VALUATION Trends

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Working with Appraisers in Valuing the Small Business

Valuing the very small company can often be more challenging than valuing a large firm or corporation. These types of valuations most commonly arise in divorce cases, although they also are frequently present in shareholder litigation, partnership dissolutions, and similar disputes. Often, client budgetary restrictions are an overriding consideration. However, attorneys and appraisers can work together from the outset of an engagement to meet client budgets and provide credible valuation. Here are a few areas where communication and cooperation can be the most helpful.

- Valuation standards. Just like attorneys, accredited valuation specialists are bound by standards of professional conduct. However, none of those standards distinguish between a valuation for a small business (and perhaps small budget) and a larger business. Once engaged, appraisers often find themselves caught between performing a complete and credible valuation, complying with the applicable standard(s), and keeping the job within a client's budget. In litigation settings, most appraisers expect to be cross-examined on whether they adhered to the proper standards. If not, a lack of client funds will be no defense, and the appraiser's credibility as well as the client's case could suffer.
- Managing expectations. Proper client screening is just as important in the valuation as in the legal context. Appraisers can help retaining attorneys inform the client why the appraisal is necessary, its potential costs and the benefits that will inure to the case. Clients—especially in a divorce setting—will often suffer from misplaced expectations or assumptions. These clients need to receive the proper information and guidance from their professionals as to the scope of the valuation engagement, its process and the problems it can solve—as well as those it can't, including creating value in a business when in reality there may not be as much as the client anticipated or hoped. These clients may end up dissatisfied, often transferring their displeasure to an unwillingness to pay professional fees—or worse, filing a grievance or malpractice claim.
- Discovery and access to records. Few things can drive up litigation costs and conflict faster than trying to compel another party to comply with applicable disclosure and discovery rules. At the same time, the other side may be genuinely frustrated by receiving an overly broad and generic discovery request. Appraisers can work with attorneys and the client from the outset of the case to narrow and tailor the scope of production, so that the experts will receive all of the documents they need—and none of what they don't. Documenting clear, successive requests for production to the opposing party will also help in the event a motion to compel or an interim motion for fees becomes necessary.
- Professional protection. Communication and documentation are likewise critical to ensuring that both the attorneys and appraisers meet the appropriate standards of care when valuing a very small business—with perhaps a small client budget to go with it. There are rarely any shortcuts in a valuation procedure that pay off in

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terms of case outcome or client satisfaction. By documenting every action and notifying each other whenever problems or roadblocks may arise, attorneys and the experts will help maintain their own credibility as well as their client and referral sources.

IRS Proposes Writing Kohler Out of the Law

Last March the Internal Revenue Service announced its decision not to acquiesce in the Tax Court's ruling in Kohler v. Commissioner. (See the Action on Decision published in the Internal Revenue Bulletin, 2008-9, March 3, 2008.) A brief footnote elaborated:

Nonacquiescence relating to whether I.R.C. section 2032 allows a discount for transfer restrictions and a purchase option imposed on closely-held corporate stock pursuant to a post-death tax-free reorganization in determining the fair market value of the decedent's stock on the alternate valuation date.

Section 2032 generally permits an estate to elect an alternate valuation date, six months after the date of a decedent's death. If the overall value of the estate has decreased during that time, the estate can reduce its tax burden. The IRS expanded on its decision in April, when it published new rules in the Federal Register that would permit estates to elect the alternate valuation date (per §2032(a) and Form 706) only when market conditions and not "other post death events" have reduced the gross value of the estate. (For the complete proposed regulations, see http://edocket.access.gpo.gov/2008/pdf/E8-9025.pdf.)

Congress enacted the predecessor to Section 2032 after the Depression, when market values decreased so materially from the date of death to the date of distribution that at times, "many estates were almost obliterated by the necessity of paying a tax," the IRS says. Since then, two cases have interpreted the provision differently. In 1972, a federal district court in California excluded any reduction in an estate's value that resulted from the trustee's "voluntary acts." But in 2006, the Kohler decision permitted the Tax Court to consider a post-death reorganization of the company that resulted in discounts (due to transfer restrictions) on the value of the estate's stock holdings. To resolve the apparent conflict, the IRS now seeks to amend Section 2032(f) so that only "market conditions" will make the alternate valuation date available:

The term market conditions is defined as events outside of the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued. Changes in value due to mere lapse of time or to other post-death events other than market conditions will be ignored in determining the value of decedent's gross estate under the alternate valuation method.

Would the Kohler outcome be any different?

The Tax Court found several legitimate reasons for the Kohler Company's reorganization, including removing outside shareholders and keeping the longstanding private company within family control. The estate—which owned 12.5% of the voting stock, "could not have blocked or approved the reorganization on its own," the court said. Nor did it have the power to change management, the board of directors, or the company's articles of incorporation. While the Tax Court did not specifically find that the reorganization was a corporate event—if it was beyond the estate's control, then would the market value of the estate's shares necessarily reflect the resulting transfer restrictions, no matter the valuation date? For example, the date of death value would reflect the expectation that the reorganization would take place, while the alternate valuation date, six months later, would reflect the actual restructuring.

Until this matter is resolved definitively, however, attorneys can expect continued debate—and litigation—regarding what comprise market conditions and how these forces affect valuation during the alternate valuation period.

Owner Testimony as to Lost Profit Inadmissible

In Autoforge, Inc. v. American Axle & Manufacturing, Inc., No. 02-01265, 2008 U.S. Dist. LEXIS 755 (W.D. Pa. Jan. 4, 2008), the U.S. District Court for the Western District of Pennsylvania

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considered whether a business owner may testify as a lay witness under Fed. R .Evid. 701 to the business' lost profits where the business expert witness on the same issue was excluded under Fed. R. Evid. 702 and Daubert. In 2000, Autoforge contracted with American Axle & Manufacturing, Inc. ("AAM") to deliver a quantity of specially produced auto parts. Autoforge sent AAM a quantity of the parts to test, but the contract was never fulfilled. In 2001, Autoforge ceased operating. It brought suit against AAM in 2002 and sought lost profits for breach of contract to deliver specially manufactured goods without a resale value.

In earlier motion practice, the court excluded Autoforge's expert witness. The court concluded that the expert witness' damages calculation was speculative. Autoforge then listed its president and sole shareholder as a lay witness to give evidence as to Autoforge's lost profits. The president assessed the amount of the lost profit from the contract between 2000 and 2002. He projected the revenues that would have been earned in those years and multiplied it by a 35% profit margin to arrive at the lost profits. In calculating the profit margin, the president relied on his memory of the costs during the relevant period as well as research of certain other costs. AAM moved to exclude the testimony of lost profits as determined by the expert as not within the purview of Fed. R. Evid. 701.

The district court noted that Fed. R. Evid. 701 provides that a witness may give lay opinion testimony so long as it is rationally based on his perception, helpful to the court, and not expert witness testimony within the scope of Fed. R. Evid. 702. Further, it noted that the business owner and officers may give opinion testimony as to the business' value or its lost profits provided that the witness establishes a proper foundation. The court restated the test as "a lay damages witness may offer a damages report only if he has personal knowledge of the components and materials of the report; and either (1) he helped to prepare the report based on personal knowledge; or (2) the contents of the report are admissible themselves."

The court here concluded that the president could give evidence on lost profits provided proper foundation was satisfied. Unfortunately, the court found that the president lacked personal knowledge of the market prices of several cost components. It found that the market price of steel, electricity, and scrap metal were not within the personal knowledge of the president and his research was not independently admissible. It stated, "This general knowledge of the steel and electricity markets by an outsider such as [the president] is not sufficient to offer his lay opinion as to a proper estimate of market prices for steel or electricity over the period in question." It further stated, "Without actual market price data for the period in question, properly admitted before this court, [the president] cannot offer a lay opinion of an estimation of the market prices of steel and electricity which are critical to his formulation of lost profits damages." Further, it noted that where the cost factors were the same in the excluded expert's report as in the president's opinion and did not appear in the business' income statements, the president could not testify to those cost estimates. Therefore, the court concluded that the opinion was admissible in part and inadmissible in part. However, it nevertheless excluded the owner's opinion under Fed.R. Evid. 403, which allows the court to exclude relevant evidence where it could confuse the issues, mislead the jury, or is unfairly prejudicial.

Lack of Independent Business Valuation Affects Viability of Fraud Claims

Lusins v. Cohen, 2008 WL 662717 (New York) (March 13, 2008)

Clients who opt to save money in the short-term by foregoing a formal business valuation in connection with buy-sell agreements could eventually add considerable cost to any attendant dispute—including claims against the business' attorneys.

Parties initially agree on minimum value

At the time of his death, the decedent was a partner in multiple medical business entities with another physician. The partners had a buy-sell agreement providing that should one of them die, the succeeding partner would be entitled to purchase the deceased's partner's share for no less than $500,000. After receiving information concerning the business' financial condition from their attorney, their CPA, and the succeeding partner, as well as advice from the estate's attorney, the deceased's daughter—acting as executor of the estate—agreed to sell her father's share for $500,000.

Shortly thereafter, a family friend and CPA informed

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the widow that the value of her husband's interest in the entities "far exceeded" $500,000, and that their financial condition had been "misrepresented." She subsequently sued her husband's former partner, the entities' attorney and their CPA for fraud, negligent representation, and breach of fiduciary duty, and requested an accounting. The trial court dismissed all of the plaintiff's claims except for the accounting request, and she appealed.

Appraisal could have uncovered value

At trial, the estate's attorney testified that the defendants had provided all requested financial and legal documents, and that he, in turn, had sought advice from decedent's CPA, who was "intimately familiar" with the business entities and could assist in their valuation. After reviewing the documents, the CPA believed that "the estate would not be able to establish a valuation greater than $500,000." Significantly, the CPA did not convey any information that conflicted with the defendants'.

More importantly, before the estate accepted the $500,000 payment, the widow could have compelled an independent valuation of the entities, discovering their "true nature" and underlying condition. But because she declined to do so, the widow could not have justifiably relied on any alleged deception by the defendants, and the appellate court upheld the dismissal of the claims against them.