VALUATION Trends

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A New Guideline for Identifying Active vs. Passive Business Appreciation?

Recent state rulings in divorce cases have increasingly supported the concept that increased value of separate property resulting from spousal efforts (active appreciation) becomes the property of the marital partnership, whereas increased value attributable to other sources (passive appreciation) remains separate property. While laws vary state-by-state, the pressure is increasingly on the business owner in the marriage to "prove" claims of separate property.

Two important valuation tasks now must be performed when the closely held business needs to be valued in the course of a divorce action. The first is to identify the separate property component of the business, and the second is the more complex apportionment between active and passive appreciation. Several cases around the country have addressed this issue, but a defendable approach to passive vs. active appreciation has not been defined, and appellate courts have generally steered clear of laying down guidelines.

Mayhew v. Mayhew (197 W. Va. 290, 475 S.E.2d 382 (1996)) may offer a rare roadmap. First, the court suggested that expert testimony identifying the reason(s) for appreciation of particular business assets would be significant. Second, the court noted that it would be helpful to compare the performance of the business to that of other similar businesses during the period of analysis. Third, the court noted that an owning spouse's contribution to appreciation may not necessarily be in proportion to the size of the owner's interest; the role(s) of other shareholders and employees in the increase in business value must also be considered.

Our firm can provide the data and modeling to analyze the first two components of this valuation issue in ways that apply statistical techniques so that the analysis is replicable and meets Daubert standards.

Identifying the new "active" individual contribution of the divorcing spouse requires new methods, particularly as the business gets bigger. An analysis of corporate minutes, for example, may identify if the divorcing owner acted as a hands-on or hands-off manager. The proportion of junior management decisions vetoed by the owner spouse would be another indication of the active influence exercised by the divorcing spouse. Quantitative valuation analysis may also play an essential role in explaining the sources of increased business value.

Efforts to lock in value for buy-sell purposes often fail

The transaction price in a buy-sell agreement between the terminating and continuing shareholders needs to be clear, though no single approach addresses all situations. Despite the best of intentions, we've found that difficulties often arise. Whichever approach you use, our firm is available to review the likely issues—and resultant values—to "lock in" an understanding that minimizes the potential for subsequent conflict.

One of the best analyses of this contentious issue recently appeared in Business Valuation Review. In "Valuation Aspects of Shareholders' Buy-Sell Agreements," Richard Wise argues that "book value" may be inappropriate and unfair in determining a price. For example, a "book value," payment to the withdrawing shareholder may be substantially below a fair and reasonable amount because increases in the values of fixed and certain other assets and the existence of valuable intangibles generally will not be recognized in the calculation of book value.

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Using "adjusted book value" may be a potential way to avoid inequities.

If "fair market value" is the term used in the clause, then other issues should be considered, such as whether minority and/or marketability discounts apply. Other concerns that might arise without further instructions might be, "In the absence of specific instructions, does the valuator take into account the loss to the company of the terminating shareholder's future services?" and "How is corporate-owned life insurance to be treated when the company is the beneficiary?"

The date of calculation is another integral aspect of the valuation. Also, the question of whether the interim statement is to be audited (as well as who bears the cost) may need to be addressed.

There are various advantages and disadvantages of price-fixing mechanisms. When a fixed price is determined periodically, a current fair market value is maintained if the periodic setting of the price/value is adhered to, but if the parties do not routinely meet to establish an up-to-date price, the fixed price may no longer be relevant. This method also requires a fair amount of cost due to professional fees which are incurred on an annual or other periodic basis. If an independent third party determines the price/value as of the time that the specified event occurs, a current value will be provided. Using a formula approach is easy and is the least costly of any of the alternatives (as no outside professionals are retained), but is unrealistic and doesn't take into account many changes in the firm over time. Determining the price by an option's put-call arrangement may set a fair price, but it assumes that both parties have equal financial strength, and information about the company, and that the respective shareholdings are of similar size.

Report is inadmissible unless expert is certified, uses correct methodology, and does independent analysis

***In re Med Diversified, Inc.*, 2005 Bankr. LEXIS 2236 (Bankr. E.D.N.Y. November 14, 2005).** *Judge Bernstein.*

In a case of first impression in a bankruptcy adversary proceeding, the narrow issue was whether the proposed business valuation expert witness for Addus Healthcare, Inc. (Addus), was qualified and whether his purported expertise satisfied the standards of relevance and reliability under *Daubert v. Merrill Dow Pharmaceuticals, Inc.*, 509 U.S. 579, (1993).

Addus, the defendant in the case, called the expert to testify on the value of 100 percent of Addus's shares, as well as on the reasonably equivalent value of an alleged option payment of $7.5 million paid by Med Diversified, Inc. (Med D) for a 6 ½ month extension to close its purchase of these shares. Med D was insolvent at the time of the payment, and the bankruptcy trustee for Chartwell Litigation Trust (Chartwell), Med D's successor, was attempting to set aside the payment as a constructive fraudulent transfer.

Qualification and reliability of alleged valuator rejected

Chartwell filed a motion in limine to exclude all of the expert's testimony on the ground that he did not qualify as an expert on valuation of all of the shares of a privately held health care services company. This motion gave rise to the court's exercise of its gatekeeper function under Daubert, to "ensure that the courtroom door remains closed to junk science while admitting reliable expert testimony that will assist the trier of fact."

The expert had no peer-granted certifications or formal education as an expert on business valuations. His support staff was certified business valuators who provided input into the Expert Report, but those valuators were not available for cross-examination.

The court indicated it was not prepared to admit an Expert Report submitted by a corporate entity, saying that "the person who signs the report has to testify until the admission of his Report for all evidentiary purposes has been stipulated to." The court also indicated that it would not qualify the expert because

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he had neither sufficient experience in the field nor formal training or certification, even though he had worked for over twenty-plus years as an accountant and as a liquidating agent or bankruptcy trustee.

The court also found that even if the expert was found to be otherwise qualified, his testimony would still be inadmissible because he "showed a discernible measure of negligence in purportedly applying the alleged professional standards and techniques found in the published practical treatises, including the standards and techniques published in the writings of Dr. Shannon Pratt and his co-authors, which were repeatedly propounded by both the Defendants and the Plaintiffs." He based his analysis on inadequate data, conflated the discreetly different concepts of gross cash flow and net cash flow from operations, and failed to explain why the DCF method was excluded. If this wasn't enough, he did not independently analyze the data from the databases from which he derived his figures—"Mergerstat" and "Factset;" in choosing the comparable companies and transactions.

Failure to challenge distinction between personal and professional goodwill leads to affirmation for opposing valuation

***Geaccone v. Geaccone,* 2005 Tex. App. LEXIS 5857 (Tex. App. July 28, 2005).** *Judge Hanks.*

One of the issues in this marital dissolution was the value of husband's dental practice.

The wife's expert submitted a report indicating that the dental practice had an appraised market value of $433,000, and testified that his "values all excluded the issue of personal goodwill."

The husband's expert valued the dental practice between $19,000 and $47,000, depending on the accounts receivable, arguing that the opposing valuation "includes a substantial amount of goodwill, which in my understanding is not divisible [in] Texas."

The trial court concluded that the dental practice had a net value of $377,740. The court concluded that because the husband's expert had not challenged the opposing report at trial, and had not attempted to distinguish between personal and professional goodwill, it could not determine if there had been error. Therefore, the court held that because the wife's expert testified that his values all excluded the issue of personal goodwill, the trial court did not abuse its discretion in its valuation of the dental practice.

11th Circuit affirms that estate tax value cannot be set by changeable buy-sell agreement, but insurance proceeds used for buyout not included in value

***Estate of Blount v. Commissioner,* 428 F.3d 1338, 2005 U.S. App. LEXIS 23502 (11th Cir. October 31, 2005).** *Judge Birch.*

Blount owned 83.2 percent or 43,080 shares of Blount Construction Company (BCC). In 1981, prior to the formation of the BCC ESOP, he and the only other shareholder, entered into a shareholders' buy-sell agreement with BCC. The agreement restricted the transfer of stock during the lifetime of the shareholder and at death, and set the per-share purchase price as BCC's book value at fiscal yearend immediately preceding the deceased shareholder's death.

Then, in 1996, Blount as the only remaining shareholder entered into a new buy-sell agreement with BCC. The new agreement was operative only upon his death and set a fixed, lump-sum purchase price of $4 million. He signed the agreement in his individual capacity and on behalf of BCC as its president. Additionally, there was a life insurance policy owned by the company that provided about $3.1 million to pay off the mandated buy-out of the shares.

Tax Court decision

The Tax Court found that the 1996 buy-sell agreement was a modified version of the 1981 agreement, and ignored the agreement's set value because Blount had the unilateral ability to modify it, thus failing to satisfy the requirement that it be binding during life. The court also disregarded the agreement under IRC Section 2703, which requires that to be included in a valuation, a buy-sell agreement's terms must be "comparable to similar arrangements entered into by persons in an arm's length transaction." Here, the court concluded

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that the parties were "related" and had not engaged in arm's-length bargaining. The Tax Court included the full amount of the insurance proceeds as nonoperating assets, and also concluded that because the buy-sell agreement had been disregarded, the issue of whether BCC's obligation under that agreement to redeem decedent's stock should offset the proceeds was not before the court.

Holding and rationale

The Eleventh Circuit affirmed the Tax Court's decision that the buy-sell agreement could not set the value of BCC for estate tax purposes, but reversed on the inclusion of the insurance proceeds as nonoperating assets.

The appellate court determined that the exception to the rule that the value of the taxable estate generally is the fair market value of the decedent's property at the date of death, codified by the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, 104 Stat. 1388 (OBRA), was inapplicable because the stock-purchase agreement in this case was unilaterally changeable during Blount's lifetime, and thus violated the exception's requirement that the buy-sell agreement must be binding during the life of the decedent.

The court came to the same conclusion under the different theory that the agreement did not satisfy the exception's requirement that the buy-sell agreement must be comparable to similar arrangements entered into at arm's length, because it found that the Tax Court had not erred in its determination that the agreement had not been made at arm's length.

As to the insurance proceeds, the appellate court ruled that the Tax Court had erred because those proceeds had already been taken into account in the determination of net worth. The court noted that even when a buy-sell agreement is inoperative for purposes of establishing the value of the company for tax purposes, the agreement remains an enforceable liability against the valued company, if state law fixes such an obligation—which it had in this case. Here, the insurance proceeds were offset dollar-for-dollar by BCC's obligation to satisfy its contract with the decedent's estate. The court thus concluded that such nonoperating "assets" should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets.