VALUATION Trends

Trugman Valuation Associates, Inc.

WELCOME TO VALUATION TRENDS!

To our friends, colleagues and clients:

This is the first edition of our new newsletter. Although we have provided this by mail, we will be providing this newsletter by e-mail in the future. If you wish to continue receiving these newsletters, please send an e-mail to **info@trugmanvaluation.com** and put "newsletter" in the reference line. This way you will not miss out on future issues.

On a separate note, have you received our CD-Rom brochure? If not and you would like one, please send us an e-mail with the word "brochure" in the reference line.

Speaker's Bureau

Did you know that Gary and Linda Trugman are available to teach your firm about various business valuation topics? Please contact us if we can help train you or your staff.

We look forward to providing our valuation and litigation support services to you in the future.

IN THIS ISSUE

IPOs do not generally create liquidity opportunity—DLOM still valid for controlling interests

***The Willamette Management Associates Failed IPO Study: Does a DLOM Apply to Controlling Ownership Interests?*, Gregg S. Gaffen,** *Insights*, Autumn 2004, pp. 52-54.

Valuation analysts often overlook applying a discount for lack of marketability to controlling interests in a privately held firm. The IRS believes that this discount should not be applied, and many cite the reason that an owner with a controlling interest can pursue an IPO, which creates liquidity for the shares. To test this hypothesis, **Willamette Management Associates** conducted what they called the *Failed IPO Study*.

This study compares the number of companies that filed an IPO registration with the SEC to the number of companies that successfully completed their IPO. The study is based on quarterly stock market data from 1990 through 2002. The study also analyzes successfully completed IPOs in which the subject stock is no longer publicly traded.

The study was performed to gain insight into the likelihood of a privately held company successfully completing an IPO, and to determine if some level of DLOM should be applied to valuing controlling ownership blocks in a closely held company.

The results of the study show that, even once registration is completed and filed with the SEC, successful completion of an IPO is highly uncertain: many companies never make it through the registration process. The study also shows that, even if a firm successfully completed its IPO, it took an average of three months to achieve share liquidity after the IPO registration filing date.

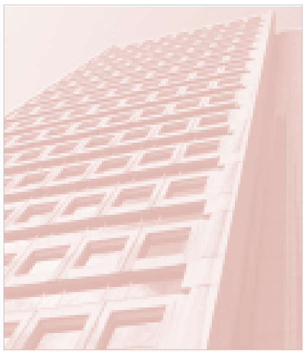
Furthermore, the investment banking fees related to the IPO are typically 7.5% of the initial market capitalization. In addition, other professional fees and costs were incurred during the IPO process. So, even successful owners who completed the IPO process can experience illiquidity from an uncertain IPO stock price, significant transaction costs, and a significant time lag to achieve amortization.

This information leads to the conclusion that controlling ownership interests in closely held companies should not be valued as if readily marketable.

Buy-sell agreement's terms dismissed, effect discounted

Estate of HA True v. Commissioner, 2004 U.S. App. LEXIS 24844 (10th Cir. December 2, 2004). *Judge Seymour*.

The issue in this tax case focused on the ability of the taxpayer's restrictive buy-sell agreement to reduce the value of the family business by its terms. The tax court ruled that it was unable to do so because the buy-sell agreements were not supported by full and adequate consideration and the agreements had testamentary inferences. However, the court held that the agreements were still enforceable and held that a marketability discount could be applied.



The True family conducted multiple businesses in the industries of oil, cattle and environmental clean-up. Although some of the enterprises were more successful than others, on average the True family was very successful. When the patriarch, H.A. True died, the buy-sell agreements were activated.

Buy-sell agreement

The court noted the terms of the buy-sell agreements:

> The agreements dictated that an owner or partner could not transfer or encumber his or her interests in the business, and each owner or his or her spouse had to work in the business. Failure to work in the business, any attempt to transfer an interest in the business, death, and disability were each treated as if the holder of the interest had notified the other owners of his or her intent to withdraw from ownership. Upon the occurrence of such an event, the other owners were required to purchase the departing owner's interests at a formula price listed in the buy-sell agreement.

In addition the True family used the tax book method of accounting and not GAAP. The Court of Appeals noted that although this was reasonable, it was not a proper method of valuing the business.

Holding and rationale

The IRS challenged the agreements at the tax court level and the court sided with the IRS. The Court of Appeals agreed, stating that:

> [T]he transactions at issue here were neither conducted at arm's length nor without donative or testamentary intent. We noted the lack of arm's length negotiations between the True family members when entering into the various buy-sellagreements, as well as the inferences properly drawn from those agreements: they served, in part, to fulfill Dave and Jean True's overall testamentary plan to pass the family business on to their sons. The tax court ddi not clearly err in finding that these transactions could not aptly be construed as occurring within the ordinary course of business.

Unopposed but incomplete evidence of value is not enough to support verdict

Montage v. Athle-Tech, 2004 Fla. App. LEXIS 14973 (October 13, 2004). *Judge Wallace*.

The issue in this damages case arose out of the breach of an agreement between **Athle-Tec** (plaintiff) and **Montage** (defendant) relating to the development, ownership and licensing of computer software. The breach, which was characterized as a failure to deliver source code, resulted in the complete destruction of the business. When a business is destroyed, the business damages equal the market value of the business, which, in this case, the jury valued at $2,909,562.50.

Valuation evidence

Athle-Tec proffered the testimony of **Steven Oscher.** Oscher testified that if one would use the "guideline company" approach, the 8.9 million net dollar offer to buy a related company would be a good indication as to the value of Athle-Tec. However it was brought out during his testimony that Oscher had not conducted a valuation of Athle-Tec because he was never engaged to do so.

Oscher then admitted on cross-examination that he was not expressing an opinion that the loss value of Athle-Tec was 8.9 million. It was noted in the court of appeals opinion that, "Oscher's testimony on the question of value was limited to identifying a comparable indicator of value. Oscher did not perform the remainder of the extensive analysis that would have been necessary to arrive at an appraisal of the value of Athle-Tech's business at the time it was destroyed." The defense did not offer any evidence as to the value of the business.

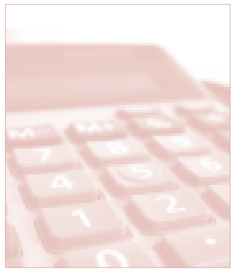
Holding and rationale

The court of appeals reversed the trial court and remanded the case because Athle-Tech failed to provide legally sufficient proof of the business damages awarded by the jury.

The court of appeals noted that, "Athle-Tech did not offer any other evidence directed to the value of its business, and the Defendants did not offer any evidence on this issue.Because neither Oscher nor any other witness testified to the value of Athle-Tech's business on the date of its destruction, Athle-Tech's proof at trial was insufficient to establish the amount of the loss it sustained on account of the destruction of its business."

Inadequate valuation report disregarded

May v. May, 2004 Minn. App. LEXIS 1206 (October 19, 2004). Judge Lansing.



The issue in this marital dissolution was the value of the couple's one-half interest in **Northern Bait**. The parties agreed to an appraiser, who concluded that the company had a going concern value of zero and that the fixtures and equipment were worth $6,000. Husband claimed the value of the fixtures and equipment was $8,140. Wife claimed they were worth $47,850.

Holding and rationale

The trial court valued the equipment at $25,000, and husband appealed its decision. The court of appeals affirmed the trial courts ruling. In its opinion the court of appeals held that:

> It found the appraisal was incomplete. Even David May's valuation is higher than that offered by the appraiser, suggesting an acknowledgment that the report is inaccurate. The [trial] court commented on the [valuation] report's departure from recognized appraisal processes, the limited amount of time the appraiser spent in the store, and the brevity of the appraiser's discussion with [husband].
>
> The court's explanation of its rationale presents a reasonable basis for doubting the report's credibility and selecting another value. In so doing, the court was free to choose a value within a reasonable range of values. A reasonable range, in this case, would be from the lowest estimate to the highest: between $ 6,000 and $47,850. The district court's valuation of $ 25,000 is well within this reasonable range and is not clearly erroneous.

Lack of reliable valuation ends in forfeit of issue

Skomaroske v. Skomaroske, 2004 Wisc. App. LEXIS 842 (October 21, 2004). Per Curiam.

In this marital dissolution, the issue was the value of the family business. The husband claimed that the trial court erred in adopting wife's expert's valuation, which concluded the value of the company to be $250,000. Husband argued that the family business had no value beyond its personal and real property, which was valued at $204,000.

The court of appeals affirmed the valuation portion of the decision, noting that although the valuation proffered by wife's expert may not have been perfect, husband offered no evidence of his own that could be shown to be any more reliable. Additionally, the court of appeals noted that on cross-examination, husband admitted that several years earlier the company was appraised at $236,000.

Enterprise goodwill, personal goodwill distinguished

Desalle v. Gentry, 2004 Ind. App. LEXIS 2297 (November 22, 2004). *Judge Riley*.

The valuation issue in this marital dissolution focused on the classification of the goodwill in the business. Husband and wife operated multiple toy show venues under the name **Desalle Promotions Inc.** Husband contended that all the goodwill in the business should have been classified as personal goodwill because he was well known in the industry, as opposed to wife, and thus should have been excluded from the marital estate and been immune from marital division.

Holding and rationale

The trial court determined that the goodwill was enterprise goodwill and divided the venues between the parties. The appellate court upheld the trial court's ruling, noting the distinction between the two types of goodwill:

> Enterprise goodwill is based on the intangible, but generally marketable, existence in a business of established relations with employees, customers and suppliers, and may include factors such as a business location, its name recognition and its business reputation…On the other hand, personal goodwill is goodwill that is based on the personal attributes of the individual.

Q&A

Q: How often do appraisals end up in some type of court proceeding if you have done your work well?

A: I don't think they show up in five percent of the cases. And the five percent that end up in court is because either we have a factual dispute, which is something beyond the ability of the appraisers to resolve, or more often than not, someone's just wrong and they've made a mistake somewhere along the line where the value difference is so many miles apart that they just can't be reconciled.

Gary Trugman, CPA/ABV, MCBA, ASA, MVS

Two-year restrictive contract disregarded

***Alpha v. Alpha*, 2004 Fla. App. LEXIS 16668 (November 5, 2004).** *Judge Sharp*.

The issue in this martial dissolution was the value of husband's **Allstate** insurance agency. Prior to the filing of the petition for dissolution, Allstate required husband to enter into an agreement that restricted for two years his ability to sell his business to the book of business he generated during those two years. After the contract lapsed, just prior to trial, husband could sell his entire book of business, subject to Allstate's approval of the buyer. Husband was also subject to a 90-day termination period in which he had to find a suitable buyer or face a small termination payout.

Valuation evidence

Both parties provided expert testimony during trial. Husband's expert testified that as of the date the petition for dissolution was filed, the book of business husband could sell was worth between $17,600 and $23,500, because the limiting contract was in effect. However, he testified that as of the date of trial it was worth between $209,400 and $279,000.

Wife's expert testified that he used a net income analysis in determining the value of the business, which he calculated at $220,000. Husband was making in excess of $100,000 a year. The expert noted that, "He did not consider the two-year contract with Allstate because, he explained, it was improper to base a valuation on contingencies that had not occurred." (The court of appeals noted in a footnote that, "Florida law holds otherwise.")

Holding and rationale

The trial court valued husband's insurance business at $200,000. The court of appeals upheld this determination, noting that the value arrived at by the trial court was:

> Close to the value arrived at by [husband's] expert had [husband's] expert disregarded the two-year contract that both created the possibility of selling his complete book of business and required a two-year waiting period.
>
> The trial court could also have properly discounted the values arrived at by [wife's] expert due to the limitations and difficulties [husband] testified about, even after the two-year period expired, that he would experience by having to sell his business to a buyer approved by Allstate, and that he would continue to remain subject to a ninety-day termination period, during which he would have to find such a buyer or suffer a small termination payout.