Summer 2012

VALUATION Trends
Trugman Valuation Associates, Inc.

www.trugmanvaluation.com

Are We Still Confused About Goodwill?

Courts across the U.S. still struggle to determine and divide goodwill in divorce cases—particularly in those jurisdictions that follow the majority rule and require making a distinction between personal goodwill (nondivisible) and enterprise goodwill (divisible). "Or is it the valuator who is confused?" was a question posed at the recent AICPA/AAML National Conference on Divorce in Las Vegas.

For example, some appraisers practice in states like New Jersey, which does not recognize the distinction. In those states, "It's all divisible, but one practitioner insists that with respect to a highly skilled professional, there is no goodwill: It's all personal." Other states' courts have agreed, relying on an inverse argument. For example, in a Missouri decision, the husband claimed he was a key employee in his seven-man roofing business, but the court declined to reduce its value by any personal goodwill, finding the husband didn't provide the highly skilled professional services that would qualify.

Some courts have determined that all professional goodwill must be salable to be divisible, as evidenced by a noncompete; still others preclude the appraiser from assuming the presence of a noncompete. Notably, in *Gaskill v. Robbins* (2009), the Kentucky Supreme Court held:

> *While fair market value of [the wife's practice] anticipates what a willing buyer would give a willing seller, the fictional sale must be viewed as a "fire sale," meaning that it must be valued in its existing state. This precludes factoring in a nonexistent non-compete clause, as there is no requirement that [the wife] enter into one other than as a possible negotiated term of a real sale.*

The *Gaskill* court also required that any goodwill value "must" have a rational basis in accounting principles and "should avoid speculation and assumptions as much as possible." This language is a "little disconcerting." BV appraisers have to make assumptions, particularly regarding goodwill. "But courts don't like it," a presenter added, noting that *Gaskill* is a "must read" case, no matter where you practice. In fact, this year the case came up again after another trip through the courts, and the appeals court affirmed the previous decisions.

Daubert Challenges to Financial Experts Fall to a Record Low, but Success Rate Climbs to Six-year High, Says Annual PwC Study

Gossiping among attorneys can be the "kiss of death" for any financial expert says an attorney who presented at the AICPA/AAML biennial gathering in Vegas this spring. Attorneys will talk about the exclusion and by the end of the day, that expert will be off of everyone's referral list.

Continued on next page...

IN THIS ISSUE

- Are We Still Confused About Goodwill?
- *Daubert* Challenges to Financial Experts Fall to a Record Low, but Success Rate Climbs to Six-year High, Says Annual PwC Study
- Well-Planned FLP Survives IRS Challenge
- 'Laborious' Buy-Sell Agreement Leads to Lengthy Litigation

Over 11,000 challenges in 2011. Last year marked the 12th anniversary of the U.S. Supreme Court's *Kumho Tire* decision, which expanded *Daubert's* reach to financial experts and their opinion evidence. In 2011, alone, there were 11,262 cases citing *Daubert* or *Kumho Tire*, according to this year's *Daubert Challenges to Financial Experts* by PricewaterhouseCoopers.

Highlights of the current report include:

- The number of challenges to financial experts rose every year from 2001 to 2009, but then declined between 2010 and 2011 by a total of 40%.
- The percentage of successful challenges has varied widely over the past 12 years, with a low of 29% in 2002 and a high of 59% in 2005. In 2011, 54% of all challenges to financial experts were successful in excluding their testimony in whole or in part, or well above the 12-year average of 45%.
- In 2011 70% of all challenges targeted the plaintiff's expert. Over the same time, however, just about the same number of experts from both sides were excluded, 46% for plaintiffs' side and 48% for defendants'.
- Challenges to economists, accountants, and appraisers are still the most frequent, last year accounting for 57% of all challenges to financial experts. Notably, accountants and appraisers were excluded much more frequently in 2011 (64% and 70%, respectively) compared with their 12-year average (51% and 46%).
- Breach of contract actions saw the most *Daubert* challenges during the past 12 years, but once challenged, a higher percentage of fraud and IP experts were excluded (53% and 52%, respectively) than contract experts (44%) and a broad class of "others" (46%).
- For the 12th consecutive year, lack of reliability was the top reason that courts excluded financial experts (7 out of 10 cases), most often due to the lack of valid data or analytical framework for the data. In 2011, alone, lack of reliability was the reason for 76% of the exclusions.

Well-Planned FLP Survives IRS Challenge

***Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (March 19, 2012)**

It's hard to imagine a better set of facts supporting the formation, funding, and operation of a family limited partnership (FLP), yet the IRS still took issue. In 1990, a widow inherited her husband's quarry business plus additional real property and stock. Shortly thereafter, she executed a will leaving many of the specific assets to her three grown children, dividing the residual equally among them.

Some years later, when their mother was suffering from Alzheimer's, the three children (who all managed the family businesses in various capacities) agreed to divide their mother's estate equally and petitioned the probate court to become her co-guardians.

Three FLPs plus a corporate GP. An estate attorney advised the creation of three FLPs, one for the benefit of each grown child, plus a corporation to serve as general partner (GP) for all three. Each FLP would receive equal assets, while the mother would retain over $1.1 million in a separate guardianship account for her living expenses.

The corporate GP would also receive a "reasonable management" fee for its services, thus ensuring that the mother (who would own all the stock in the corporation) would receive "adequate income to cover [her] probable expenses for support, care, and maintenance for the remainder of [her] lifetime." Finally, they noted that the plan should reduce estate taxes by nearly $3 million.

The probate court approved the plan in June 2003. In December 2003, the mother transferred equal values of stock and other property to the FLPs. Over the next three years, she gave partnership interests to the three children, with appropriate entries to her capital accounts. During the same time, the children maintained the properties and the accounts. They also met regularly as officers and directors of the corporate GP.

In 2005, the mother died. Her federal estate tax return reported her remaining ownership interests in the FLPs as well as her full (100%) ownership of the corporate GP. Three years later, the IRS assessed a deficiency of just over $2.2 million based on its determination that the full fair market value of the FLP assets should be included in the decedent's estate pursuant to IRC Sec. 2036(a). In response, her estate argued that the decedent's transfer of assets met the "bona fide sale" exception to Sec. 2036(a) because she had "legitimate and significant nontax reasons" for creating the FLPs and because she received partnership interests proportionate to the value of the transferred property.

Estate (but not tax) planning is paramount. The facts substantially supported the mother's position: including the mother's clear and primary concern to distribute her estate equally among her children; her legitimate concern about the management of the assets, which was undertaken by her children; and that she received appropriate partnership interests in the FLPs. Although the probate court petition mentions estate tax planning, the court held that "there is no evidence that tax savings motivated the defendant." Thus the value of the FLP transfers fell within the bona fide sale exception to Sec. 2036(a).

The facts substantially supported the mother's position...

As a second argument, the IRS claimed the parties had an implied agreement that the decedent would continue to enjoy the income from the FLPs during her lifetime. The court rejected this argument, too.

The decedent had a bona fide purpose for creating the FLPs, and she had a bona fide purpose for creating the corporation to manage them. She also appropriately reported the full value of the corporation on her estate tax return. Based on all these facts, the court excluded the value of the FLPs from the decedent's gross estate.

'Laborious' Buy-Sell Agreement Leads to Lengthy Litigation

***Dimaria v. Goor*, 2012 U.S. Dist. LEXIS 21457 (Feb. 21, 2012)**

Twenty years ago, the co-owners of a commercial transport business entered into a stock agreement to ensure the continuity of the closely held company. If one of them died, the agreement gave the company the right to buy all of the decedent's stock. If the company declined its option, then the surviving shareholder was obligated to purchase the decedent's stock, which his estate was equally obligated to sell.

Determination of the death price. The agreement provided that the surviving shareholder would pay a price equal to the "total value" of the company divided by the number of shares. This value would be determined in one of two ways: If the two shareholders had executed a "Certificate of Agreed Value" within two years of the date of death, then that value would control the purchase price. If not, then the defined "value" would equal the amount stated on the most recent Certificate of Agreed Value, which stated "plus (or minus) an amount which reflects the increase (or decrease) in the net worth of the corporation from the date of the most recent Certificate of Agreed Value to the end of the month immediately preceding the decedent's death, as determined by the certified public accountant regularly employed by the corporation, applying generally accepted accounting principles."

At the time the co-owners executed the stock agreement (1992), they also executed a Certificate of Agreed Value for the company of $2 million.

In 2006, one of the shareholders died. After inheriting his 50% interest, his wife demanded $1 million for her shares. The surviving shareholder refused, asserting that by then, the business was merely a "payroll company" and was worthless. The wife sued the surviving shareholder for a variety of claims. The court eventually found that

Continued on next page...

the company was obligated to repurchase the decedent shareholder's interest. The defendant moved for summary judgment, accepting his repurchase obligation but claiming the company was worth nothing.

In support, the defendant provided testimony from the company's CPA, who said that the "actual equity" of the company as of the valuation date (the shareholder's death) was –$5,800—in effect, a zero value. At the same time, the CPA did not attempt to determine the net worth of the company as of 1992 (the date of the last Certificate of Agreed Value) or calculate the amount by which this net value might have increased (or decreased) between 1992 and 2006.

The plaintiff cited several objections. First, she said the shareholders' agreement empowered the CPA to determine the change in the company's net, but that the ultimate determination of its value must be made in accordance with the formula set forth in the repurchase provisions. Her CPA expert criticized the defendant's accountant for failing to properly apply GAAP, which does not equate "value" with "net worth" or mandate the application of book value. Instead, GAAP defines "value" as the amount of money something is worth, he said.

Complex contract is controlling. After considering both sides, the federal district court (E.D. N.Y.) held that the "plain language" and intent of the shareholders' agreement foreclosed the defendant's argument.

The defendant's reasoning also inverted the "complex" formula contained in the buyout clause, the court said. The contract clearly envisioned the "value" to be the dependent variable, calculated by inputting the most recent agreed-upon value ($2 million, in this case) and the change in net worth since that time.

Although the court conceded that it could not, from the face of the agreement, determine which particular valuation method the parties intended to use, "I can determine that the parties did not intend to use the 'book value' methodology." Instead, the court found that, under the contract, the company's CPA must calculate the change in its net worth between 1992 and the valuation date: "He may not simply assume that the net worth was $2 million."

Indeed, there was evidence that the company's book value was not equal to $2 million in 1992, but that the agreed-upon certificate simply reflected the value of the life insurance policies that the shareholders had purchased to fund any future forced repurchase obligation. Because the company's net worth may have been substantially less than $2 million in 1992, the court said, subtracting the change in net worth between 1992 and 2006 from $2 million could produce a positive value, "even if its 2006 net worth was a deficit." For these reasons, it denied the defendants' motion and ordered the parties to conduct a valuation of the company that complied with the court's interpretation of the buyout clause.

Trugman Valuation
ASSOCIATES, INC.
Call (800) 330 - VALU to request a free CD-ROM brochure
or visit our Website at:
www.trugmanvaluation.com

Florida: 1776 N Pine Island Rd, Suite 314
Plantation, FL 33322
Phone: (954) 424-4343

New Jersey: 2001 Rte 46, Suite 310
Parsippany, NJ 07054
Phone: (973) 983-9790

©2012. No part of this newsletter may be reproduced or redistributed without the express written permission of the copyright holder. Although the information in this newsletter is believed to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal or consulting advice.