TRUGMAN Valuation

VALUATION Trends

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Court Infers Nature of Goodwill from Nature of Business

Rabe v. Rabe, **2015 Ky. App. Unpub. LEXIS 379 (May 29, 2015)**

An opinion in a divorce case from the Kentucky Court of Appeals, although unpublished, merits attention because it shows the court ruling on the nature of goodwill in a business valuation based merely on the type of business at stake. The opinion also serves as a reminder that failure to address questions regarding the nature of the goodwill head-on may put the client at a disadvantage in trial and on appeal.

This case has a business valuation history. The husband was the sole owner and operator of a transportation company that he brought into the marriage. The business provided him with an income of between $350,000 and $400,000. In the original proceeding, the issue for the trial court was the company's increase in value during the marriage. That amount was divisible marital property.

Both parties presented expert testimony, with the husband's expert concluding the increase in value was about $149,000, whereas the wife's expert claimed it was nearly $462,000. The husband's expert explained that, based on information he had received from the husband, the company was "fragile." Some 60 to 80 percent of the company's business stemmed from one customer that could terminate its relationship with the company on 30 days' notice. For this reason, the expert used a low earnings multiplier of one.

The trial court found this testimony "more accurate" than the testimony from the wife's expert, but decided to modify the amount to arrive at an increase in value of nearly $205,000.

In the first appeal, the wife successfully argued that the trial court erred by crediting the testimony of the husband's expert. The expert blindly relied on information from the husband that proved to be inaccurate as concerned the company's business relationship with its alleged sole client. Rather than being the subject company's largest customer, the latter had an agency relationship with the subject company. Under the parties' franchise agreement, the company generated all of its business independently and had many customers.

The appeals court remanded, ordering the trial court to reconsider its determination. If the trial court decided to rely again on the opinion of the husband's expert, it had to provide specific findings of fact that justified its reliance.

On remand, with a different judge presiding, the trial court decided to rely on the wife's expert for its valuation of the business. Once the trial court had entered its supplemental judgment, the husband filed a motion asking the court to reconsider its calculation of the wife's interest in the company and also to determine the nature of goodwill included in the business valuation. The trial court declined to do so.

The husband appealed the valuation a second time. He claimed it was error for the trial court suddenly to rely on the wife's expert when it simply could have made new findings of fact that supported its earlier reliance on the valuation from the husband's expert. The husband blamed the court's change in position on the fact that two different judges oversaw the case. He also contended that the valuation the wife's expert offered included goodwill value, but failed to distinguish between enterprise and personal goodwill.

As to the first objection, the appeals court said that, even though it sympathized with the husband's frustration about multiple judges presiding over the case, the trial court's crediting the valuation of

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the wife's expert on remand was not an abuse of discretion.

As for the goodwill issue, the court noted that under state case law, only enterprise goodwill, not personal goodwill, was subject to division. The appeals court said that, in the case in front of it, it seemed that the trial court, by including the goodwill in the value of the business, attributed the goodwill to the business and as such considered it divisible. The trial court had discretion to do so, the Court of Appeals said.

The appeals court explained that, in *Gaskill*, the business at issue was a professional practice. Personal goodwill, it said, was "most commonly found in similar professional practices that receive business as a result of the professional's reputation. The business would not have the same value absent the professional because the professional's reputation cannot be transferred to a buyer."

In contrast, the business in this case was not a professional practice. Consequently, "it seems likely that the business's name and reputation earn it business rather than [the husband's] name and reputation." Further, neither party offered testimony that any of the goodwill was personal rather than enterprise goodwill. "Hence, the goodwill of [the company] is enterprise goodwill, something which would be transferable in a sale of the business," the appeals court concluded. Consequently, it found the trial court did not err in including goodwill in the value of the business and upheld the valuation.

What Passes for a Reliable Yardstick Method Under *Daubert*?

***Washington v. Kellwood Co.,* 2015 U.S. Dist. LEXIS 63457 (April 21, 2015)**

How closely does a business have to resemble a comparator to produce a yardstick analysis that meets the *Daubert* requirements? Judging from a federal court decision, the answer is "not that closely."

The creator of a new brand, Sunday Players, wanted to conquer the compression apparel market and made a licensing deal with the defendant, a large manufacturer, marketer and seller of private labels and brands. Compression apparel has become big due to the rising success of the Under Armour brand. In the parties' dealings, the defendant allegedly told the plaintiff that MTV was interested in partnering with Sunday Players and that an MTV promotion would result in hundreds of millions of dollars in product sales. Ultimately, the promo deal with MTV did not materialize.

The defendant abandoned the partnership, saying it was unable to make a single sale even though it pitched the Sunday Players' brand to some 18 large retailers and spent about $220,000 in marketing. The plaintiff sued on several legal theories, including breach of contract, asking for damages in excess of $50 million. Both parties retained experts and filed pretrial motions to exclude the opposing testimony.

Comparable to market leader? One of the ways in which the plaintiff's expert calculated damages was by developing a yardstick analysis that used Under Armour as the point of comparison. He justified his choice of benchmark by noting that, at the relevant period, Under Armour had executed a promotion agreement with ESPN—a development that illustrated the growth potential in the market and brought to mind the joint venture efforts between the plaintiff and the defendant toward the never-executed promotion agreement with MTV. Also, at the relevant period, Under Armour, like the plaintiff, focused on selling compression sportswear and was then in "its early startup period." And, MTV, like ESPN, had a significant geographical reach and cultural influence. The plaintiff anticipated that the way in which Under Armour was marketed might parallel the marketing strategy for Sunday Players' had the defendant realized the promotional agreement with MTV.

The defendant claimed the analysis was unreliable, stating: "Under Armour and Sunday Players are so dissimilar as to render [the expert's] selection of Under Armour laughable." Whereas Under Armour for a long time has dominated the market, Sunday Players' merchandise has had a woeful performance record.

The court admitted the testimony. Under *Daubert*, "[e]xpert testimony should not be rejected simply because the conclusions reached by the witness seem subjectively improbable," the court said. Even if the expert's claim that Sunday Players could have had a success similar to that of Under Armour seemed an improbable conclusion, the expert provided reasons for arriving at that conclusion and a methodology to support it. The court noted there was no bright-line test for yardstick analyses. "Reliability," the court said, was a "flexible" concept and no one set of factors applied to all experts in every case.

The court rebuffed the defendant's proposition that the standard for a reliable yardstick analysis was set in *Celebrity Cruises Inc. v. Essef Corp*. Moreover, the court said, to the extent that *Celebrity Cruises* spelled out what a reliable yardstick analysis was, the expert's analysis met the test in that the benchmark company was "similar to [plaintiff] in material respects."

New Chancellor's First Words on Tax Affecting in Fair Value Case

Tax affecting is alive and well in the Delaware Court of Chancery, as the new chancellor, Andre Bouchard, makes clear in his decision in a joint fiduciary duty and appraisal action. As part of the discussion, the court addressed the issue of whether or not a valuation based on the controlling *Kessler* model should consider the company's earnings distribution policy.

A company's former president sued his partners and the company, alleging that they orchestrated a "boom, done, Blitzkrieg style" merger in which he was cashed out for a mere $26.3 million. At the same time, he petitioned the court to determine the fair value of his shares. The company was organized as a Subchapter S corporation.

Both of the opposing valuation experts performed discounted cash flow ("DCF") analyses but arrived at spectacularly different conclusions. According to the petitioner's expert, the stock's value was $52.65 million. In contrast, the company's expert said it was worth $21.5 million. Tax affecting was one of the major disagreements shaping the results. The petitioner's expert concluded it was appropriate to tax affect the company's earnings using a 21.5 percent tax rate to account for its S corporation status. The company's expert rejected tax affecting and applied a 44.8 percent tax rate. But he said that, if the court were to tax affect, it should use a 34.1 percent tax rate. This rate was based on the premise that the petitioner should only receive the value of being an S corporation stockholder for the actual distributed earnings (76.7 percent), not for earnings the company retained and reinvested in the company (23.3 percent).

The court found this rationale problematic. At the start of its analysis, it noted that the petitioner had a right to that which had been taken from him. "A critical component of what was 'taken' … in the Merger was the tax advantage of being a stockholder in a Subchapter S corporation." It said that adequate compensation for the petitioner's loss required tax affecting the company's earnings as part of a DCF valuation.

In terms of how much of the earnings should be subject to tax affecting, "the operative metric under the *Kessler*-based valuation method is not the actual distribution made by a Subchapter S corporation, but the amount of funds that are available for distribution to stockholders." To conclude otherwise would deprive the petitioner of "his proportionate interest" in the company as a "going concern," the court said. Also, here, the company did not actually reinvest significant amounts of its undistributed earnings in the business. Instead, it kept the earnings as cash on its balance sheet. And it did not need to reinvest earnings to grow. Both experts testified that the relevant projections included all of the capital expenditures necessary to enable the company to generate the projected future cash flows.

Using the *Kessler* model, the court determined the appropriate tax rate was 22.71 percent. Under its own DCF analysis, it valued the petitioner's shares at $42.16 million. This was based on the amount available for distributions, not the company's decision of how much to distribute.

IRS Assault on Valuation Discounts for FLPs Is Looming

In recent months, one persistent rumor has circulated in the blogosphere dedicated to estate and gift tax issues - it's that the IRS is about to eliminate or at least limit the application of discounts related to family limited partnerships and similar structures. Articles have also appeared in *The New York Times* and *The Wall Street Journal* discussing the impending crackdown.

FLPs and their variants are a popular tool to shift significant family wealth from one generation to the next at greatly discounted values. Under a common scenario, the transferor contributes assets to a FLP and then assigns fractional limited partnership

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interests to the transferees. Provisions in the partnership agreement or the organizational structure may place restrictions on the fractional ownership interest, as far as concerns control, marketability and transferability. If the restrictions stand up to scrutiny, they can translate into significant discounts and gift and estate tax savings.

The IRS has long been concerned over depressed valuations but has had limited success litigating the issue. Representatives from the IRS and the U.S. Treasury said that new regulations limiting the use of valuation discounts would be forthcoming. It is not clear when this will be or how the language will read, but business valuers are concerned.

In 1990, Congress enacted Chapter 14 of the Internal Revenue Code, particularly sections 2703 and 2704, to prevent perceived abuses of the system. Section 2704(b), which deals with restrictions affecting the ability of a partnership or corporation to liquidate, is likely to be the focal point of the threatened regulations. It says that, if there is a transfer of an interest in a corporation or partnership to a member of the transferor's family and immediately before the transfer the transferor and his family have control of the entity, any "applicable restrictions" are disregarded when determining the value of the transferred interest.

In a 2001 technical advice memorandum (FSA 200143004), which discusses sections 2703 and 2704, the IRS's office of chief counsel explained how the agency might deploy the provisions in a gift tax matter. More on this issue is sure to follow and we will keep you apprised of any new developments.

Discovery Reveals Expert's Lack of Independence

***TWC I, L.L.C. v. Damos,* 2015 Iowa App. LEXIS 438 (May 20, 2015)**

It does not pay to fudge on an expert report. That's the message from a court in a state statutory appraisal action in which discovery evidence cast doubt on the expert's truthfulness and independence.

When a broker raised the possibility of a sale to two related construction companies that had run into dire financial straits as a result of the economic downturn, they agreed to the deal. The sale was deemed to be arm's length. But two minority stakeholders objected to the transaction, and one of them was the companies' former CFO, CEO and chairman.

The sale price was $75.01 per share, which the objector claimed did not represent the fair value of his shares. At trial, both parties offered expert testimony from CPAs who also were credentialed business valuators and who agreed that in this instance the net asset value approach was the preferred valuation methodology. But their differing treatment of the companies' accounts receivables and "backlog" resulted in a big value gap. Backlog referred to "future work that the [companies] had contracted to do but which had not yet been completed."

The objector's appraiser valued the accounts receivable at over $42 million and the backlog at about $16.5 million. His calculation yielded a per-share price of approximately $199. In contrast, the companies' expert valued the accounts receivable at a little over $18 million and the backlog at only $1.5 million, yielding a per-share price of $70.81- less than the sale price.

The trial court discredited the testimony from the objector's expert. It noted "clear errors" in the expert's report, which the companies' expert had corrected and it questioned the independence of the appraiser based on a letter from the appraiser to the objector and his counsel and the objector 's responses to discovery questions from the opposing side. This discovery evidence suggested that the appraiser used the client's valuation as a "starting and stopping point," the court said. Also, the expert failed to account for the obligations the company earlier had incurred in connection with substantial layoffs and which it could not meet at that time. The court pointed out that "such reporting is clearly required under all applicable standards for business value reporting." And the expert did not disclose or discuss the assumptions underlying his accounts receivable and backlog calculations.

The trial court adopted the company expert's valuation and the state Court of Appeals affirmed, finding the trial court gave detailed reasons why that valuation was more credible.

Nothing beats an expert's careful, honest work and knowledge of the applicable discovery rules. Here, the expert testimony self-destructed due to technical errors and claims that a skilled opposing attorney could easily prove to be flimsy.

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