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Minority Discount Can Help Determine Passive Versus Active Appreciation

***Iacampo v. Oliver-Iacampo*, 2012 Ohio. App. LEXIS 1574 (April 23, 2012)**

The wife held a 12.5% interest in a long-established family printing business. The parties stipulated that the minority interest was the wife's separate property and further agreed—based on a report by the wife's expert—that it had appreciated during the marriage by $593,000. They only disputed whether this appreciation was due to the wife's active contributions, in which case it would be marital property, or whether it was passive appreciation, thus retaining its character as the wife's separate property.

Husband objects to expert's testimony. Despite the parties having stipulated to the appreciated value of the business, the wife's expert explained the factors that are relevant to determining whether appreciation in business value is active or passive.

For example, he described whose efforts among the wife's family had contributed to the success of the business. This testimony was corroborated by members of the wife's family, including her cousin, who took over as president after the wife's father died, and aggressively pursued growth. In addition, the wife testified that she had no control over the business and had to "fight" her family to retain her job as a bookkeeper after her father's death.

Based on this record, the trial court attributed the business appreciation exclusively to the "pivotal role" played by the cousin, such that the wife's minority interest remained her separate property. The husband appealed, claiming the trial court never should have permitted the wife's expert to testify regarding the active/passive nature of the business appreciation, since this exceeded the scope of his original report.

After reviewing the expert's report, however, the appellate court found that its stated scope was broader than the husband claimed. Its cover letter, for instance, explained that the purpose of the valuation was to "render an opinion as to the fair market value" of the wife's ownership interest and "the appreciation of the share value during the marriage." The report "expressly addressed certain valuation factors" that could aid the trier of fact in making this determination, the appellate court explained, "such as the discount due to lack of control."

The only reason the wife's expert appraised the company was to determine the value of the husband's share in its appreciation, "if any," the court said, with emphasis. Such a determination necessarily depended on whether the appreciation was active or passive. The appellate court affirmed the trial court's findings regarding appreciation.

Dissent says expert's report must include passive versus active opinion. A single judge on the appellate panel dissented. An opinion on active versus passive appreciation is not something a layperson would give, the dissent added. "If an expert is going to give such an

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opinion, it should be in [his or her] report." If not, the trial court should bar the expert from testifying regarding that issue or risk "opening the door for litigators" who might actually withhold critical opinions until the day of trial. In this case, permitting the expert to exceed the scope of his report placed the husband "at a distinct disadvantage," the dissent concluded, and the error was not harmless, because it was impossible to determine the weight the trial court gave the expert's testimony regarding this "critical issue."

Bernier Trial Court Gets Tax Affecting Wrong Once Again

***Bernier v. Bernier*, 2012 Mass. App. LEXIS 211 (June 29, 2012)**

At the parties original divorce trial back in 2002, their principal dispute focused on the value of their two successful grocery stores. Although their experts agreed on a valuation date (Dec. 31, 2000) and on applying the income approach, they arrived at markedly disparate appraisals due to their different approaches to tax affecting and discounts.

On expedited appeal, the state Supreme Court concluded that the trial court erred by adopting the husband's tax-affecting approach. Applying a C corporation rate of taxation to an S corporation "severely undervalues the fair market value of the S corporation by ignoring the tax benefits of the S corporation structure and failing to compensate the seller for the loss of those benefits," the court held. At the same time, the failure to tax affect an S corporation at all would artificially inflate its value by overstating the retaining shareholders expected rate of return.

After reviewing the scant authority on the subject, the Supreme Court sent the case back, with orders for the trial court to adopt the metric employed in *Delaware Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006). In that case, the Delaware Court of Chancery assumed a dividend rate of 15% and a personal income tax rate of 40% to impute a "pre-dividend" rate of 29.4%.

Husband retains a non-BV expert. The directive to use the "*Kessler* metric" or the "*Kessler* approach" created some uncertainty on remand, arising in large part due to a change in federal income tax treatment of corporate dividends. When *Kessler* was decided in 2004, the applicable rate was 15%, but in 2000—the stipulated date in this case—the rate was 40%. Since the Massachusetts Supreme Court did not address the rate change, the trial court, the parties, their attorneys, and their experts were without explicit guidance on what specific rates to use in applying the "*Kessler* metric."

The wife's new expert, a credentialed business appraiser, testified that he used the formula set forth in *Kessler* but input the applicable dividend rate in 2000 (40%). This resulted in an overall tax effect of zero because the personal income tax rate at the stipulated valuation date was also 40%. Utilizing this rate, the wife's expert valued the two grocery stores at $14 million as of 2000.

By contrast, the husband retained a CPA who had never conducted a business valuation but who qualified purely as a tax expert. Since an S corporation's earnings are taxable to the shareholders at state and federal ordinary income tax rates, he applied a 5.85% Massachusetts rate and 39.6% federal rate to reach a 46% combined rate, which resulted in a value of approximately $9.3 million for the two supermarkets.

The trial court discredited both approaches. Having rejected both of the expert opinions, it strictly applied the 29.4% *Kessler* rate and valued the stores at just under $11.4 million. This time, both parties appealed.

Trial court too literal. The wife argued that the trial court should have strictly applied the overall *Kessler* method instead of its rates, which did not apply to the timing of this case. Although the husband conceded that applying the applicable 2000 rates would net a tax affect of zero, he argued that the decisions in *Bernier I* as well as *Kessler* and the intervening *Adams v. Adams*, 459 Mass 361 (2011) case, stand for the proposition that "subchapter S corporation earnings must be tax affected to avoid an inequitable result in the valuation process." The "accidental timing" of this case should not control its outcome, the husband

added. Rather than applying the *Kessler* metric on the "basis of pure mathematics," the more equitable solution would be to adopt his expert's combined 46% rate.

The Massachusetts Court of Appeals decided that the wife presented the more "cogent position" than the husband or even the trial judge. The Supreme Court's orders on remand were to apply the same general tax-affecting metric as in *Kessler*, but only the wife's expert offered a valuation consistent with the mandate. "Furthermore, application of the *Kessler* metric, even as it results…in a zero percent tax affecting rate, does not necessarily lead to an inequitable result," the appellate court stated.

In attempting to capture the tax benefit to the buyer of S corporation shares of receiving cash dividends that were not already taxed at the corporate level, the *Kessler* metric also calculates "the effect of taxes on the buyers and the sellers." In effect, the metric prompts a trial judge to ask: "If the S corporation at issue were a C corporation, at what hypothetical tax rate could it be taxed and still leave to shareholders the same amount in their pockets as they would have if they held shares in an S corporation?" the court explained, quoting *Bernier I*. Because the dividend tax rate in effect in 2000 was 40%, a tax-affecting rate of 0% was necessary to answer the question accurately, the court held:

> While the [trial] judge clearly sought to reach what she viewed as an equitable result in this difficult and complex case, her ultimate determination of the value of the supermarkets, which utilizes a 29.4 percent tax affecting rate, cannot stand, because the 29.4 percent tax rate bears no relationship to, and is contrary to, the parties' stipulated valuation date of December 31, 2000.

To the extent the husband cited the *Adams* case for additional support, "we fail to discern anything…that would cause us to reach a different result," the court ruled, and remanded the case—once again—to the trial court for a valuation of the parties' S corporations consistent with its opinion as well as *Bernier I*. The trial court could also order additional evidentiary hearings as necessary to reach a proper result.

Actual Transaction Is 'Gold Standard' of Valuation, 7th Circuit Says

***Malik v. Falcon Holdings, LLC*, 2012 U.S. App. LEXIS 5336 (March 14, 2012)**

After starting a company to operate 100 fast food restaurants, the owner promised his top 20 managers that when he bought out his private equity investors, he would give them each an equal share in half (50%) of the company's equity. At the time, the owner held 40% of the common units in the limited liability company; the PE investors held all of the preferred units and 60% of the common. The managers also agreed to take lower salaries in anticipation of receiving a stake in the company once it was a success.

By 2005, the owner was able to acquire full ownership of the company—but he failed to distribute any equity to his managers and denied ever promising to do so. Five of the managers sued the owner and the company in federal district trial. On a summary judgment motion, the court found sufficient evidence to conclude that the owner had promised the plaintiffs an equity stake in the company. At the same time, the court found that the plaintiffs failed to adequately estimate their damages and dismissed the suit.

Damages estimate too simple? The plaintiffs appealed to the U.S. Court of Appeals for the 7th Circuit, which first examined their "simple" estimate of damages. Specifically, the plaintiffs used the price paid for the PE investors' share to infer that the company as a whole was worth $48 million in 2005. Half of that amount was $24 million, which, when divided among the 20 qualifying managers, resulted in an award of $1.2 million apiece.

The district court had spotted two flaws in the damages estimate, according to the 7th Circuit. First, because the PE fund did not own 100% of the company, it was "impossible to derive the value of the whole firm from the amount paid for its holdings." Second, the amount the PE investors received depended on how much the defendants (the company and the owner) could

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borrow. “Neither of these propositions is true,” the 7th Circuit explained.

To illustrate its finding, the court simplified the transaction even further, assuming that the PE fund received $6 million for its 60% share of the company, which would make the company as a whole worth $10 million

This rationale also applied to the district court’s belief that the owner and the company’s borrowing ability effectively “capped” the buyout price. If this meant the PE investors accepted less for their units than their proportional share in the company represented, the plaintiffs would have once again underestimated their damages, the court said. “That’s not a good reason why they should go home empty-handed.”

To say that the company could not pay the PE investors more than it could borrow is not the same as saying the price was arbitrary. If the price had been a poor estimate of the firm’s value, then the PE fund would have turned it down. “Instead, it took the offer,” the court said, with repeated emphasis. The price a willing buyer and seller agree on “is the value of the asset.”

What was really wrong with the plaintiffs’ estimate? The courts also pointed out several “real” problems with the plaintiffs’ calculations, which had less to do with valuing the company as a whole and more with the owner’s promise to convey a 50% equity interest.

It was unsound for the plaintiffs to assume that the owner’s equity interest in the firm was worth 100% of its value. “It might take an expert financial economist to derive an equity valuation,” the court said, “and the plaintiffs did not disclose an expert in discovery.” At the same time, the defendants did not ask the court to affirm the dismissal based on any omission of the value of the owner’s equity.

The plaintiffs made a second questionable assumption, the court said: that the owner would “hand over” 2.5% of the company’s equity units to each manager without any terms or conditions. “That would be a disaster not only for the ownership structure of a closely held firm but also from a tax perspective.”

“So many vital terms are missing that any promise may well be too indefinite to enforce,” the court cautioned. The plaintiffs would likely be able to use the discovery process to learn the facts, beginning with the details of the buyout transaction, before adding specifics to their claims, and the court remanded the case for proceedings “consistent with this opinion.”

Proposed USPAP Revisions Prompt Sharp Criticism From ASA BV Committee

Members of the American Society of Appraisers (ASA) “are not happy with” some of the current proposed revisions to the Uniform Standards of Professional Appraisal Practice (USPAP), reports Linda Trugman, chair of the ASA BV Committee, in a recent e-update to members. Among other changes set forth in the exposure draft for the 2014-2015 USPAP, the most controversial are those to the definitions of “assignment results” in Section 2a and “report” in Section 2b.

In particular, a letter signed by Trugman on behalf of the ASA BV Committee expressed its concern that elevating draft reports to the status of “assignment results” would counter the prevailing trend in litigation matters to preclude discovery of an appraiser’s draft materials. Moreover, the proposed broader definition of “report” would include “any communication of an opinion of value … at any time” (emphasis added in the letter). Instead, “we believe the definition of a ‘Report’ should be linked to the completion of an assignment.”

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