or an average of asked prices rather than an average of the two. With appreciable amounts involved, careful practice requires not only the ascertainment of the existence of sales but also an investigation of the nature of such sales.

Open-end Mutual Funds

A peculiar problem is presented with respect to the valuation of open-end mutual fund shares. These shares are issued by regulated investment companies which stand ready to redeem or to sell their shares at any time at their approximate current net asset value. Thus, there is only one seller and only one buyer, the fund itself. Such funds issue bid and asked prices on a regular and frequent basis.

The Regulations thus far have provided no special rule with respect to the valuation of such shares. Presumably, the valuation is to be determined by the mean between the bid and asked price. However, it may be argued forcibly that the bid price should control in this case. A shareholder can never receive more than the bid price, and a mean price cannot be rationalized as an averaging of several quotations, inasmuch as there is only one buyer and seller. Nevertheless, a proposed Regulation recently has been issued which provides that "replacement cost"[7] is to be taken as the measure of fair market value.[8] This approach is consistent with the theory that estimated selling commissions are not deductible, but cannot be logically reconciled with the treatment of over-the-counter securities. In the over-the-counter market, where one has the privilege of shopping for various bid prices, fair market value is defined as the mean between bid and asked prices. When this shopping area contracts to only one buyer, with purchases always at the bid price, the Service proposes the asked price as the fair market value. There is perhaps more revenue than reason in the proposal.

EX-DIVIDEND ACCRETIONS TO VALUE

Recently the lives of executors have been further complicated by what may be termed the "ex-dividend accretion" theory. A corporation pays its dividend to those persons who are owners of its stock as of the record date. Stock brokers, on the other hand, have adopted trading rules under which owners of stock as of the ex-dividend date[9] are entitled to the dividend. If a decedent was alive on the record date, he clearly is the person entitled to the dividend and it is added to his estate as an accrual, being in effect an account receivable.[10] If the decedent was alive on the ex-dividend date but died before the record date, the Service agrees that no dividend accrual exists as such, but holds that the amount of the dividend should be added to the value of the stock.[11] This accretion to value is justified on the theory that, once the ex-dividend date passes, the selling price of the stock reduces by the amount of the dividend. Since the dividend is not added to the estate as an accrual, it must be restored as an accretion to value.[12]

It should be noted that such accretions to value apply to the alternate valuation date, so that dividend accruals as of the date of death and ex-dividend accretions to value as of the alternate valuation date may exist in the same estate. It seems doubtful that the additional revenue generated is sufficient to justify the complications introduced.

---

7. "Replacement cost" is obviously the asked price, *i.e.,* the cost of purchasing a new share from the fund. Replacement cost is also used in determining the fair market value of insurance and annuity contracts. Reg. § 20.2031-8 (1958).

8. Proposed Reg. § 20.2031-2(k), 27 Fed. Reg. 5268 (1962).

9. The ex-dividend date is usually two or three days prior to the record date and has been established by exchanges and brokers to facilitate the clearing of customer transactions.

10. Inasmuch as this right to the dividend originated prior to death, it represents income in respect of a decedent and is entitled to the deduction provided by § 691 (c) of the Internal Revenue Code of 1954 [hereinafter cited as CODE §].

11. Reg. § 20.2031-2(j) (1958); Rev. Rul. 60-124, 1960-1 CUM. BULL. 368. This accretion to value becomes a part of the cost basis of the stock whereas an accrual does not.

12. This approach is suggested by a dictum in Estate of George McNaught Lockie, 21 T.C. 64 (1953), which is apparently the basis for the Service's position. *But see* Provident Trust Co. v. United States, 170 F. Supp. 74 (E.D. Pa. 1959).

ESTIMATED SELLING COMMISSIONS

The scant authority available indicates that, in determining the fair market value of listed securities, estimated selling commissions may not be used to reduce the value otherwise determined.[13] If such securities are sold to meet debts and expenses of the estate, however, the actual commissions incurred may be deducted as administration expenses.[14] However, the estimated costs of marketing stock by special arrangement may be allowed as a reduction of the value, as for example, in the "blockage" valuation of securities[15] and as a measure of the discount for lack of marketability in the valuation of closely-held stock.[16]

TREASURY BONDS REDEEMABLE AT PAR

A designated series of United States Treasury bonds may be redeemed at par upon the death of the owner by applying such bonds toward payment of the federal estate tax obligation. Two basic eligibility requirements are imposed: (1) the bonds must have been owned by the decedent at the time of his death; and (2) they must constitute a part of the decedent's probate estate or, if not, they must be held in such form as to be liable for all or a proportionate share of the tax liability.[17]

In *Banker's Trust Co. v. United States*[18] it was held that such bonds must be valued at par value despite a prevailing market price substantially lower than par value, regardless of whether the bonds were in fact so redeemed. That case was followed by *Candler v. United States*,[19] and the issue appears to be settled. The decisions are sound. If an absolute market exists, the fact that the market is narrow or specialized is immaterial. It should be noted, however, that such bonds must be valued at par only to the extent of the federal estate tax obligation. If the amount of the bonds exceeds the amount of the tax, only a portion of the bonds are valued at par and the balance at prevailing market quotations.[20]

13. Scott v. Hendricksen, 41-2 U.S. Tax Cas. ¶ 10966 (W.D. Wash. 1941); Estate of Katherine H. Daily, 16 P-H Tax Ct. Mem. 103 (1947).

14. Estate of Dudley S. Blossom, 45 B.T.A. 691 (1941), *acq.*, 1942-1 CUM. BULL. 2.

15. For a discussion of the "blockage" valuation of securities, see at 184 *infra.*

16. For a discussion of the discount for lack of marketability in the valuation of closely-held stock, see Butala, *Valuation of Securities of Closely-held Corporations*, at 205 *infra.*

17. Treas. Dept. Circular No. 300, rev. April 30, 1955; 1 FED. EST. & GIFT TAX REP. ¶ 4220.05 (1962).

18. 284 F.2d 537 (2d Cir. 1960).

19. 303 F.2d 439 (5th Cir. 1962). See also Rev. Rul. 53-156, 1953-2 CUM. BULL. 253.

20. If the current market quotation is above par, however, the quotation will control in the valuation of the entire block of bonds owned by the decedent. In recent years, such bonds consistently have sold below par value.

United States Savings Bonds

Series E, F, J, and H[21] United States Savings bonds pose no special valuation problems for the executor. In each case, their fair market values are their redemption values and such redemption values do not change by reason of the death of the owner.[22] Series G and K bonds,[23] however, carry special redemption provisions upon the death of an owner or co-owner. Although such bonds are redeemable prior to death at values below their par values, upon the death of the owner or co-owner, they may be redeemed at par, provided redemption is effected on or before the second interest payment date. If such bonds are held in a trust at death, they may be redeemed at par in whole or in part, depending upon the extent to which the trust becomes distributable by reason of such death.[24] It has been held that, if such bonds may be redeemed at par upon death, they must be valued at par for federal estate tax purposes.[25] Again, the principle followed is that the narrowness or specialized character of the market is not a significant factor since the market is absolute in nature.

BLOCKAGE

The term "blockage" is commonly regarded as meaning a discount in the valuation of a large block of securities which discount is justified on the ground that an attempt to sell so large a block would depress the prevailing market price. The discount is based on elementary economic theory: supply would outrun demand and a price concession would be required to generate sufficient additional demand to absorb the entire block.

After repeated defeats in the courts,[26] the Internal Revenue Service now recognizes the blockage principle, and the Regulations contain the following statement concerning blockage:

> In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be

21. Series F and J bonds are no longer issued but a substantial number of such bonds remain outstanding.

22. Treas. Dept. Circular No. 530, 8th rev., Dec. 26, 1957.

23. Neither Series G nor Series K bonds are currently issued.

24. Treas. Dept. Circular No. 530, § 315.36(d) (3), 8th rev., Dec. 26, 1957. When such bonds are held in a trust, the portion of the bonds which may be redeemed at par is determined by the ratio of the distributable portion of the trust to the total value of the trust. A trust is considered to be distributable to the extent that death taxes are payable from the trust.

25. Collins v. Commissioner, 216 F.2d 519 (1st Cir. 1954); Estate of Harry Hauptfuhrer, 19 P-H Tax Ct. Mem. 888 (1950); Rev. Rul. 55-301, 1955-1 CUM. BULL. 442. Interest does not accrue between interest payment dates on Series G and K bonds. Rev. Rul. 55-301, 1955-1 CUM. BULL. 442.

26. Groff v. Munford, 150 F.2d 825 (2d Cir. 1945); Mott v. Commissioner, 139 F.2d 317 (6th Cir. 1943); Helvering v. Maytag, 125 F.2d 55 (8th Cir. 1942); Henry F. du Pont, 2 T.C. 246 (1943).

> relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. Complete data in support of any allowance claimed due to the size of the block of stock being valued shall be submitted with the return. . . .[27]

Blockage therefore may be redefined as the discount involved in a special marketing effort when a prudent man would not risk selling by normal methods. A blockage price may also be regarded as a wholesale price involving a concession by the seller when he does not dare retail the block of shares.

As is often the case, although the principle is conceptually clear and now undisputed, the application is difficult. Much of the difficulty is concentrated in the question of whether a special marketing effort is required or warranted. As indicated by the Regulations, this depends upon whether the stock can be sold within a reasonable period of time without depressing the market.[28] If the answer to this question is "yes," then a blockage valuation will not be sustained.

Unfortunately, neither the Service nor the courts have provided any guidelines to assist in determining what is a reasonable period of time for this purpose. It is, of course, a factual matter and varies with a number of factors, such as the number of shares involved, the extent of trading activity in the stock, the prevailing price trend of the stock, and general market conditions. It has been suggested that ninety days may be taken as a reasonable period.[29] In the author's opinion, this is much too long. The period should not extend beyond several weeks. Surely, no seller would hazard a block of stock over a period of several months if he wished to reasonably assure himself of the current market price, and, certainly, no seller could predict with any reasonable assurance the continuation or improvement of prevailing market conditions beyond a few weeks. Further, it is understood that the Board of Governors of the New York Stock Exchange authorizes the use of special marketing ar-

---

27. Reg. § 20.2031-2(e) (1958) (estate tax). For a comparable statement applying to valuation for gift tax purposes, see Reg. § 25.2512-2(e) (1958).

28. The valuation clearly is not determined by the price which could be realized by a sale of the entire block begun and ended on the valuation date itself. Richardson v. Commissioner, 151 F.2d 102 (2d Cir. 1945).

29. Gordon, *What is Fair Market Value?*, 8 TAX L. REV. 35, 56 (1952-53). See also Sewell L. Avery, 3 T.C. 963 (1944), in which it is indicated that three months should not be taken as the outside limit of a reasonable period of time. If this is so, an awkward procedural problem is created with respect to the filing of the federal estate tax return. The federal estate tax return must be filed within fifteen months after death, and, if the alternate valuation date is elected, the executor may be required to file the return before the evidence necessary to determine the valuation is available.

rangements for blocks of stock representing substantially less than ninety days' trading supply.[30]

The blockage discount itself may be regarded as consisting of three main elements: (1) the depression in price, if any, upon announcement of a public offering;[31] (2) the underwriter's or broker's charge for handling the marketing arrangement; and (3) registration and other costs when the sale must be registered with the Securities and Exchange Commission or state regulatory bodies.[32]

Since an estimated selling commission on securities which have not been sold cannot be applied as a reduction in the valuation of such securities,[33] it can be argued logically that the blockage discount otherwise determined should be reduced by the normal selling commission. However, no case appears to have required a reduction of this nature, and the language of the Regulations[34] does not indicate in any manner that such a requirement exists.

There are a number of special marketing methods available for the disposition of substantial blocks of securities. All require approval by the authorities of the exchange on which the stock is listed. These methods are listed and briefly described as follows:

(1) *Specialist Block Purchase:* When the auction market does not have sufficient depth to absorb the block, the stock exchange specialist in the issue may make a bid for the entire block at a price somewhat below the going market. In such a case, the costs to sellers have ranged from 3.08 to 3.64 times the average minimum commission, with the composite average at 3.49.[35]

30. Specific approval by the exchange authorities is required before such special marketing arrangements can be employed, and it is understood that the following rules of thumb are used for this purpose: at least one day's trading supply of stock is required for approval of a specialist block purchase; one week's supply of stock is required for approval of an exchange distribution or special offering; and three week's supply of stock is required for approval of a secondary distribution.

31. Such a price depression is established by expert opinion evidence. See Merrill, *Effects of Market Pressure and Distribution Costs on Value in Registered Secondary Distribution of Listed Stocks* in AMERICAN SOC'Y OF APPRAISERS, APPRAISAL AND VALUATION MANUAL 147 (1958).

32. Such costs may include expenses for printing, registration statement, filing fees, transfer agent, legal and accounting fees, underwriters' out-of-pocket expense, and "Blue Sky" expense. See Paine, Webber, Jackson & Curtis, *Buying & Selling Large Blocks of Securities* 9 (1958).

33. Scott v. Henricksen, 41-2 U.S. Tax Cas. ¶ 10966 (W.D. Wash. 1941); Estate of Katherine H. Daily, 16 P-H Tax Ct. Mem. 103 (1947).

34. Reg. §§ 20.2031-2(e), 25.2512-2(e) (1958). The language may be taken inferentially as suggesting that such a reduction need not be made, since it refers to a valuation established by "the price at which the block could be sold as such outside the usual market." This price is commonly quoted to the seller as a net price.

35. New York Stock Exchange, Marketing Methods 9 (*circa* 1959). The costs cited were based upon a study of sixty-five block specialist sales during the period August 1953 through August 1959. A block specialist sale would appear to be appropriate when speed and convenience of sale are important factors and thus would have limited value as evidence in a blockage valuation.

(2) *Exchange Distribution*: Using the regular auction market, a member firm of the exchange employs its own sales organization to generate sufficient additional purchase orders to move the entire block in return for additional commissions. The seller pays all brokerage costs. The stock is offered to purchasers at a net price, and the seller in effect pays the buying commission to stimulate demand. No public announcement is made until after the sale orders and purchase orders have been matched and the transaction completed. The costs to sellers have ranged from 2.46 to 3.16 times the average minimum commission, with the composite average at 2.92.[36]

(3) *Special Offering*: A fixed net price to the buyer is advertised on the stock exchange ticker, and the block of stock is sold through the facilities of the exchange during regular trading hours. The additional commissions paid by the seller are in effect used to recruit the entire list of registered representatives of the exchange as a sales force to increase demand. The costs to sellers have ranged from 4.29 to 5.81 times the average minimum commission, with the composite average at 4.61.[37]

(4) *Secondary Distribution*: A selling group, consisting of both stock exchange member firms and associated non-member firms, is formed to offer the stock at a fixed net price, usually after the close of the market. The selling group may act either as an agent for the seller or may purchase the block for its own account and assume the risk of resale. Registration with the SEC may or may not be required, depending upon the legal position of the seller.[38] The costs to sellers have ranged from 3.99 to 6.67 times the average minimum commission, with the composite average at 4.84.[39]

The determination of blockage valuations for gift tax purposes has given rise to a conceptual problem. Where a donor has made several gifts of blocks of the same security to several donees on the same day, the question is presented as to whether the separate gifts are to be treated for valuation purposes as one block or as several blocks. The courts have

36. *Id.* at 13. The costs cited were based upon a study of 143 exchange distributions during the period January 1954 through August 1959.

37. *Id.* at 16. The costs cited were based upon a study of 474 special offerings during the period January 1942 through August 1959.

38. Registration is required if the sale constitutes a "distribution" by "controlling persons" under the Securities Act of 1933. A simplified registration known as a "Regulation A offering" may be made under certain conditions. See Paine, Webber, Jackson, & Curtis, *Buying & Selling Large Blocks of Securities* 6-9 (1958), for a simplified outline of regulatory problems.

39. New York Stock Exchange, Marketing Methods 18 (*circa* 1959). The costs cited were based upon a study of 1140 secondary distributions during the period January 1942 through August 1959.

In addition to the marketing methods listed, there is also the possibility of a private placement. This is simply a negotiated sale, usually with an institutional purchaser, somewhat below the prevailing market price.