VALUATION Trends
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Two Taxpayer Victories Demonstrate Winning Facts for FLPs

As textbook examples of how to form, fund, and operate a family limited partnership (FLP)—sufficient to value various assets (including publicly traded securities, real estate, and restricted holdings) at substantial discounts for federal estate tax purposes—the Murphy and Black cases make excellent reading for attorneys and financial advisors alike.

Legitimate business purpose proves critical. The Murphy Oil Corp. grew from a small family-owned business into a $2 billion international conglomerate. During the 1990s, Mr. Murphy established an FLP with $89 million in company stock plus bank and real estate holdings. Importantly, this represented only half his net worth and he never mingled his personal assets with the FLP's. Overall, the father retained a 95% limited partnership interest in the FLP, with his two sons in charge of daily operations.

For five years, the FLP traded assets, managed employees, held regular meetings, and prepared regular statements. It made only two distributions, with appropriate adjustments to the partners' capital accounts. After the father died unexpectedly in 2002, the IRS cited over $34 million in tax deficiencies and the estate sued for a refund. In Murphy v. U.S., 2009 WL 3366099 (W.D. Ark.)(Oct. 2, 2009), the federal court found the FLP was created to:

- Pool and invest the family assets according to the father's philosophy;
- Pass management responsibility onto the next generation;
- Enable the father to gift interests in the FLP while the underlying assets stayed under central management;
- Educate the father's heirs about wealth acquisition, management, and preservation; and
- Protect the family assets from creditors, divorce, and dissipation by future generations.

Moreover, the FLP was an active, ongoing entity that respected partnership formalities. Based on these strong facts, the court concluded the FLP was established for legitimate and significant non-tax purposes, sufficient to exclude the value of its underlying assets from the father's gross estate per IRC Sec. 2036(a)(1)(bona fide sale exception for adequate consideration).

To value Mr. Murphy's 95% LP interest, the court considered the parties' credentialed experts, who took the net asset values of the underlying interests before applying Rule 144 and blockage discounts as well as minority and marketability discounts. Their results diverged widely, but in each instance the court found the taxpayer's expert to be more credible, largely because he considered specific qualitative factors, including the FLP's substantial cash balance and the relative holding period, risk, distribution policy, and transfer restrictions of its assets. After adopting all the estate's discounts, the court found the fair market value of the 95% Murphy LP interest to be $74.5 million—and ordered a complete tax refund.

Another winning story. Samuel Black worked his way up from peddling newspapers on the street to senior vice president and second largest shareholder of the Erie Indemnity Co., a national insurance company. To pool, protect, and prolong his family's wealth, Mr. Black formed an FLP in 1993, retaining a 1% general partnership interest with LP interests dispersed among his son and his grandsons' trusts, with substantial restrictions. He funded the FLP with Erie stock worth $80 million, which increased to $318 million over the next seven years. The partnership distributed 92% of Erie dividends, with appropriate adjustments to the partners' accounts, and the Blacks never dipped into the assets for their own expenses.

Mr. Black died in 2001 and Mrs. Black followed soon after. The IRS assessed deficiencies totaling over $83 million on their estate tax returns. The parties resolved all the valuation issues prior to trial, leaving only the

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Sec. 2036(a) issue; i.e., whether the stock transfers were bona fide, for a legitimate non-tax purpose. The taxpayer claimed the following in support:

- The FLP's net asset value increased dramatically through active investment according to Mr. Black's "buy and hold" philosophy;
- The transfer restrictions successfully prevented Mr. Black's son from dissipating his assets in divorce and his grandsons from reaching their stock, even when their trusts terminated; and
- The Black family's consolidated position allowed it to maintain a seat on the Erie board.

The taxpayer also cited Estate of Schutt v. Comm'r (T.C. Memo 2005), in which the Tax Court validated an FLP for its "unique circumstances"—primarily its pooling of assets according to the founder's investment philosophy, to preserve them against claims from creditors, divorcing spouses, and irresponsible heirs. The IRS tried to distinguish Schutt by claiming that Black's concerns for his Erie holdings was either "ill-founded" or insignificant. The court was persuaded by the precedent, however, and the similar "unique" facts of this case. Moreover, the FLP respected partnership formalities, including appropriate adjustments for contributions and distributions. Accordingly, the court held that the fair market value of Mr. Black's FLP interest, rather than the fair market value of the underlying Erie stock, was includable in his gross estate.

Checklist: Make Sure Your Expert Survives a Daubert Challenge

Why do experts get excluded from court? Lack of reliability is the leading cause under the Daubert standard, followed by lack of relevance and lack of qualifications, according to the most recent studies. Methodological flaws caused by the misuse of accepted financial and/or economic methods are also a frequent basis for denying financial expert testimony. And, of course, any new or untested approach will receive heightened scrutiny, under Daubert's by now familiar four-part test:

- Has the theory or technique been scientifically tested?
- Has the methodology been peer-reviewed and published in professional journals?
- Does it have a known error rate, with established standards to control its use?
- Is the methodology generally accepted by the relevant professional community?

Thirteen questions for your expert. Nearly 18 years after the U.S. Supreme Court's decision in Daubert (1993), only about half of the states apply the federal standard. The remaining apply the "general acceptance" test of Frye v. U.S. (D.C. Cir. 1923), or some hybrid or independent standard. Thus it's important for attorneys to know their local court rules, to understand how high they have set the admissibility hurdles for expert testimony. For those jurisdictions that apply Daubert or a similar standard, the following 13-point checklist will help you evaluate your financial experts prior to litigation. If the experts can't answer any one question to a satisfactory degree, perhaps they shouldn't be retained in the case.

1. Do you have the requisite background, training, and experience required to gain acceptance by a court if a Daubert hearing is held?
2. Is it realistic to expect that your testimony will be admissible?
3. Has anyone performed a review of your work to see if it appears reasonable?
4. Have you followed all relevant professional standards? These can include the standards promulgated by the American Society of Appraisers, the AICPA, The Appraisal Foundation (Uniform Standards of Professional Appraisal Practice), etc.
5. Have you used proven, commonly accepted valuation methodologies? Is the method generally endorsed by experts in the field? Can you cite relevant publications to support them?
6. If you apply an unusual or novel method, has it been peer-reviewed? If so, is there a basis on which the method would gain general acceptance in the BV professional community?
7. Does your work fit the case? Are your assumptions reasonable, given the underlying facts? (Attorneys: Make sure to clarify which facts will be admissible at trial.)
8. Is the underlying data reliable? Did you take reasonable steps to ensure the accuracy of the information before deriving your conclusions?
9. Have you considered alternative scenarios? This is especially critical in lost profits and economic damages cases, in which causation plays such a critical role.
10. Are your assumptions consistent with the facts?
11. How have you dealt with facts that are inconsistent with the ones you used?
12. Are you familiar with the relevant statutes and case law to assist in developing a damages or other economic theory?

13. Have you considered the track record of the relevant industry and the performance of comparable companies within that industry? Note: In the current economy, make sure your expert understands how the subject company and its comparables are faring.

Exit Planning Made Easy—With the Aid of a Good Business Appraiser

Credentialed business appraisers have a valuable but often overlooked function: to serve as financial facilitators for privately held and/or family-run companies that are contemplating succession. Exit planning typically involves dealing with the tough questions of estate planning, asset values, the age and health of current owners, and the passing of substantial management responsibility to the next generation—who may or may not be ready to take on such a heavy mantle (even if they do want the wealth).

A good succession planner consultant will tackle these sensitive issues up front—while the business is still running smoothly and everyone is in a good position to discuss the options and opportunities. By bringing the entire process to fruition, the business appraiser can help the family avoid personal and financial disasters in the future.

The critical questions. In particular, business succession brings together traditional M&A planning with "key" employee and family considerations, along with buy-sell agreements and related appraisals. Exit planning strategies begin with the broad question: What is the business worth? The discussion branches out into three typical alternatives, each with its own specific issues:

1. Sell the business. What are the possible profit motives and value enhancements? What are the potential tax strategies and consequences?
2. Sell to employees. Smaller, professional service companies have different concerns—and different layers of organizational and administrative experience—than larger operating companies.
3. Family transfer. Gift and estate tax strategies are implicated here; planning fundamentals include tax consequences, structured vehicles for gifting or transferring the assets; and potential valuation discounts.

In addition, business owners will face some version of the following questions as the process moves forward:

- What if the business has no significant value? This is a disappointing conclusion, but a SWOT analysis (strengths, weaknesses, opportunities, threats) can help identify value-creating areas and places for improvement.
- Asset or stock sale? Or does an installment sale make sense, to spread the tax consequences over time? For an operating business, would a SARS plan (stock appreciation rights) work? What about an ESOP? What about recapitalizing the business by issuing more stock and then redeeming the founding shareholders' equity?
- Internal transfer? If the owner wants to pass the business onto key employees, consider how they might structure a buy-in that will "incentivize" new partners while providing sufficient retirement for the owner/older partners, and how they might maximize retiring partners' return without burying the succeeding owners in debt.
- Family transfer? How can the owner pass the business to the next generation at the lowest possible transfer/tax costs? How do specific gifting plans and estate options work? What about installment sales of minority shares? How do minority/marketability discounts come into play?

All three tracks end, more or less, in a clear, carefully-crafted buy-sell agreement, for which an accredited business appraiser is ideally suited and indispensible. A buy-sell should balance a number of interests, including the continued viability of the business; the needs of the affected (departing) principals and their families; and the needs of the remaining principals. On balance, the paramount concern must be the continued economic viability and health of the enterprise. Appraisers quantification of value will support the best approach that ultimately works to the advantage of all parties and their financial counselors.

Possible pitfalls in succession plans. Like taxes, most business owners don't want to think about death or divorce or other painful issues. Similarly, they don't want to discuss the "death" of their own businesses. A good business succession planner will do everything possible to ease the owner's pain all the way through the process. This means permitting the owners to:

- Leave the company on their own terms and timetable and not as the result of external, unexpected pressures or sudden deadlines;
- Realize the full value of the business and all their hard-earned wealth, minimizing the impact of transfer and estate/gift taxes;

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- Retain control of the situation by entertaining a variety of exit options;
- Suffer the minimum of psychological stress and family conflict;
- Watch a lifetime of work come to a fulfilling, profitable finish; and
- Guarantee the continuity of the business.

Exit planning can be time consuming—and most owners are buried in day-to-day operations and management. The planning process can appear complex and costly. But a financial facilitator can help owners understand the tremendous return on investment that solid exit plans provide. Nothing feels better than bringing the entire organization and family together in a unified plan, and knowing that your business will keep bringing them rewards long into the future.

Delaware Chancery Rules on Attempt to "Freeze Out" 15% Shareholder

In re Sunbelt Beverage Corp., 2010 WL 92519 (Del. Ch.)(Jan. 5, 2010)(Unpub.)

The Delaware Chancery Court found the majority owners of a large, privately owned alcohol distributor (Sunbelt) authorized a merger to "freeze out" a 15% minority shareholder by using a process that was "anything but fair." A fairness opinion, obtained a week prior to the merger, was an "afterthought…pure window-dressing" to justify the majority's objective.

The majority tried to justify the buy-out price (approximately $46 per share) based on a stock repurchase agreement negotiated in 1994, the last transaction taking place in 1997—just weeks before the merger. But this overlooked the obvious: The formula pricing arrangement was more than three-years old by the time of the merger. The parties may have been sophisticated investors, but for reasons the court refused to speculate, they negotiated a price heavily dependent on book value, excluding goodwill and other intangibles. An expert for the minority shareholder also found the formula priced 12 comparable public companies at three times less than market value, the court emphasized. Thus it was no fair proxy for Sunbelt's value.

Under a comparable transactions approach, the minority expert valued the company at over $104 per share, but the selected deals differed too much in size, pricing terms, and geographic location. They also took place in a private, "tightly controlled market," the court said, refusing to accept "personality-driven" transactions. To compensate for these admitted shortcomings, the minority expert applied the median multiples, but the court wouldn't accept this "Goldilocks" approach to market value. It also rejected an asset valuation by the majority's expert ($42 per share), because a large alcohol distributor derived far less of its value from its physical assets.

Court confirms preference for Discount Cash Flow analysis. The majority's expert used a discounted cash flow (DCF) analysis to price the company at approximately $36 per share. Using essentially the same financial inputs, adjusted for alleged overstatements, the minority's expert calculated a $114 per-share value under a DCF. In particular, he applied a smaller size premium and declined to use any company-specific risk premium.

After a lengthy discussion of the "circular logic" inherent in the determination of a size premium, the court adopted the minority expert's number, because he relied more on the strict selection criteria in the Ibbotson's data source. It also rejected a company-specific risk premium, because the majority expert failed to supply "rigorous, quantitative" support. Interestingly, in a rare agreement between experts, the minority expert adjusted his value to account for the company's conversion to an S Corp following the merger, but this violated a fundamental principle of Delaware appraisal law, the court found, which precludes an oppressed shareholder from claiming any expectations or accomplishment of the merger.

The court ultimately adopted the minority's unadjusted DCF value of $114 per share. In so doing, it rejected the minority shareholder's alternative request for rescission and compensatory damages, asking the court to carve out approximately 15% of Sunbelt's distribution portfolios at the time of the merger. But this would involve another problematic valuation exercise, fraught with uncertainty. "Simply put, Sunbelt and its business portfolio are too complex to unscramble," the court said, in finding its statutory appraisal had fully and fairly compensated the minority shareholder for her holdings.

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