VALUATION Trends

Trugman Valuation Associates, Inc.

www.trugmanvaluation.com

Spring 2008

Florida Court Considers Prohibiting Marketability Discounts in Divorce

Erp v. Erp, 2007 Fla. App. LEXIS 18726 (November 28, 2007)

In this case, the Florida Court of Appeals considered whether, as a matter of law, a discount for lack of marketability (DLOM) should not be applied when valuing a business for divorce purposes.

During the marriage the couple purchased an RV dealership, formed as a Subchapter S corporation, which they grew to a business that earned more than $1 million annually. Each spouse owned a 40% interest while their two children held the remaining shares equally. Prior to trial, the parties agreed that one of them should be awarded the entire 80% interest while the other spouse would receive an equalizing payment of one-half the fair market value of that interest.

Demonstrative exhibit makes impact

At trial, both parties' experts generally used an income-based approach to value the business. The wife's expert valued the business at $12.5 million and $5 million for her 40% share. By contrast, the husband's expert valued the business at $4.56 million and the wife's one-half share at only $720,000.

However, the husband's expert presented a "demonstrative exhibit" to the trial court, which presumed to detail the differences between the two appraisals. Of particular note was the expert's application of a 25% discount for lack of marketability (DLOM).

The trial court awarded the 80% interest in the business to the husband, with an equitable distribution to the wife. The court used parts of each expert's appraisal, and ultimately valued the business at $6.2 million. Further, it valued the wife's one-half interest at $2.48 million (or 40% of the total value of the corporation).

The trial court explained its determination by reference to the demonstrative exhibit, and applied the marketability discount, but at a reduced level of 10%. Among other issues, the wife appealed the application of a marketability discount.

Should DLOMs be precluded in divorce?

The wife argued that a marketability discount should be prohibited as a matter of law in a divorce valuation. She analogized the divorce context to that of an oppressed and/or dissenting shareholder. Because a court orders judicial "buyout" in those cases (as it does in divorce), and because local (Florida) law does not permit DLOM in the oppression context, the wife argued that the court should not be permitted to apply a marketability discount in this case.

The appellate court was not persuaded. Dissenting shareholder cases arise in the context of an "involuntary change in the fundamental corporate structure," it said. The appraisal remedy protects minority shareholders who are cashed out of their investment by precluding further reduction of their interests through marketability discounts. This situation is not present in the divorce context. "What is appropriate in the oppressed shareholder or minority appraisal rights cases may not necessarily be desirable in a judicial dissolution of a corporation or in an action for dissolution of marriage involving equitable distribution."

In this case, the wife was not the victim of majority shareholder oppression. The more proper analogy, the court reasoned, is to a judicial dissolution of the business based on shareholder deadlock, where a

Continued to next page...

IN THIS ISSUE

court has discretion to determine whether a marketability discount is appropriately applied to a closely held corporation.

Accordingly, the court declined to prohibit marketability discounts as a matter of law in divorce cases. Finding no abuse of discretion, it affirmed the trial court's application of a 10% DLOM.

In a World of Diverse BV Standards, Credentials and Competency are Critical

The lack of unified standards has become one of the most controversial—and critical—topics for the business valuation profession. As a result, BV litigation experts may be more susceptible to intense examination regarding compliance with the appropriate professional standard(s), an area they (and their attorneys) should be prepared to expect—and use to their advantage, when cross-examining an opponent's expert.

Standards from diverse sources

Many believe that professional standards for business valuation "began" with IRS Revenue Ruling 59-60. Issued in 1959 and applicable by law to federal estate and gift tax valuations, Rev. Ruling 59-60 still remains the seminal guidance on valuation of ownership interests in closely held businesses. Its influence carried over into the BV standards that began to appear in the 1980s and 1990s: first, with The Appraisal Foundation's issuance of the Unified Standards of Professional Appraisal Practice (USPAP) in 1987, followed by standards from the American Society of Appraisers (1992), the Institute of Business Appraisers (1993), and the National Association of Certified Valuation Analysts (1993).

More recently, this past summer the American Institute of Certified Public Accountants (AICPA) issued its Statement on Standards for Valuation Services No. 1 (SSVS 1). As a result, BV professional standards are currently dispersed among five different organizations, plus continued federal guidance. The U.S. Tax Court has recognized USPAP and so has Congress, in legislation such as the Financial Institution Reform, Recovery and Enforcement Act (1989) and the 2006 Pension Protection Act. In 2006, the IRS issued Notice 2006-96, which cited USPAP as a generally accepted appraisal standard.

Multiple standards feed multiple questions

The pressure to adhere to these emerging standards is currently impacting all BV professionals, irrespective of their accrediting organizations. Beginning in January 2008, for example, when SSVS 1 became effective, many of the AICPA's approximately 300,000 members became bound by the standards when they perform valuation-related engagements.

In the litigation arena, appraisers who hold multiple credentials can expect to hear questions such as: "Which standards are best?" and "Do they ever conflict?" To maintain their credibility, experts should be prepared to answer these questions as they relate to their credentials and also their competency—that is, whether the opinions set forth in their reports comply with the appropriate standards. By the same token, accredited BV experts can help guide attorneys in developing the same questions for cross-examining their opponent's expert, identifying areas where credentials or compliance may be lacking.

Must Experts Verify Client Financials in Calculating Economic Loss?

Tidwell Industries, Inc. v. Diversified Home Products, Inc., 2007 U.S. Dist. LEXIS 78227 (October 19, 2007)

In this case, a cabinet manufacturer and its distributor traded claims for breach of contract and economic damages as well as motions to exclude their respective experts.

The distributor offered a finance professor to calculate lost profits, including loss of customers resulting from the alleged breach. In assessing this expert's knowledge and experience under Rule 702 of the Federal Rules of Evidence, the U. S. District Court (W.D. Texas) found that his master's degree program included "courses relevant to corporate valuation—specifically, managerial accounting, accounting for financial decision making and financial management." Further, his doctorate program included advanced financial management courses and a seminar in corporate finance. The professor taught finance and corporate valuation, and prior to his teaching career, he served as a bank president.

Continued to next page...

The manufacturer argued that the expert's qualifications did not qualify him to present valuation testimony—in particular, the valuation of a cabinet distribution business. His prior appearances as a litigation expert consisted mostly of calculation of personal injury losses. Further, the expert relied on financial information prepared by the distributor, including a list of lost customers, but did not independently verify the financial information beyond interviewing the distributor's employees.

Reasonable reliance on third party financials

The district court acknowledged that the expert had never previously performed a valuation of a cabinet distributor. Nevertheless, his education qualified him in this case. Further:

'[I]t seems unreasonable to expect valuation experts to ascertain the accuracy of financial information provided by their clients. It seems reasonable for a business valuation expert to rely on information the client provides…in valuating a business's economic loss."

In essence, the manufacturer's Daubert motion sought to challenge the truthfulness of the distributor's allegations regarding the number of lost customers. Should the distributor be unable to establish those claims at trial, then "it would be appropriate" for the expert to adjust his valuation and his assumptions, the court stated.

Reliance on customer interviews hearsay?

The court also considered the claims by the manufacturer's rebuttal expert, that since he'd been able to interview all twelve of the alleged lost customers, the distributor's expert should have done the same. In response, the distributor argued that any customer interviews would introduce unreliable hearsay into the expert's report.

"Expert witness testimony is a widely recognized exception to the rule against hearsay testimony," the court said, in qualifying the rebuttal expert. His discussions with the customers would help the jury to better assess the accuracy of the distributor's lost profits analysis. The best evidence would be to produce the customers at trial, the court observed, but it found no basis for excluding either party's expert.

Does Fair Value of FLP Include Marketability and Minority Discounts?

Winn v. Winn Enterprises, Ltd., 2007 Ark. App. LEXIS 693 (October 10, 2007)

The Winn family limited partnership (FLP) managed 880 acres of timberland, which had been in the family for a century. The partnership agreement provided that upon withdrawal, a member was entitled to receive the interest's "fair value." When several minority members withdrew, they disputed the appraised value of the partnership as well as the application of discounts to their minority interests.

At trial, the partners presented a forester and certified general real estate appraiser, who valued the land and timber at $1.9 million. He did not apply discounts because they were not "part of the scope of his work." The partners also enlisted a certified business appraiser; he also had not been asked to apply a discount, nor did he believe one was appropriate.

The partnership retained a certified public accountant, who relied on a forester's appraisal of the timberland at just under $1.5 million to arrive at a total fair market value for the FLP of $1.63 million. Because he believed that it was "common" to apply discounts to minority partnership interests, he also applied a 30% discount for lack of control and a 15% discount for lack of marketability. Although he acknowledged that the partnership agreement called for applying "fair value," in this case the expert believed that the standard was the same as "fair market value." On cross-examination, he conceded that there could be circumstances—as in dissenting shareholder cases—where "fair value" could require a different valuation method.

Trial court applies discounts

The trial court found the partners' appraisal of the FLP assets more credible. It adopted the $1.9 million value as part of its overall valuation of the FLP, but then applied the discounts asserted by the partnership's expert—and the partners appealed.

Analogizing to federal and state law regarding "fair value" in the context of the dissenting shareholder cases, the partners argued that discounts were incompatible with their rights to recover their "complete

Continued to next page...

investment" in the partnership. If discounts apply, they said, the partnership would obtain their interests at a windfall simply because the partners had chosen to exercise their withdrawal rights.

The court of appeals agreed. Moreover, the applicable state partnership law (Arkansas) characterized withdrawing partners in a similar manner—and both statutes used the "fair value" terminology to specify the applicable valuation method. But neither statute defined "fair value," and though the partnership's expert tried to equate this with "fair market value," the appellate court disagreed. "Fair value is determined by ascertaining all assets and liabilities of the business and the intrinsic value of its stock rather than merely appraising its market value." In the case of dissenting shareholders or withdrawing partners "there is no sale on the open market; their situation is more akin to a forced sale."

Valuation Experts Required To Have Clear Credentials, Experience, and Methods

Rosvold v. LSM Systems Engineering, Inc., 2007 U.S. Dist. LEXIS 82061 (November 6, 2007)

A graduate degree from one of the top business schools in the country may not be enough to qualify an expert to testify in business valuation. To support his breach of contract claim, the plaintiff in this case proposed a well-educated business executive to testify regarding the value of a 6% corporate interest. In a pre-trial Daubert hearing, the U.S. District Court (E.D. Michigan) assessed the expert's level of "knowledge, skill, experience, training, or education" under Rule 702 of the Federal Rules of Evidence.

"Other than his personal experience of 'acquiring several companies' and having earned his…master's degree from the Wharton School of Business at the University of Pennsylvania…, [the expert's] resume fails to incorporate any professional experience in valuation analysis."

Further, the expert was not enrolled or active in any of the "recognized organizations or institutions that establish the standards or rules to which their members must adhere when preparing a business valuation." While not dispositive, the expert acknowledged that this was the first time he'd been asked to provide testimony in litigation. He also admitted that he had not written any articles or books relating to the challenged subject matter. More importantly, the methodology the expert used in his report was not clear, and the court excluded his testimony under Rule 702 for failing to be "the product of reliable principles and methods."

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