TRUGMAN Valuation

VALUATION Trends

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What Rationale for Net Book Value in Damages Analysis?

***Lane v. Lampkin*, 2014 Miss. App. LEXIS 497 (Sept. 16, 2014)**

How do you assess damages in a situation in which one of two equal shareholders died and the surviving partner feels compelled to open a new company that does the same work as the original company? A divided appeals court recently dealt with the issues of proper method of recovery and whether the trial court erred when it dismissed disagreement between the experts as just "getting bogged down in an argument over the terminology used to describe the valuation of [the company]."

Two men jointly owned land and decided to set up a business on it that bought and sold rocks. Each man owned a 50 percent interest in the company. One partner also owned a construction company that was one of the rock supplier's major clients. The rock business operated on a line of credit that both partners personally guaranteed and that was the primary source of funds for buying inventory. Ten years after the company's formation, in 2006, one partner died; his stock in the company and the land transferred to the estate. Meanwhile, the line of credit necessary to keep the business going was about to expire. When the surviving partner was unable to obtain a timely loan guarantee from the estate's executors, he set up a new company on the same property performing the same services as the subject company and selling to the same customers. He completed the subject company's contracts and paid its debts. He tried to keep profits attributable to the subject company separate from profits belonging to the new company.

He then asked the court for a judgment declaring that: (1) he had the right to invest in and operate his own rock-supplying business; (2) he had not breached a fiduciary duty to the subject; and (3) he had the authority to sell the subject's existing inventory, collect its accounts receivable, and use incoming money to pay the company's debts. The estate countersued, accusing the surviving partner of breach of fiduciary duty and usurpation of a business opportunity. It sought lost profits damages.

The trial court determined that the balance sheets showed the company was solvent, but it lacked "a substantial amount of equity with which to continue on with the business." Without credit, it was not likely to stay in business for very long. The court also found that the surviving partner had a duty to cooperate with the estate. He failed to give the estate adequate time and the financial information it needed to make a considered decision on the loan guarantee issue. Therefore, his argument that the estate's failure to renew the credit line relieved him of his fiduciary duty to the subject company lacked merit.

A separate trial took place for damages. Both sides presented experts, who disagreed as to the proper valuation method, prompting the trial court to say: "Whether you call it asset based or net book value or lost profits, this court is merely concerned with how and whether to value this business." The court's opinion does not describe the expert testimony in great detail, but it says that the court ultimately fashioned a remedy by taking parts of both experts' calculations and by reviewing the financial records of the two companies.

The court found that the company "was never all that profitable." It added that, if the court "were to carry its business assessment forward to the year 2012 based on the financial records of both companies, the court would merely be placing a net loss in the hands of the corporation." For equity's sake, it said, it would look to the subject's past performance to calculate lost profits after 2007. It first adopted the book value calculation that the surviving partner's expert offered to capture the value of the business as of the end of 2007. Specifically, the expert took the year-end net book values for 2006 and 2007 and backed out all expenses, all erroneously placed expenses personal to the surviving partner, and all accounts receivable from the partners. He then added in the value of the corporation's remaining assets—a front-end loader and a heating and cooling unit—and arrived at a total net book value of over $125,500.

In terms of lost profits, the court adopted the $21,000 average net income figure the estate's expert determined for the period 2000 to 2007. It decided to award lost profits for five years, 2008 through 2012, considering the acrimony between the parties and the likelihood that the business would not have continued for very long. Adding the total net income to the net book value yielded $230,100 in total damages owed to the subject company, the

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court decided. Because the estate was one of two shareholders of the company, it had a right to half of the total damages.

The court dismissed the estate's claim to one-half of the lease payments owed to the subject company since 2007. It credited the surviving partner's testimony that there had been no such payments in the past five years. Also, said the court, both partners were equally responsible for any lease payments and equally entitled to one-half of the proceeds. Therefore, the issue "creates a wash."

The court also rejected testimony from the estate's expert that the surviving partner had failed to account for nearly 650,000 tons of rock the subject company had bought and that this "diversion" caused lost profits to the subject company. There is no indication in the court's opinion that the expert quantified the loss "due to the circumvention of the accounting system." The surviving partner's expert admitted that the purchase of the rock did not appear in the subject's books. The court found the surviving partner and his expert adequately accounted for the whereabouts of the rock. This was a closely held corporation, it said, where on occasion rock was delivered to different places and billed to the surviving partner. This mode of doing business did not give rise to lost profits, the court said.

The estate appealed the trial court's damages calculation to the state Court of Appeals for several reasons. The essence of its argument was that the trial court erred by relying on the opposing expert's calculation. The latter performed a business valuation calculation when he should have used a lost profits analysis, the estate claimed. At the least, the expert's mistake should have prompted the trial court to defer to the estate expert's damages determination. At the most, the trial court should have excluded the erroneous opinion under the state's Rule 702.

The surviving partner contended that the trial court's calculation properly relied on parts of both experts' analyses and that it "fell within accepted methodologies to arrive at a reasonable calculation."

The appeals court sidestepped the issue of whether the trial court erroneously built its damages on the opposing expert's net book. Instead, it found that the trial court properly determined future lost profits for five years by looking to "historical lost net profits" and adopting the figure the estate's expert proposed. The methods the trial court used did not constitute an abuse of discretion, the appellate court said.

The estate also claimed the trial court's damages calculation "greatly underestimated" the lost profits by failing to consider unreported rock. That argument also had no traction. There was conflicting expert testimony on the issue, the appeals court said. The trial court had discretion to find in favor of the surviving partner's expert.

In an argument related to admissibility, the estate claimed there was another reason to exclude the opposing expert under the state's Rule of Evidence 702. On cross-examination, the expert admitted that his firm did tax work for the surviving partner and his businesses. This relationship represented a conflict of interest and compromised his objectivity in the case at issue, the estate maintained. It rendered his valuation opinion unreliable.

Once again, the appeals court disagreed. Rule 702 required that the expert be qualified and the testimony be relevant and reliable. Here, the expert had decades of experience as a business valuator. He was certified in financial forensics and had served as an expert in all types of accounting-related areas, including business valuations and lost profits calculations. There was no doubt that he was qualified. At the same time, at trial, the estate had an opportunity during voir dire and cross-examination to question the expert about his ability to provide an objective and independent opinion in the case. He said he could. The trial court was in the best position to assess the credibility of the expert witnesses, and it accepted the expert, the appeals court noted.

Four judges on the Court of Appeals disagreed with the majority's decision. They found that the trial court committed reversible error when it reduced the experts' arguments over the damages calculations to a matter of "just splitting hairs." In fact, the court's minority said, "[The experts] were testifying about detailed and important accounting terminology."

The law required the use of a lost profits analysis where there was a claim of breach of fiduciary duty, as well as where there was a claim of usurpation of a corporate opportunity, the dissent pointed out. There was no authority supporting the trial court's use of a business valuation analysis in this case. In fact, it was "illogical" to include a "net book value" calculation in a damages calculation, as the trial court did. In a dissolution case, a shareholder has a right to the distribution of the proceeds of the corporation's remaining assets, the minority explained. "'Net book value' is simply an accounting term that is not directly related to the actual value of the corporation's assets," it went on to say. "There is simply no case to support this conclusion," the dissent said, rejecting the trial court's damages analysis.

Ruling Reveals Delaware Chancery's Skepticism of Valuation Experts

***In re Dole Food Co.*, 2014 Del. Ch. LEXIS 258 (Dec. 9, 2014)**

The valuation opinions of non-experts can be a useful reality check on the opinions of bona fide valuation experts, says the Delaware Court of Chancery in a case that involves an increasingly popular technique known as "appraisal arbitrage." The court's finding applies to other cases involving valuation matters.

Two investment firms bought millions of shares in Dole stock as part of an "appraisal arbitrage" strategy. This technique involves acquiring stock in a company that's a takeover target. Then, the investors try to squeeze more money from the buyers by opposing the takeover and petitioning the court for a fair value appraisal. During discovery, Dole tried to obtain internal valuations from each of the petitioners that they had done of Dole prior to the litigation, as well as valuations done in connection with buying and selling stock and the appraisal action. The firms resisted production of the documents, arguing that the valuations were not the work of valuation experts, and therefore, were not admissible in court. Dole filed a motion to compel disclosure of all pre-litigation valuation-related information, even if laypeople had prepared it.

The court noted that under the discovery rules generally anything not privileged was discoverable as long as the material was relevant. Importantly, the relevant material need not be admissible but need only appear "reasonably calculated to lead to the discovery of admissible evidence." The court called this aspect "potential admissibility." Here, the firms soon realized that they could not claim the valuations Dole wanted were irrelevant. Instead, they argued that none of the material or testimony would result in admissible evidence. The pre-litigation valuations were opinions, not facts, and valuation in an appraisal action was "purely a matter for the experts." After all, many courts have talked about "the battle of the experts." Since the witnesses were not experts under Rule 702, they could only give lay opinions under Rule 701, but these did not fit into the narrow exceptions for the admissibility of lay opinions.

The court said the petitioners presented an "idealized depiction of valuation as a scientific process" when the "martial metaphor suggests the need to consider other evidence as a check on the warring experts' model." One piece of evidence was the contemporaneous view of financial professionals "who make investment decisions with real money." The firms' internal valuations represented "real-world" assessments by "astute" investors. As such, these value opinions may "be as or even more credible than the litigation-crafted opinions of valuation experts."

The witnesses in this case "likely" could qualify as experts, the court said. But, even if they were deemed lay witnesses, their opinions could come in under Rule 701 because the assessments would be helpful to "the determination of a fact in issue.

Goodwill Ownership Dominated 2014 Tax Court Valuation Cases

An issue that arose in several business valuation cases in 2014 was the ownership of goodwill or similar intangibles.

This is not a new issue, but the court has not spent much time on it since the 1998 *Martin Ice Cream Co.* case involving the shareholder of a company introducing Häagen-Dazs to New Jersey. When the corporation spun off its supermarket distribution rights to a subsidiary wholly owned by the company's sole shareholder, he transferred them to Häagen-Dazs along with the subsidiary's business records, customer records, and associated goodwill. The IRS argued that the ice cream company was liable for the gain from the sale of the subsidiary, but the court said the shareholder personally owned the customer relationships and distribution rights. The company could not distribute assets it did not own.

Fast-forward to 2014 and the *Adell* estate tax case. In valuing the decedent's 100 percent interest in a for-profit satellite company providing uplinking services to a nonprofit religious network the decedent's son had built, the court found that the IRS's expert significantly undervalued the pivotal role the son played in operating both companies, as well as the critical relationships he built with contributors to the religious network. The court said the son owned the goodwill and since he never transferred it by way of a noncompete, he could compete directly with the company.

However, the court ignores corporate law under which the son, as a director of the subject company, had a fiduciary duty of loyalty to the company, regardless of whether he had a contractual obligation to the company. A hypothetical buyer would have challenged the son from competing directly with the acquired company in state court. The IRS expert's valuation actually may have reflected the son's role more accurately.

Cavallaro was a gift tax case with a similar story line but a very different outcome. Here, too, a father built a successful business, along with his sons and achieved great financial success. Much of it was due to a machine the owners conceived together but built with the resources of the father's company. To facilitate a structured merger between the two companies that was to transfer most of the wealth to the younger generation with minimal tax consequences, tax advisors concocted a narrative in which the sons' company owned the technology prior to the merger. The IRS claimed the transfer was a huge gift, and the Tax Court, although highly sympathetic to the taxpayer, agreed.

This case was a clear win for the IRS. The service got its hands on very damning evidence related to the tax advisors. Perhaps counsel for the taxpayer should have emphasized the goodwill the younger generation created around the technology and machine. It was real.

Bross Trucking combined corporate income tax and gift tax issues. The father built a road construction empire that included a trucking company, which the taxpayer owned 100 percent. When it ran into serious trouble with regulators, father and sons decided to form a new company, ostensibly to ensure a clean regulatory slate. The IRS claimed the company had distributed an appreciated intangible asset to the taxpayer, who then transferred it to his sons and was liable for gift tax. The Tax Court disagreed. What the old company had was "the antithesis of goodwill." The family built a new company precisely to avoid losing customers.

Here, the court seems to ignore that the customer base was made up almost entirely of other family entities, all of which were linked to the road construction business. There were no arm's-length transactions and it is conceivable that indirect gifts were being made regularly under the contracts existing among the various business entities.

Court Chastens Expert Over 'Severely' Deficient Valuation

Wright v. Irish (Hudson Valley Clean Energy, Inc.), **2014 N.Y. Sup. Ct. Index No. 2111/2014 (Nov. 7, 2014)**

Sometimes courts face a difficult choice having to decide between equally compelling and competent valuations. Not so in a recent fair value proceeding in which the skills gap between the testifying experts made it easy for the court to pick the winner.

The petitioner and the respondent were the two owners of a New York company that installed solar energy panels on buildings. Business boomed, and the company enjoyed an 80 percent market share until competition increased, cutting that share to 11 percent. Also, there was uncertainty over the fate of federal and state tax incentives offered to users of the panels.

The owners began to argue over the direction of the business. The respondent submitted a strategic growth plan to the board of directors that proposed expanding into new markets. The board approved it over the petitioner's objection, who then filed for dissolution of the company. The respondent opted for a buyout of the petitioner's shares. Both sides presented expert testimony about the fair value of the petitioner's interest.

Both valuation analysts calculated the value under the income and market approaches but used different methodologies. Under the income approach, the petitioner's expert performed a discounted cash flow ("DCF") analysis. He used the five-year projections the management board had approved but applied a company-specific risk premium to account for "forecast risk." At the end of the forecast period, he reduced the growth rates during the remainder of the 10-year discrete forecast to inflationary growth in the terminal value.

He studied the company's financials and corporate structure and assessed the recently adopted business growth plan. He also researched the industry and found that New York State had extended the tax credits through 2016 and had started another program to incentivize consumers to install the panels. Greentech Media, a leading source of news and analysis of green technology, forecast 60 percent annual growth in the industry over the next three years. Also, the company's 2013 revenues exceeded that of the previous year by 35 percent. The final value, weighting results from the income and market approaches, was $3.8 million.

The respondent's expert, on the other hand, used the capitalization of weighted earnings method. The court noted that this approach assumes that a company has long-term stable cash flow but that the expert conceded that the company's cash flows and earnings were not consistent during the preceding four years. He also said that the DCF was his preferred method. The court discredited his valuation. It pointed to multiple flaws, including the expert's failure to include either a growth rate or management projections.

He was unaware of the board's growth strategy plan and did not know that the board had decided to reinvest dividends in the company to stimulate growth. According to the court, he "severely underestimated even his client's own projections." The court's verdict regarding the respondent expert's market-based analysis was even harsher. It had "severe deficiencies" that prevented calculating a credible fair value for the company, the court said. Except for a slight adjustment for the marketability discount, the court adopted the petitioner expert's $3.8 million value.

The prevailing expert said that the judge really responded to his industry research and knowledge of details crucial to the case: the federal tax credits and the New York State-specific initiatives. He noted that in court he discovered there was an unnecessary EBITDA adjustment in his market-based analysis due to a misunderstanding on the client's part regarding the financial statements. What saved the opinion, he says, was his immediately admitting the erroneous adjustment and his being able to redo his conclusions, calculator in hand, on the stand. It was important to provide the court with a revised, conclusive answer, he says, rather than leaving the valuation with a huge question mark and an opening for attack from the opposing counsel.

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