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VALUATION Trends
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Divorce Court Wrestles with 'Vague and Conflicting' Goodwill Testimony

***Hill v. Hill*, 2014 Tex. App. LEXIS 292 (Jan. 9, 2014)**

Goodwill in a professional partnership poses unique challenges for valuators and courts, especially in a divorce setting. In a recent Texas case, the issue came down to corporate goodwill. "Logic tells me there is some," the trial court said, "but it's probably impossible to quantify." The finding triggered an appeal.

The husband was a principal at KPMG, one of the Big Four accounting firms. A partnership agreement provided that a principal's sole interest in the firm was his required contribution to a capital account. In case of "separation," by which the agreement meant death, withdrawal, or retirement, the member would receive the balance of his capital account, excluding any amount he owed under a loan he took out to fund his interest in the firm. At year-end 2010, the amount in the husband's capital account was $715,000, and the loan amount was $700,900.

At trial, the wife argued that KPMG was a partnership, not a corporation, and that fair market value was the proper valuation. Under the applicable case law, if the asset is an interest in a partnership, any increases in the asset's value that accrue during the marriage may be a community asset, whereas increases in a corporation's net worth are not an asset of the community of each of the corporation's shareholders.

The wife's expert's report did not mention the agreement; it referred to tangible value but did not use the term "goodwill" or differentiate between commercial and professional goodwill. Under an excess earnings method, he determined that the husband owned a tenth of one percent partnership interest and that, of his $1.5 million average annual income, $700,000 was reasonable compensation and $800,000 was income attributable to the KPMG ownership interest. Applying a 33.3 percent capitalization rate, he concluded that the fair market value of the interest was $2.4 million. The buyer of the share would be someone with "the skill set to be able to step in and receive the salary plus the excess income," he explained.

The husband's expert acknowledged that a large professional practice might possess commercial goodwill but emphasized that "corporate governance" was critical to valuing interests in a firm such as KPMG. According to him, "the only way to obtain value for your partnership interest is to sell it back to the firm.... You get the capital account, you pay off the debt[,] and that's what you get." The husband's expert derived a value of $14,100, the value of the capital account, minus the loan against it.

"I don't find that the contract controls," the trial judge stated. At the same time, the court found only professional goodwill. Even if there was commercial goodwill and it could be quantified, the husband could only access it by remaining employed in the future, the court added. Perhaps, if the company were to

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liquidate in the future, "he might get some piece of the value." It emphasized that the wife's expert did not use the appropriate method to determine fair market value and concluded that the partnership interest was worth $14,000. After a thorough review of case law, the Court of Appeals affirmed, pointing to the "vague and conflicting" expert testimony as to the existence and availability of commercial goodwill.

DE Chancery Prefers Use of Merger Price to Determine Fair Value

Huff Fund Investment Partnership v. CKx, Inc., 2013 Del. Ch. LEXIS 262 (Oct. 31, 2013**)**

The Delaware Court of Chancery has historically shown a strong liking for the discounted cash flow (DCF) method in fair value determinations. However, in this case, the court expressly rejected the DCF method in favor of the actual merger price.

The case involved a merger and a group of dissenting shareholders who asked the court for a statutory appraisal of their interest. The target owned and managed "iconic" entertainment assets, including a business that owned rights to "American Idol" and "So You Think You Can Dance." A major issue for the company, and the case, was how to handle "the maturation" of the "American Idol" franchise. After the show peaked in the ratings in 2006, it declined for five seasons. Also, around the time of the merger, the contract between the company and the show's network distributor, Fox, was about to expire. The company had only limited leverage in the negotiations because Fox owned a perpetual license to renew its exclusive contract to broadcast the show. At the same time, company management believed that, with fewer shows available that had mass appeal, the value of "American Idol" was still going up, and therefore, the company might extract a higher license fee from Fox in the future.

Ultimately, the company signaled to the market that it was for sale. When potential buyers expressed an interest, management created five-year forecasts. The CFO instructed the preparer of the forecasts to assume that revenues under the to-be-negotiated "American Idol" contract would increase by some $20 million each year. Whether the additional $20 million per year was a "genuine prediction" of future revenues or merely a "marketing ploy" with which to generate a high bid became a pivotal question for the valuation experts that both sides retained. The eventual buyer paid $5.50 per share.

The petitioners' expert used a DCF analysis, as well as a guideline company analysis to appraise the stock. He concluded it was worth $11.02 per share. In contrast, the company's expert relied solely on the DCF method to compute a $4.41 value per share—$1.09 below the sales price. Much of the difference in value stemmed from the experts' use of different figures in their cash flow projections. The petitioners' expert wholly adopted the revenues appearing in the management forecasts, whereas the company's expert ignored the projected $20 million annual increase and instead assumed that Fox's fees would grow at 4 percent per year for five years. Neither treatment was reliable, the court found. When the merger took place, the future revenue streams related to "American Idol, "the company's primary asset, were "in a state of flux." Therefore, the court could have "little confidence in the reliability of using or excluding the estimated $20 million increase in revenues." For this reason, it found the DCF analysis was not the appropriate technique in this case. Instead, it looked to the actual merger price, which resulted from a sales process that was "thorough, effective, and free from any spectre of self-interest or disloyalty."

'Undue' Scrutiny of Expert's Data Triggers Erroneous Exclusion

Manpower, Inc. v. Ins. Co. of Pa., LLC, 2013 U.S. App. LEXIS 20959 (Oct. 16, 2013**)**

Under Daubert, district courts serve as gatekeepers to ensure that expert testimony is reliable before it is presented to a jury. But "reliable" with regard to what? Methodology? Data? This was the central question the 7th Circuit recently answered in reviewing a district court's decision to exclude the plaintiff's damages' expert based on his data selection.

A building collapse in 2006 damaged the plaintiff's Paris office. In addition to the property damage, the plaintiff was unable to conduct business, so it lost income. Its claims for insurance coverage triggered a dispute with the defendant insurer, which the

parties litigated in federal district court. The plaintiff's damages' expert calculated a business interruption loss of over €5.1 million. His determination followed the general procedure set down in the insurance policy, which included computing lost revenues minus non-continuous expenses and the method for estimating the various inputs. A policy provision required that in calculating net profit, "due consideration shall be given to the experience of the business before the date of damage or destruction and to the probable experience thereafter had no loss occurred." By comparing total revenues from the five-month period that preceded the collapse to total revenues generated in the same five-month period in 2005, the expert estimated a growth rate of 7.76 percent. Even though he had reviewed data going back to 2003, and the historical data indicated a downward trend, he decided to use a shorter period from which to extrapolate the rate based on company information that new management and policies had turned the business around by the end of 2005.

Ruling on the defendants' Daubert motion, the district court found his calculation unreliable. Although the expert had used an "appropriate and recognized method" to compute projected revenues, his "analysis [broke] down" when it came to his estimated growth rate, "one of the most important parts of the business-interruption calculation." He was not "an expert on business management," and his conversations with the company's managers were not a reliable basis for the revenue forecast. Had he selected a period that was not so short, the court "might have found his analysis reliable." The plaintiff asked the district court for reconsideration based on additional information on how the expert had developed the growth rate, but to no avail. In excluding the testimony, the court effectively nixed the plaintiff's business interruption claim.

The plaintiff was able to salvage its claim by appealing to the 7th Circuit. At the start of its analysis, the Court of Appeals noted that Daubert gives district courts considerable, but not unlimited, leeway to determine whether expert testimony is reliable. "Reliability, however, is primarily a question of the validity of the methodology employed by an expert, not the quality of the data used in applying the methodology or the conclusions produced." In other words, the jury, as the trier of fact, not the court, gets to decide whether the data underlying the expert's analysis is sound and whether the expert's conclusions are correct.

Here, after the district court found the expert's methodology was reliable, it should have stopped its analysis. Instead, it "drilled to a third level" to evaluate the quality of the data inputs the expert chose for his growth rate extrapolations. In so doing, it "unduly scrutinized" the quality of the data that the expert used for his model, the appellate court said. Therefore, it reversed and remanded for a fuller evaluation of the testimony.

Should Dated Buyout Set Value of Stock in Closely-Held Corporation?

***Hanusin v. Hanusin*, 2013 Ill. App. Unpub. LEXIS 2618 (Nov. 20, 2013)**

What's more relevant and reliable in terms of valuing an interest in a closely-held corporation: a 2004 stock purchase agreement or a 2012 settlement that four owners of the company made with a fifth partner to conclude litigation? This was a central question in a recent appeal from a divorce settlement.

In 2004, the husband and four colleagues bought a "manufacturer's rep" company from its owner under a stock purchase agreement ("SPA"). Four of the new owners, including the husband, acquired a 23 percent interest each; a fifth person bought the remaining 8 percent. The husband served as the company's president. Under the SPA, the former owner received 10 percent of the company's annual gross receipts for a 10-year period ending in January 2014. At the time of trial, the husband's share of past payments amounted to approximately $373,700. In 2012, four of the owners settled a lawsuit with the 8 percent owner, paying her $12,000 or $15,000 (there was conflicting testimony on the amount) in exchange for her surrendering her interest. The husband called the payment a "nuisance value."

As part of the divorce trial, the husband's expert declined to consider the price the shareholders paid under the 2004 SPA, arguing that the buyout had occurred years ago and did not factor in the effects of the 2008 recession. Instead, he relied in part on the

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amount the fifth shareholder received as part of the 2012 settlement; this arrangement, the expert said, represented an arm's-length transaction. He calculated the company's book value at $75,000 and its commission business at around $154,400. He applied a 35 percent discount for lack of control and marketability, a 25 percent discount to account for expiring client contracts and concluded that the husband's shares were worth approximately $19,000.

The wife's expert used a capitalization of excess earnings method. Because of a discovery dispute, she had no access to the company's principals or financial statements, and therefore, relied on a review of the last five years of the company's tax returns. She also considered the price per share resulting from the 2004 SPA. She applied a 28 percent discount for lack of marketability and concluded that the husband's shares were worth $324,000. The trial court found her calculations as to the total price paid under the SPA through the year 2012 "reasonable." But it adjusted her projections for 2013 and 2014; after applying several discounts, it arrived at a total value of nearly $275,000.

On appeal, the husband, citing an older case, argued that the trial court should not have considered the 2004 SPA because "[u]nlike land, which has a fairly stable value, the value of stock fluctuates freely with the operation of the business." The appeals court disagreed, noting that valuing a closely-held corporation was by nature subjective; any evidence of a sale involving a willing seller and willing buyer was, therefore, relevant when setting the value of its stock. On the other hand, relying on the 2012 litigation settlement was problematic because the payment resulting from it did not accompany "a purely voluntary transfer of the shares."

IRS Bars Appraisers for Five Years

In a press release issued on March 19, 2014, the Internal Revenue Service announced that it has reached a settlement with five appraisers. Under the agreement, the appraisers admitted to violating relevant sections of Circular 230 and agreed to a five-year suspension "of valuing façade easements and undertaking any appraisal services that could subject them to penalties under the Internal Revenue Code. For the full press release, go to www.irs.gov.

Is Your Business Worth as Much as You Think? Is Your Client's Business Worth as Much as He Thinks?

An interesting article in Forbes discusses privately-held companies and the difficulty of estimating their values. Pepperdine University surveyed investment bankers and business brokers and learned, among other things, that one in three of their engagements terminated without a deal closing. This generally happened because of the gap in pricing between the buyer and the seller. It is important that clients have reasonable expectations when conducting transactions and that often involves a third-party valuation expert who will not earn a commission as part of the deal. This valuation should be obtained prior to starting the transaction process to aid the client in setting reasonable expectations. Trugman Valuation Associates' professionals can assist with these types of assignments.

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