www.trugmanvaluation.com

VALUATION Trends

Trugman Valuation Associates, Inc.

Going concern premise is the way to value interest of wrongfully departing minority partner where business continues to term

***Anastos v. Sable*, 2004 Mass. LEXIS 813 (December 22, 2004).** *Judge Spina.*

William Anastos, a partner in a real estate firm, sought dissolution of the partnership in contravention of the partnership agreement. Under Massachusetts law, the two other partners could elect to continue the partnership business and pay the Anastos the value of his one-third minority share.

Valuation evidence

The trial judge determined the value of the plaintiff's partnership interest using a methodology appropriate to evaluate a minority interest in a going concern. The judge found that, as of the date of dissolution, the value of the net assets of the partnership was $2,494,005. The judge determined, however, that because the partnership was a going concern, the value of the plaintiff's one-third minority interest was not necessarily equal to one-third of the liquidation value.

The judge found that Anastos lacked control over the financial, operational, and management decisions of the partnership, and that his interest was illiquid. She further found that there was no ready market for the purchase of a minority interest in a general partnership whose primary asset is real estate where the partnership agreement contains limitations and restrictions on the control that can be exercised by any minority owner. These factors led to the conclusion that, in this case, the value of the one-third partnership interest was less than the value of one-third of the partnership's net assets.

Based on expert testimony of comparable sales of general partnership interests and the literature regarding the appropriate discount to apply to determine the value of the plaintiff's minority interest, the judge concluded the appropriate minority discount was 40 percent of the value of the net assets of the partnership—she ultimately determined that Anastos's interest in the partnership had a value of $500,000.

Holding and rationale

On appeal at the Massachusetts Supreme Court, Anastos alleged error, claiming that valuation of his interest had to be based on the liquidation value of the partnership's assets. This raised an issue of first impression for the court as to which valuation method was proper where a departing partner wrongfully breaches the partnership agreement, but the remaining partners elect to continue the partnership business: going concern premise or liquidation premise.

The court concluded that the proper valuation method under such circumstances should be the going concern premise. The governing statute provided that if the business continued, the departing partner's interest should not include goodwill. The court reasoned that the statute's exclusion of goodwill from the valuation of the wrongfully dissolving partner's interest supported its position, since goodwill is an asset only if the partnership business is a going concern. If the law had intended the liquidation premise to be used, it would not have needed to mention goodwill. Moreover, the court found that using the liquidation premise in such a situation would result in the application of liquidation valuation analysis in all situations, regardless of whether the partnership business continued or not.

Accordingly, the court found no error in the trial court's determination that valuation should be based on the illiquid going concern value of the former partner's share, not on liquidation value, which would have been much higher.

IN THIS ISSUE

Nebraska Supreme Court allows goodwill as an asset in a professional corporation

Detter v. Miracle Hills, 2005 Neb. LEXIS 28 (January 21, 2004). Judge Hendry.

One issue in this corporate dissolution case was the inclusion of goodwill in the value of the corporation. Detter and Schreiber formed **Miracle Hills Animal Hospital** (MHAH) in 1991. As the result of personal and business conflicts with Schreiber, Detter filed suit to dissolve MHAH in 1999.

Valuation evidence

Both parties presented expert testimony in support of their position. **Cynthia Wutchiett, CPA,** testified for Detter. She concluded that the value of MHAH was $182,082, a value that included goodwill. Wutchiett noted that a doctor leaving a veterinary practice can expect to retain only 30 to 40 percent of his or her clients, even with aggressive advertising. The court noted that Wutchiett specialized in veterinary practice valuation and was well qualified to value MHAH.

Ronald Nebbia, testifying for Schreiber, disagreed with Wutchiett's inclusion of goodwill in the value of the corporation. Nebbia stated that, "in a professional practice of this nature, goodwill primarily rests with the provider and not the practice." Nebbia valued the practice at $35,912.

Holding and rationale

The trial court concluded that "Wutchiett used an incorrect valuation method when valuing MHAH and that … goodwill was not to be added to the value of a professional corporation like MHAH." The court reasoned that any goodwill was personal and, therefore, concurred with Nebbia's valuation.

The appeals court noted that this was a case of first impression for Nebraska and turned to other states for guidance. The court of appeals relied on case law from Texas and Wyoming in its conclusion that goodwill should not be included as an asset. The court of appeals affirmed the trial court's valuation of the corporation.

The Supreme Court of Nebraska reversed the appeals court and stated that the existence of professional goodwill as a distributable asset was a question of fact and not of law. The court remanded the case for a determination as to whether enough evidence was presented at trial to establish the "salability or marketability of goodwill as a business asset and, if so, to determine that value."

Chancery court charts own course in appraisal action

Gholl v. eMachines, Inc., 2004 Del Ch. LEXIS 171 (November 24, 2004). Judge Parsons.

The issue in this appraisal action was the value of the shares of **eMachines Inc.**, a company that provided low-cost computer goods to consumers. Charles and Michelle Gholl, owners of 339,000 shares, brought this appraisal action. Other shareholders, who combined owned 1,005,600 shares, also exercised their appraisal rights for the fair value of their shares.

Like many technology-based companies, eMachines went public in March of 2000 in a successful IPO, with the stock set at $9 a share. eMachines' business model was modified to gain revenue from initiating Internet-based consumer relationships. As a result of this change, the company sold its computer hardware for cost or less than cost. This Internet-based revenue model was later labeled a "financial disaster" by eMachines. By late 2000, eMachine stock was trading below $.50 a share.

As a result of this downturn in business, eMachines recruited new management that implemented a turnaround strategy. Despite the changes that were being made, eMachines was delisted from the NASDAQ and began being traded on the Over-the-Counter (OTC) Bulletin Board market.

The new business plan proved successful in turning the fortunes of the company around. Wayne Inouye, the new CEO, declared in an October 2004 conference call that he didn't "understand why the stock is not at least a $2 stock." In April 2001, the board of directors considered the possibility of a sale of the company. To this end, they retained the services of **Credit Suisse First Boston** (CSFB). CSFB contacted 55 potential buyers and received some indications of interest ranging from $.71 a share to $.83 a share. The company rejected the offers as inadequate and never disclosed the offers publicly.

In October 2001, John Hui, a member of eMachines' board of directors, tendered an offer at $.71 a share. This began a bidding war, which concluded with Hui's offer of $1.06 per share, which was the high bid submitted to the board just prior to the November 18, 2001 deadline.

CSFB prepared a fairness opinion concerning the offer and determined it was fair. The board unanimously approved the merger and recommend it to the shareholders. Hui commenced the tender offer on November 27, and by December 27 controlled 87 percent of the shares. Hui then exercised a "top-up" option that allowed him to purchase additional shares from the company giving him the 90 percent he needed in order to complete a short-form merger, which was completed on December 31, 2001.

CSFB's fairness opinion

CSFB stated in its written report to the board that it thought the final offer was financially fair. In its valuation of the company, CSFB used several valuation methods including two discounted cash flow models. The first DCF was based on management projections, submitted in November of 2001 for 2002, and resulted in a value range of $1.41 to $2.22 per share. This method was termed "Management Case" by the court. The second DCF analysis was termed "Sensitivity Case" and was based on "much gloomier predictions" resulting in a value range of $.91 to $1.20. Although CSFB never stated which method it relied on in its opinion, the court assumed that it was based on the Sensitivity Case projections.

Shareholder's expert's valuation

Daniel Larson, ASA, testified as the expert for the Gholls. Larson used both a DCF analysis and a market analysis. Based on the 2002 budget Larson weighted the methods 75%/ 25%, respectively. His valuation resulted in a value of $2.48 per share.

Company's expert's valuation

Gregg Jarrell, a professor of economics and finance, testified as the expert for the company. In his valuation, Jarrell first used a DCF analysis using the Management Case projections and arrived at a value range of $.93 to $1.03 per share. Then Jarrell used the 2002 budget, just as the shareholder's expert did, and arrived at a range of $1.00 to $1.22 per share. Jarrell conducted two market-based analyses, but because he did not rely on them for his report, the court considered them only as a "reality check."

Court's valuation

The court, after deciding that neither party had met their burden of persuasion, conducted its own valuation of the company as of the merger date. The court agreed with both experts on methodology and used the DCF method. The court then applied a weighted average cost of capital (WACC) rate of 18.5 percent. The court used a growth rate of 5 percent and calculated the company had $162.5 million in excess cash. These figures resulted in a valuation of $1.62 per share.

Court rejects DCF and uses comparable public company method

Doft & Co. v. Travelocity.com Inc., 2004 Del. Ch. LEXIS 75 (May 20, 2004). Judge Lamb.

A minority shareholder of **Travelocity.com Inc.** (Travelocity) brought a dissenting shareholder action contesting the $28 per share it received in a short-form merger of Travelocity and seeking a determination of the fair value of its shares.

William H. Purcell was the shareholder's expert, and **Paul A. Gompers** was the expert for Travelocity. Both experts used essentially the same methods to value Travelocity's stock; i.e., a discounted cash flow (DCF) analysis and a comparable company analysis. In performing their comparable company analyses, both Purcell and Gompers used Expedia—one of Travelocity's main competitors—as the single comparable company. Despite the similar approaches taken, the results arrived at by the experts varied widely. Gompers' DCF analysis returned a value between $11.38 and $21.29 per share. Purcell's DCF yielded a value between $33.70 and $59.95 as of the merger date. The two experts' comparable company analyses also yielded significantly divergent results because they disagreed about the appropriate discount to apply to reflect Travelocity's competitive disadvantages.

Court rejects DCF, finding unreliable inputs

The Delaware Chancery court, quoting that "methods of valuation, including a discounted cash flow analysis, are only as good as the inputs to the model," found that the most fundamental input used by the experts—the projections of future revenues, expenses and cash flows contained in management's five-year plan—"were not shown to be reasonably reliable."

The court criticized Gompers's selective use of management projections, and observed that its conclusion that no one was

continued on next page...

able to produce a reliable set of long-range projections for Travelocity was reinforced by the fact that "Gompers's DCF produced values ranging from $11.38 to $21.29 relative to a squeeze-out merger in which Travelocity's 70 percent parent agreed to pay $28 per share to acquire the minority interest."

Court relies on comparable company method

Having rejected the DCF method, the court turned to the comparable company method. Both experts used Expedia as the single comparable company in their analyses, but disagreed on the appropriate discount to be applied to the multiples derived from their analyses of Expedia.

The court agreed that Expedia was clearly comparable to Travelocity. Gompers argued for a 40 percent discount, whereas Purcell argued for a 10 percent discount. After considering numerous factors, the court concluded that a 35 percent discount to the valuation multiples was appropriate, to reflect the competitive obstacles Travelocity faced. The court used EBITDA and price-to-earnings multiples, and applied a 30 percent control premium. After conducting its comparable company analysis, the court determined that the fair value of the dissenter's shares was $32.76 per share.

Court finds fraudulently operated companies difficult to value

In re Marriage of Thompson, 2005 Iowa App. LEXIS 24 (January 13, 2005). Judge Hecht.

In this marital dissolution, one issue was the value of the multiple companies owned by husband. Expert testimony placed the value of the assets of these companies between $142,080 and $213,120. Husband was incarcerated for over a year on drug charges. The court stated that because of the fraudulent way in which the companies were run, it was difficult to determine their value.

The court noted that, "the assets of [the companies] are byzantine, deceptive and almost impossible to get a firm handle on." The court went on to say, "The companies inflict more fraud and financial injury on those who come into contact with them than they do good." Ultimately, the trial court determined that there was nothing to divide in terms of value in the marital estate. The court of appeals affirmed.