TRUGMAN Valuation
VALUATION Trends
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May Court Disregard Shareholder Agreement in Judicial Buyout?

Piche v. Braaten, *2014 Minn. App. Unpub. LEXIS 92 (Feb. 3, 2014)*

In a shareholder dispute, the district court ordered the majority owners to buy out the minority owner for a price and in a manner that deviated from the parties' stock purchase agreement and also from the expert testimony at trial. The majority stockholders appealed the buyout order and the court's valuation.

In 2006, 10 years after joining one of the eight companies that made up a closely- held corporation, an employee became a shareholder when he signed a stock purchase agreement. It did not specifically discuss the transfer of shares in the event of a court-ordered buyout, but it contained a clause discussing what would happen if there was a "triggering event." The term included death, divorce, and bankruptcy of a shareholder. The three majority shareholders would pay the minority stockholder $8,333 per month until they had repaid the full purchase price of $1.5 million. Under the agreement, the shareholders also were to revise the purchase price annually. By the time an irremediable dispute between the majority and minority shareholders broke out, resulting from the minority shareholder's problematic workplace conduct, he owned a 22 percent share in the corporation. In 2010, the majority owners terminated his employment and subsequently froze him out as a shareholder.

The minority owner sued, claiming he was wrongfully terminated as an employee and the majority shareholders acted in an "unfairly prejudicial" manner toward him as an owner of the company. The majority shareholders countersued, arguing that he breached the non-compete provision of his employment contract and his fiduciary duties to them as a shareholder.

No comparables. During trial, it became clear that the parties had never revalued the minority owner's shares. Therefore, both sides offered expert testimony as to the stock's fair value as of December 31, 2010. Both experts used a market approach, but were unable to find guideline companies. The minority owner's expert said his interest was worth approximately $2.2 million, whereas the majority owners' expert valued it at $1.3 million.

One of the majority owners testified that the $8,333-per-month payment stated in the contract was based on an agreement among the shareholders to make a lower monthly payment to ensure the financial solvency of the corporation in case there was a stock sale.

The district court found that there was no wrongful termination but that the majority shareholders acted improperly toward the minority owner as a shareholder. It concluded that relations among the parties were irreparable and ordered a buyout. It dismissed the agreement's price and the experts' valuations as "unreasonable." The terms of the agreement did not apply, the district court said, because it did not contemplate a judicial buyout as a triggering event. The court ordered the majority owners to pay the minority owner a lump sum of $1.6 million, instead of making monthly payments, finding that their companies had a net value of more than

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$7 million and likely could obtain financing to ensure the corporation continued to be solvent.

The majority shareholders appealed, contesting the district court's buyout order and its valuation. The court should have abided by the terms and price of the stock purchase agreement, they contended.

The appellate court affirmed the buyout "given the acrimonious history among the parties." Had the status quo continued, there would have been endless litigation, it said. It also agreed with the district court's $1.6 million valuation, but found that the district court erred when it disregarded the agreement's providing for monthly payments, since this provision reflected the shareholders' concerns and reasonable expectations. Therefore, the Court of Appeals ordered the majority shareholders to make monthly payments of $9,005, $672 more than the agreement had stated to cover the valuation increase, in accordance with the agreement's 15-year formula.

Murky Goodwill Testimony Makes Partner Agreement Best Indicator of Value

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

What happens to the commercial goodwill of a big accounting firm when a principal gets divorced? In a recent Texas appeals case, the wife accused the trial court of failing to account for commercial goodwill in valuing the subject interest by relying on a partnership agreement that did not address compensation under a divorce scenario.

Shortly after getting married in 2008, the husband joined KPMG as a Class B principal. A 2008 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.

KPMG's 2008 offer letter stated that compensation depended on satisfactory performance, that is, meeting "mutually agreed upon goals." It went on to say: "If you cease to be a member of KPMG, you will be entitled only to the compensation that has been earned and accrued through the date you cease to be a member of the firm."

'Incomplete and nonstandard' valuation?' The parties retained experts to value the husband's interest. In an August 2011 "letter," the wife's expert explained: "This Letter does not constitute a valuation report as defined by the Uniform Standards of Professional Appraisal Practices" and said that his submission was not a complete valuation report. He acknowledged that his calculation did not mention the partnership agreement, and, while it referred to tangible value, it did not discuss goodwill or distinguish between commercial and personal goodwill. He also ignored language in the offer letter as to the conditions applying if the husband were to end his employment at the firm. Further, he did not speak to the husband.

He essentially performed an excess earnings analysis. He determined that the husband owned approximately a tenth of one percent partnership interest in KPMG. A comparison of the husband's position with similar positions led him to conclude that reasonable compensation amounted to no more than $700,000; therefore, $800,000 of the husband's $1.5 million average income was attributable to his KPMG ownership interest. Applying a cap rate of around 33.3 percent, he determined the fair market value of the interest was $2.4 million. Because the $800,000 was excess income, he said, "it requires a higher rate of return than, say, normal income-based salary and so forth." The market for the husband's share was "a specific type of buyer that would have the skill set to be able to step in and receive the salary plus the excess income." Also, since the valuation covered a single period and not a discounted cash flow period "out a number of years," he did not adjust for present value.

The husband's expert acknowledged that a large professional practice might possess commercial goodwill "when the firm is marketed and operated as a collection of individuals as opposed to a group of individual practices." In this type of practice, owners usually hold a minority interest, he said; when one of them leaves, it "is generally not devastating to the entirety of the firm." He emphasized that "corporate governance" was critical to valuing interests in a firm such as KPMG. He decided to base his valuation

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on the partnership agreement and the offer letter. 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.” Here, the interest was valued at $14,100, the value of the capital account, minus the loan against it.

He also critiqued the report that the wife’s expert had submitted. For one, it was “incomplete and nonstandard.” It also contained errors, he said. For example, the expert determined that the interest was a minority interest but failed to apply the standard discounts for lack of marketability or lack of control. The competing valuation basically came down to normalizing compensation, the husband’s expert believed. But “you don’t make normalizing adjustments when you are appraising a minority interest because the owner of the minority interest has no power to enforce those types of normalizing adjustments.” He also contended that the wife’s expert overstated value by applying “the typical 33% cost of capital applicable to post tax benefit streams to [the husband’s] pretax benefit streams.” Finally, the wife’s expert failed to take into account the outstanding debt against the partnership interest and the offer letter, which indicated that compensation was performance-driven.

‘Impossible to access.’ Texas is a community property state, and the community’s interest in the value of a spouse’s interest in an entity depends on the form the entity takes. Generally speaking, 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.

Against this background, in her closing argument, the wife claimed that KPMG was a partnership, not a corporation, and fair market value was the applicable standard of value. In contrast, the husband characterized the interest as a “set of contractual rights defined and limited by the agreement.” Those rights were not salable, transferable, or assignable, he reminded the court.

“I don’t find that the contract controls,” the trial court stated at the outset of its analysis of the valuation issue. At the same time, the court only found professional goodwill, even though “[l]ogic tells me there is some [commercial goodwill].” Also, “it’s probably impossible to quantify.” Most importantly, even if there was a way to assign a value to commercial goodwill, the husband could only access it by remaining employed in the future. Perhaps, the court added, if the company went out of business in the future, “he might get some piece of the value.” Prior case law required valuing the partnership as a going concern, which neither of the experts did, the court emphasized. Assuming that is done, the court would consider other facts, including partnership goodwill, in determining the value of the interest at issue. In light of the evidence in front of it, it concluded that the husband’s interest was worth $14,000.

It denied the wife’s motion for reconsideration, emphasizing that the wife’s expert did not use the appropriate method to determine fair market value.

‘Goodwill is key factor.’ The wife attacked the trial court’s ruling in an appeal with the Texas Court of Appeals. Goodwill, she argued, was “the key factor in valuing the [husband’s] partnership interest,” and it was error to use the partnership agreement as the only method with which to establish the value.

To value goodwill subject to division upon divorce, there has to be evidence that commercial goodwill exists, the appeals court noted. In this case, the trial court heard expert testimony that was “vague and conflicting” as to the existence and availability of commercial goodwill. The wife’s expert admitted he did not distinguish between personal and commercial goodwill; the husband’s expert acknowledged that commercial goodwill could exist in a multi-owner professional practice but found the partnership agreement controlling. And even though he admitted that the husband received “some interest” on his capital account besides guaranteed payments for services rendered, he considered it “minimal” and subject to offset against outstanding debt.

Another complication confronting the trial court was the lack of any provisions in the partnership agreement for accessing the value of a spouse’s interest in an ongoing partnership at the time of divorce, the appeals court stated. Ultimately, the reviewing court brought back its analysis to an established principle: Whether a business possesses goodwill and what that value consists of were questions for the trier of fact, here the trial court. The latter could choose to credit the testimony of the husband’s expert as to the status of the partnership interest and reasonably come to the conclusion it reached. Therefore, the appellate court affirmed the trial court’s valuation of the husband’s interest.

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U.S. Tax Court Judge Laro Discusses Valuation and Expert Testimony Issues

At a recent luncheon, Judge Laro of the U.S. Tax Court answered a number of questions. He explained that there is one Tax Court in Washington, D.C., that is composed of 19 federal judges, all of whom have their own jurisdiction. Most tax-related cases settle rather than proceed to the U.S. Tax Court. In cases where the parties do not come to a resolution, they can litigate in federal district court, the U.S. Court of Federal Claims, or the U.S. Tax Court. Litigants may appeal a U.S. Tax Court decision at the U.S. Court of Appeals of the appropriate regional circuit. But the appeals court decision only serves as precedent in that circuit—it doesn't bind Tax Court judges in other circuits. The appeals court affirms 94 percent of the time. Tax Court memos are fact-intensive and do not serve as precedent, but they can serve as persuasive authority.

Why don't all judges provide a thorough description of how they arrived at their valuation conclusions? Different judges prefer different approaches, Judge Laro explained. It's a matter of transparency, and not every judge wants to set out his or her thought process. Judge Laro's approach to *Mandelbaum* was to research the DLOM legal landscape and provide a methodology that valuators and future litigants could use to create their valuations. When he discovered that many of the earlier memo cases broaching the subject lacked explanations as to how the court arrived at its decision, he made a deliberate effort to develop a decision that could guide the appraisal industry.

Tailor approach to presiding judge? Should knowledge about the presiding judge influence the way an expert performs a valuation? No, said Judge Laro, although he allowed that he would question the thoroughness of a report in which an expert appearing in front of him failed to discuss the *Mandelbaum* factors.

He also thought it was good practice for an expert to read the cases in which a presiding judge discussed valuation issues to get a picture of where the judge is coming from, but he felt that it would be a mistake to tailor a valuation to the judge. What matters is the expert's independent, unbiased opinion. How did he or she arrive at it? Can he or she back it up?

There are so many variables, Judge Laro said, that go into a judge's decision-making: the facts specific to a case, the experts, the witnesses, documentary evidence, and the judge's own views and preferences. For an expert to assume he or she can influence the outcome of a case by studying the judge's prior decisions would be a big mistake.

Tax affecting. Although Judge Laro would not answer technical questions, he did believe that the issue of tax affecting was not a closed matter, at least in his court. The Delaware Court of Chancery allows it, he noted. "The door is wide open," he says, and he is waiting for the right set of facts to walk through it.

'Hot tubbing.' What's the future of expert testimony? "Hot tubbing," responded Judge Laro. Hot tubbing is an alternate way to handle cross-examination of expert witnesses. In our system, he explained, the parties retain experts to teach the fact-finder and the court (sometimes the same) about valuation and other issues that require specialized knowledge. But, the judge points out, think of what the expert's testimony looks like to a judge after the opposing counsel has put the expert through cross-examination, as our adversarial model requires. The testimony is fragmented because of the sustained attack on the expert's credibility.

The solution to a more equitable outcome, he says, is a technique practiced in a number of other countries known as hot tubbing or, more formally, "concurrent witness testimony." Judge Laro, who has used it in a few cases, says he usually sits at a table with the two experts flanking him and the attorneys relegated to the periphery. The judge opens a conversation, asks questions of the experts, and invites them to pursue their own dialogue. Without having to worry about attacks on their credibility, the experts are able to have a collegial discussion about their work on the case. Judge Laro thinks this approach is the way forward: It provides the judge with coherent expert testimony, and as such, aids the decision-making.

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