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Expert Event Study 'Almost Obligatory' to Prove Loss Causation in Securities Fraud Litigation

In re Vivendi Universal, S.A. Securities Litigation, 2009 WL 920259(S.D.N.Y.)(March 31, 2009)

Loss causation is fast becoming the cornerstone of proving damages in complex securities claims. The expert's event study in this case showing the causal link between the loss and the securities fraud was sufficient to prevent summary judgment and enable the matter to proceed to trial.

Claiming insufficient evidence to show loss causation. In 1998, a new CEO promised "a grand strategy" to transform Vivendi, S.A. from a small, publicly traded French water utility into an international telecommunications conglomerate. A series of acquisitions culminated in a three-way merger with two large U.S. companies (Seagrams and Universal Pictures). Yet, within four years, Vivendi's debt had mushroomed from €3 billion to €21 billion.

The plaintiffs (a combination of individual and class-certified shareholders) alleged that the company promoted its merger efforts while misleading the marketplace about the enormity of its debt and the resulting drain on liquidity. Outside events soon began to reveal the company's true financial condition. These events are at the heart of the plaintiffs' expert evidence in the case for loss causation. The Vivendi defendants filed a motion for summary judgment claiming the expert's evidence was insufficient to establish loss causation.

Eleven days, eleven events. The core of plaintiff's expert evidence consisted of a regression analysis and event study. The regression analysis attempted to "disaggregate the market and industry declines from residual, company-specific share price declines." By comparing day-to-day percentage changes in Vivendi's stock to the same changes in both industry and market indices, the expert found eleven days when company declines exceeded indexed declines. On most of these days, events such as the company's unexpected asset sales and credit rating downgrades took place.

The expert's event study then isolated company-specific information from the tangle of market and industry factors, attributing the company's price declines to the gradual revelation of its true condition. As a final step, the expert quantified damages based on the per-share price declines that took place on each of the eleven days.

Current case law on loss causation doctrine. The plaintiffs needed to prove: "1) a connection between the alleged false statements and one or more events disclosing the truth concealed by that fraud; and 2) a connection between these events and the actual share-price declines." To prove their case, an expert event study is "almost obligatory," the court said. The evidence need not be absolute, but only sufficient for a jury to conclude that the fraud-related event was a "substantial cause" of the stock-price declines.

The court found that the ratings downgrades and unexpectedly quick asset sales were reasonably related to the company's liquidity risk, and could be seen as materializations of those risks and not just bad news (as the defendants had argued). Plaintiffs' expert also adequately disaggregated competing causal events—at least for the purposes of a summary judgment motion—by showing that on the majority of the eleven days, there was a sufficient link between the prior concealed risks and the defendants' alleged fraud.

Door is still open on damages. The trial will hinge largely on plaintiffs' ability to establish a sufficient chain of causation. As to damages, the court said, "Defendants have moved for summary judgment on loss causation, and damages issues, while related,

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are quite another matter," the court said, opening the door for more litigation on this equally critical element of a securities fraud claim.

No Legitimate Business Purpose for FLP Precludes Analysis of Discounts

Estate of Jorgensen v. Commissioner, 2009 WL 7920771 (U.S. Tax Ct.)(March 26, 2009)

The Jorgensen estate could not persuade the U.S. Tax Court to find a single legitimate (non-tax) business purpose for its family limited partnership (FLP).

One FLP, two FLP. In 1995, Colonel Jorgensen and his wife funded an FLP with roughly $500,000 of marketable securities. They each became limited partners (LPs) along with their six grandchildren. The colonel and his two children were named general partners. The stated purpose of the FLP was to "pool certain assets and capital for…investing in securities." When the colonel passed away in 1996, his estate attorney recommended that the widow transfer all of their brokerage accounts into the FLP, so that "hopefully your limited partnership interest… will qualify for the 35% discount." The attorney also recommended that she form a second FLP, funded with some $1.8 million in marketable securities. After she died in 2002, the IRS audited the two FLPs and assessed nearly $800,000 in deficiencies. The estate appealed.

Looking for a legitimate, significant nontax purpose. The Tax Court looked at whether the widow "had a legitimate and significant nontax reason…for transferring her property," which would be sufficient to keep the FLPs from being valued fully as part of her gross estate. The court found the following:

1. No active management. There were no books and records, no formal meetings or minutes. The widow's only "activities" were to make cash gifts to family members and pay taxes and other personal expenses out of the FLP.
2. No financial education or family unity. The family let the investment adviser make most decisions and the promotion of family unity was "no more than a theoretical purpose."
3. No investment philosophy. The "perpetuation of a 'buy and hold' strategy for marketable securities is not a legitimate or significant nontax reason for transferring the bulk of one's assets to a partnership."
4. No benefit to pooling of assets. Transferring the investment accounts directly could have accomplished the same gift-giving purposes as the FLPs, without adding any significant expense or oversight, and might have incurred less.
5. Spendthrift tendencies continued unabated. The FLPs did nothing to protect the LPs, in particular the profligate son, against his own tendencies. The widow's son borrowed a total of almost $170,000 from the FLPs, but made only two interest payments, and his mother later forgave one of the loans, without reporting it as a gift.
6. Giving equal gifts. Facilitating and simplifying gift giving, alone, is not a legitimate nontax purpose.

The court found that I.R.C. Sec. 2036(a)(1) pulled the FLP assets back into the value of the wife's gross estate.

Tax Court's Adjustment to Reasonable Compensation 'Dizzying and Arbitrary'

Menard v. Commissioner, 2009 WL 595587 (C. A. 7)(March 10, 2009)

The CEO of The Home Depot was paid $2.8 million in salary in 1998. The CEO of Lowe's received $6.1 million (neither including bonus). Yet when the CEO of the nation's third largest retail home improvement chain, Menards, posted roughly $20.6 million in salary (including bonus), the IRS stepped in and disallowed $19 million as a corporate deduction. The reason: The IRS claimed that it was a disguised dividend.

The Tax Court applied a unique formula. The CEO, John Menard, founded the Wisconsin-based Menards hardware stores in 1962. He worked six or seven days a week, up to 16 hours a day, and was involved in every detail of company operations. Under his management, revenues grew from $788 million in 1991 to $3.4 billion in 1998. The company's return on shareholder equity in 1998 was 18.8%. By contrast, Home Depot returned a 16.1% return on investment that year, and Lowe's rate of return was lower.

Menard owned all the voting shares in the company and 56% of the non-voting shares. He was paid a modest base salary and a portion of a profit-sharing plan; in 1998, he earned $157,500 and $3 million from these sources. A bonus program, adopted by the board of directors in 1973, for his "commanding" management role, awarded him an additional 5% of company earnings (before taxes) at the end of each year. In 1998, the 5% bonus yielded the CEO an additional $17.5 million, conditioned on the IRS allowing its deduction from corporate income.

At trial the IRS not only persuaded the Tax Court that the bulk of the CEO's compensation was excessive, but that because it was conditional and paid at year's-end, it was also intended as a dividend, especially since the company didn't pay formal dividends to other shareholders.

As to the "excess", the Tax Court found that any compensation above $7.1 million for Menard was too much. The court used its own unique formula to arrive at this conclusion:

(1) Divide Home Depot's return on investment (16.1%) by its CEO's salary ($2.84 million);

(2) Divide Menard's return on investment (18.8%) by the result of step (1); and then

(3) Multiply the result ($3.32 million) by 2.13, or the ratio of the compensation of Lowe's CEO to that of Home Depot's CEO.

The Appellate Court considered the Tax Court's formula an arbitrary and dizzying adjustment. It disregarded differences in the full compensation packages of the three executives being compared (the Home Depot CEO made more than $124 million from 1998-2004) , differences in whatever challenges faced the companies in 1998, and differences in [their] responsibilities and performances (Menard was by far the most active, hard-working).

Not a concealed dividend. The Tax Court ignored the substantial level of risk in Menard's compensation structure, given its direct tie to company earnings. Not to mention the fact that the 5% bonus program had been in place for 25 years before the IRS "pounced," the court said. It did not look like a dividend, because corporate dividends are generally tied to specific dollar amounts and do not serve the same incentive purpose to the passive shareholder.

The Seventh Circuit reversed the Tax Court's decision.

Fair Market Value Includes Only Reasonably Foreseeable Subsequent Events

Alan Baer Revocable Trust v. U.S., Inc., 2009 WL 1451577(D. Neb.)(May 18, 2009)

The owner of stock in a private, closely held, telecommunications company died in 2002. He left his shares to 23 beneficiaries through a trust, contingent on the trustee selling the stock for a profit. The remainder of the shares—plus additional assets—were to go into a qualified residual interest trust (QTIP trust) for the spouse, and for which the estate claimed a marital deduction—based on an appraisal at the owner's death of the present value of the partnerships holding the stock, minus the contingent bequests of $41.5 million.

In determining federal estate taxes, the estate discounted the contingent bequests, using a six-year term and a discount rate of 5%.

Parties agree on stock basis, but not company valuation. On review, the IRS reduced the marital deduction, based on its finding that the 2002 appraisal of the partnerships was over-valued. An appraisal performed for the tax proceedings in 2006 found the partnerships to be worth only $3 million. The substantial difference was due to the fact that a joint venture agreement (the partnership's principal asset) had been in breach since 2002 (which the appraiser had not realized in the original valuation).

Both parties agreed that the decedent's basis in the stock was just over $4.8 million.

Motion for summary judgment denied. The IRS filed a motion for summary judgment, arguing that the proper inquiry was whether the contingent bequests qualified for the marital deduction. "The underlying value of the stock relative to decedent's investment is irrelevant."

The estate argued that the contingent bequests essentially had no value, because the contingency—that the stock would sell at a profit—could not be realized. The stock's value was therefore directly at issue, because at the date of death, it amounted to less than the decedent's $4.8 million basis.

The Federal District Court (Nebraska) agreed that the value of an estate for federal tax purposes is a factual inquiry. As a general matter, the court added, citing Estate of Noble v. Commissioner, a fair market value determination does not include events subsequent to the valuation date, unless those events were reasonably foreseeable at the time. The essential question regarding any evidence is whether its admission would make an asserted fair market valuation more or less probable.

"The issue is whether [the company's] value can be ascertained with fair certainty, and if so, what that value is." If the estate can show that at the date of death, the contingency on which the bequests depends (selling the stock at profit during the spouse's lifetime) will never occur, then their value could be extinguished for federal estate tax purposes.

The court denied the IRS motion for summary judgment.

Top Five Key Factors in Expert Damages Testimony

Having a solid business appraisal expert to assist in determining damages is critical at trial. But it will backfire if the expert does not adhere to the Federal Rules of Civil Procedure, or if the expert's conclusions are thrown out due to a successful Daubert challenge. Here are five key factors to consider:

1. The expert witness report must be court-ready. The expert's report is direct testimony and needs to contain all the content needed to establish (or refute) alleged damages.
2. Experts need the essential information first. Information requests need to be prioritized. Establishing damages will be difficult, if not impossible, if that essential information is unavailable.
3. Experts need to read the depositions and interrogatories. The result will be a more robust opinion and a more thorough and defensible report.
4. Daubert challenges are both real and unpredictable. Even the most respected business appraisal experts have lost Daubert challenges.
5. A good expert reveals the truth to the court. A judge or jury wants someone they can trust: Expert witnesses reveal the truth to the court in their testimony and their reports. To do that, in addition to great work, an expert needs to follow the rules flawlessly, and speak clearly and confidently.

The Most Credible Experts Admit the Weaknesses in Their Reports Up Front

As judges boost their knowledge and more IRS engineers and appraisers become BV-credentialed, they are better able to spot the weaknesses in valuation reports. Should you admit them up front? "Absolutely," says U.S. Tax Court judge, the Honorable David Laro. "If you don't address them, the other side will, or the court will have questions." If an appraiser discusses and analyzes, for example, omitted methods, and explains why they were not applicable to a particular case, they automatically raise the sophistication level of their report.

What other elements must a report have? Ethics, independence, intellectual honesty, and transparency, Laro said. "When you offer a report that is free of bias and advocacy, independently arrived at and transparent, then this is the best we can have." Howard Lewis, former national program manager of the IRS and current IBA Executive Director, seconded these requirements, as applied to the Service. "It is not the job of the IRS to be advocates," he said. IRS appraisers and examiners are "charged with the responsibility to be fair, honest and unbiased." At the same time, they regularly see only the worst-case appraisals, and this system-bias led even Lewis to develop a bias early in his career, which he focused on correcting in later years, in both himself and his fellow engineers. The point: "Understand the perspective of the IRS," he said.

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Trugman Valuation
ASSOCIATES, INC.

Call (800) 330 - VALU to request a free CD-ROM brochure
or visit our Website at:
www.trugmanvaluation.com

Florida: 1776 N Pine Island Rd, Suite 314
Plantation, FL 33322
Phone: (954) 424-4343

New Jersey: 2001 Rte 46, Suite 310
Parsippany, NJ 07054
Phone: (973) 983-9790