TRUGMAN Valuation
VALUATION Trends
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What Role for Revenue Ruling 59-60 Factors in Valuing Closely-Held Business?

J&M Distributing, Inc. v. Hearth & Home Technologies, Inc. **2015 U.S. Dist. LEXIS 2314 (Jan. 9, 2015)**

A recent *Daubert* decision addresses the use and relevance of Revenue Ruling 59-60 for purposes other than valuation for estate and gift taxes and discusses how an expert's purported assumptions of liability turned into opinions on issues outside the expert's area of expertise and authority.

For over 25 years, the plaintiff's business was devoted exclusively to distributing the defendant's fireplace and hearth products. But, in 2011, the plaintiff suspected the defendant was trying to undercut its business by selling directly to the plaintiff's customers and generally pursuing a strategy that placed the plaintiff at a competitive disadvantage. Discussions between the parties did not resolve the conflict and in March 2012, the defendant gave notice of the impending termination of their redistribution relationship. The defendant also went to court seeking a declaration that it had the right to end the relationship. The plaintiff, meanwhile, sued the defendant and one of its other distributors in federal court alleging breach of contract, tortious interference with business relations, violations of the Sherman Act and civil conspiracy.

The plaintiff and the defendant-manufacturer retained experts and both filed pretrial *Daubert* motions to exclude all or part of the opposing expert's damages opinion. The plaintiff argued that damages must be tied to the fair market value of its business prior to any of the harmful effects stemming from the defendants' alleged misconduct. The plaintiff's expert was an experienced certified financial analyst, who stated he had valuation experience in various areas, including closely-held businesses. He valued the company as of December 31, 2011, the most recent full fiscal year before termination of the distributor agreement, and calculated net profits related to sales the plaintiff intended to prove it would have made but for the defendant's conduct.

The expert reviewed the plaintiff's financial statements, payroll information, a summary plan description of its 401(k) plan and an actuarial report, as well as publicly available information about the defendant and litigation-related documents. For his calculation, he looked to Revenue Ruling 59-60, which, he said, "is viewed universally as the guiding tool for determining fair market value of closely held companies." The ruling provides eight factors it considers fundamental to any fair market valuation. The expert gave particular consideration to factor one, which takes into account the nature of the business and its history from its inception, and factor three, which considers the book value of the stock and the financial condition of the business. He found that among the business's unique aspects were that it distributed $300,000 to its primary shareholders and that it was reluctant to use debt in its capital structure. He said he included the distributed income, which would otherwise go to a buyer. As for debt, "this measurement assumes that an acquirer seeks to retire (pay off) all outstanding debt of the company using internal cash resources." Since the plaintiff had significantly more cash on hand than net debt, as of the valuation date, he considered this factor in his valuation.

He also considered the company's book value. He explained that shareholder equity, as reported in the company's financial statements, was over $693,000 as of the valuation date. He applied a multiplier of 2.2029 to reach a book value of $1.4 million. Belatedly he explained in a declaration (rather than in his original report) that, based on his judgment and experience in valuation, he applied a price/book value multiple discount of 25.7 percent to account for the company's lack of liquidity and marketability and a price/book value multiple discount of 16.3 percent, reducing the multiplier from 3.5 to 2.029.

Continued on next page...

In this issue

He stated that the public stock of the defendant's parent company served as a point of comparison for valuation in the industry as a whole. Based on all of this information, he concluded that the plaintiff's business at the end of 2011 was worth close to $3.5 million. He also calculated over $175,000 in net profits related to sales the plaintiff said it lost due to the defendant's actions.

The defendant presented an expert who performed her own damages analysis (not discussed) and critiqued the plaintiff's expert's calculation. She said that the plaintiff's expert did not explain who provided him with the sales numbers for the calculation or why the defendant was responsible for the losses or how the sales losses were computed. He also did not show that lost sales for 2012, which according to him amounted to over $440,000, were not already part of the business valuation calculation. Further, she said that, since she had no information supporting the opposing expert's calculations or assumptions, she was unable to respond to his computation. Until she had more information, she considered the losses "completely without merit."

The defendant's expert said she assumed liability for her own damages analysis. However, her report included numerous observations as to whether the defendant manufacturer had cause for terminating the relationship with the plaintiff. For example, she said it appeared that the manufacturer's termination was for cause. Even if the manufacturer could not terminate the relationship except for cause, she said, there were reasons that provided cause, "which would mean [the plaintiff] would have no recoverable damages." She said that there was an expectation that the plaintiff's owner would retire in the foreseeable future and believed that "any number of things could have happened in the latter half of 2012 that would have constituted cause for termination." Therefore, the plaintiff's damages "could be limited to 2012."

The defendant claimed the plaintiff's report was inadmissible on all of the *Daubert* grounds: He was unqualified and his opinion was irrelevant and unreliable. As to qualifications, he had a financial background but insufficient experience valuing small, closely-held businesses. In addition, he lacked the qualifications to calculate lost profits. As to relevancy, he based his calculation on Revenue Ruling 59-60, which is only relevant for valuations for estate and gift taxes, not damages calculations. As to reliability, he improperly considered income to the plaintiff's primary shareholders in determining the company's fair market value, even though they were not a party to the litigation. He also should not have included a "net debt calculation" and he did not provide support for his calculation of net profits lost.

None of the defendant's objections gained traction with the court. The plaintiff's expert had extensive experience in finance, including valuations, the court noted. He had worked for the U.S. Department of Treasury, in addition to working for many years in the private sector. "Such qualifications are sufficient."

The guidelines underlying Revenue Ruling 59-60 have been used in a variety of contexts, not just for estate and gift tax purposes, the court noted. Case law showed the ruling was applicable in valuing securities in income tax cases and in valuing a closely- held corporation as marital property for equitable distribution purposes. A study of IRS rulings and business valuation suggested "its usage has spread as it is routinely referenced and used in the valuation of closely held businesses for various litigation purposes and its principles are applicable in the valuation of most closely held business valuations." Also, the court pointed out, the plaintiff's expert himself had used this method in the past to perform valuation analyses in regard to potential acquisitions of closely-held companies. A damages calculation relying on it in this case was relevant, the court said.

In terms of the specifics of the valuation, such as consideration of income to shareholders and the debt treatment, the plaintiff's expert appeared to have used the information in applying factors from the revenue ruling, rather than to support an impermissible recovery of damages to the primary shareholders, the court found. However, the defendant would have ample opportunity to challenge the plaintiff expert's approach during cross-examination. For its part, the plaintiff asked the court to strike portions of the defendant experts' opinion related particularly to liability, arguing that many of the statements had nothing to do with the expert's expertise—the calculation of damages.

The court agreed. Although the defendant's expert said she "assumed liability" in order to analyze damages, she went beyond simple assumptions, the court noted. She debated whether the defendant manufacturer had cause to terminate the agreement with the plaintiff, when that deliberation was for the jury to perform. According to the court, "any expert testimony to this effect both invades the province of the jury and is superfluous," the court observed. Also, she lacked the qualifications to discuss substantive legal issues, such as cause for termination. These, too, were for the jury to resolve. Moreover, her statements were speculative and irrelevant, the court said. Whether the manufacturer could have ended its relationship with the plaintiff in the future had nothing to do with the termination it announced in March 2012 and the related losses the plaintiff claimed it sustained then. The expert's statements also had the potential to prejudice and confuse the jury, the court added.

For all of these reasons, the court excluded portions from the defendant expert's report.

Delaware Chancery Grapples With Sale Price vs. Post-Merger DCF

***In re Ancestry*, 2015 Del. Ch. LEXIS 21 (Jan. 30, 2015)**

What's more plausible: the merger price or the value derived from the discounted cash flow ("DCF") method performed after the fact? This was the overarching question the Delaware Court of Chancery recently explored in a statutory appraisal action.

Ancestry.com was a self-described "pioneer and the leader in the online family research market." The company went public in 2009, when its shares traded at $13.50 each. After it became the sponsor of a popular NBC show, "Who Do You Think You Are?" the price per share rose as high as $40. But its fortunes changed again, and its board decided to sell the company to a private equity investor for $32 per share. The merger price represented a 41 percent premium on the unaffected trading price of company stock. Ninety-nine percent of the voting shares approved of the transaction, but the dissenters asked the court for a fair value determination.

Both sides retained experts who agreed on the use of the DCF analysis, but disagreed about key inputs. According to the Chancery, the petitioners' expert "proved something of a moving target" in that he proposed at different points in the litigation that the company was worth as much as $47 per share and no less than $42.81. The company's expert concluded the stock was only worth $30.63 per share. That price was actually below the value the buyer, a nonstrategic investor, was willing to pay, the court observed.

Both experts were respected and well qualified, but their valuations were "less than fully persuasive," the Chancery noted. The analyses were "result-oriented riffs on the market price." By his own account, the petitioners' expert "tortured the numbers until they confess[ed]." The company's expert "candidly suggested" that if his valuation had been as far from the merger price as that of the petitioners' expert, he "would have tried to find out a way to reconcile those two numbers."

The Chancery said these statements showed the limited use of a post hoc DCF valuation. "If an analysis, relied upon to assess whether a sales price presents the fair value, in turn uses that very sales price as a check on its own plausibility, and if it must be revised if it fails that check, then the process itself approaches tautology."

Instead of relying on either expert's analysis completely, the court performed its own DCF, arriving at a value of $31.79 per share. But, since the sales process was "reasonable, wide-ranging and produced a motivated buyer," the court decided it would be "hubristic" to elevate its DCF estimate of value over the value an entity "for which investment represents a real—not merely an academic—risk" placed on the company. Therefore, the Chancery found the $32 merger price best represented the fair value of the company's stock and was useful as a check on the market-derived valuation.

Mixing Lost Profits and Lost Business Value for Damages Calculation

Most jurisdictions allow plaintiffs to claim either lost profits or lost business value to avoid double recovery. Therefore, the valuation analyst either does a damages analysis or a business valuation. But this separation is no longer so strict, as some recent cases illustrate.

Case No. 1: In a New York case involving a restaurant, the plaintiff claimed harm to the corporation and himself because of the siphoning off of cash during the years he worked there. He also tried to claim harm to himself because he never got a distribution of profits. The court determined that whatever profits were siphoned off belonged to the corporation. But, when all was said and done, the court decided to add the diverted profits (including interest) to the valuation of the business to derive a buyout price for the plaintiff.

However, it appears that the court took two components and added them together. One component was the plaintiff's share of the unreported income. Since the income was unreported and apparently not modified in determining the value of the business, it needed to be added to the amount necessary to make the plaintiff whole in terms of receiving his fair value. The case is *Cortes v. 3A N. Park Ave Rest Corp.*, 2014 N.Y. Misc. LEXIS 4693 (Oct. 28, 2014) (Slip Op).

Case No. 2: In another case, one that involved the expropriation of a Baton Rouge, LA donut shop, the analysts essentially did a business valuation, but the calculation included a damages component. The company's valuation analyst, in particular, insisted that the owner was entitled "to the value of the owner's pecuniary position in the business enterprise on the date of taking plus any additional compensation necessary to the full extent of his or her losses." Therefore, he added full owner's compensation to the cash flow determined based on tax information.

In this case, it seems that both valuation analysts, to some extent, mixed loss of value and damages principles in arriving at their damages. Since both sides did this, the court did not pick up on it and allowed the mixed methodologies as a measure of damages. The case is *City of Baton Rouge v. Jay's Donuts, Inc.*, 2014 La. App. Unpub. LEXIS 722 (Dec. 17, 2014).

IRS Issues Two New Job Aids

On October 29, 2014, the Internal Revenue Service issued two new job aids. The first entitled, *Reasonable Compensation: Job Aid for IRS Valuation Professionals* was created to assist IRS valuation professionals with examinations of reasonable compensation of both for-profit and not-for-profit businesses. The table of contents includes the following sections:

- Purpose, Background and Case Coordination
- Identifying a Reasonable Compensation Issue
- Developing Reasonable Compensation Issues
- Taxpayer Arguments for Reasonable Compensation Issues
- Consideration of Penalties
- Focusing Specifically on Not-For-Profits

The second job aid is entitled V*aluation of Non-Controlling Interests in Business Entities Electing To Be Treated As S Corporations for Federal Tax Purposes*. This job aid is to assist IRS Valuation Analysts involved in the valuation of minority interests in S Corp. entities and includes the following sections:

- Executive Summary
- Discussion and Analysis
  - o Introduction
  - o Identification of the Property to be Valued
  - o Valuation – Background and Approach
  - o Additional Factors for Consideration
  - o Evidence-Based Valuation Analysis
  - o Theory-Based Valuation Analysis
  - o Weighting of Factors and Approaches
- Assessment and Synthesis
  - o Setting a Framework for Evaluation
  - o Summary

If you have not obtained a copy of these documents and would like to, please contact us and we will be happy to provide them.

Congratulations to our Principals

We are pleased to announce that Linda B. Trugman CPA/ABV, MCBA, ASA, MBA has been elected to serve as International President and that Gary R. Trugman CPA/ABV, MCBA, ASA, MVS has been elected to serve on the Business Valuation Committee of the American Society of Appraisers. Both terms begin July 1, 2015.

The American Society of Appraisers (ASA) is an international organization of appraisal professionals and others dedicated to the education, development and growth of the appraisal profession. ASA is the oldest and only major organization representing ALL disciplines of appraisal specialists originating in 1936 and incorporating in 1952.

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