TRUGMAN Valuation

VALUATION Trends

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Expert's Best-Effort Medical Practice Valuation Holds Up on Appeal

Ramundo v. Ramundo

A New Jersey divorce case revolving around the valuation of a chiropractic practice is a good example of how a skilled valuation expert can produce a credible, if incomplete, appraisal when denied access to vital information by the opposing party. Here, even though the expert's analysis did not address such fundamental issues as goodwill, the appeals court declared the testimony "reasonable and competent."

The husband owned a successful chiropractic practice, which he had set up two years before the marriage, as well as a business spun off from the practice. Throughout the litigation, the husband disobeyed discovery orders and failed to make financial documents available in a timely manner. Because of his lack of cooperation, the trial court limited his participation to cross-examination.

The wife's expert valued the practice based on limited data using the capitalization of earnings method. He determined that the business' annual gross revenues were about $1.6 million. He added back expenses that the business paid for, but which he did not consider legitimate business expenses. The expert's reasonable compensation determination was based exclusively on survey data. The expert never received a breakdown of the time the husband actually spent working at the practice or the number of patients the husband saw. The expert admitted that details about the actual conduct of the business might have changed the reasonable compensation calculation. The expert determined his discount rate by balancing factors such as the practice's strong referral base and the practice being well-established with the fact that there was a problem with limited parking, which affected the number of patients who could be seen. The expert concluded that the practice was worth $1.2 million.

As a check, the expert also performed a market-based analysis using data from the Institute of Business Appraisers, BIZCOMPS and Pratt's Stats. This analysis produced a value of $983,000.

The expert acknowledged he was unable to develop the pre-marital value of the business because he never received the tax returns covering that period. He also said that missing financial data made it impossible to perform an excess earnings or "goodwill" analysis.

The trial court record was replete with instances in which the husband had failed to comply with discovery orders. The court adopted the wife's expert's $1.2 million valuation, but only awarded the wife a one-third interest in the business: approximately $403,000.

In appealing the valuation findings, the husband tried to exploit gaps in the valuation analysis and mischaracterized a number of the expert's trial statements to argue that the valuation was "not supported by credible evidence." For example, the husband claimed that the expert "admitted" that he "arbitrarily excluded certain expenses, which, if included, would have yielded a substantially lower value for the practice." The record showed that the husband's characterization was "misleading," the appeals court said. In fact, the expert specifically said the exclusion was not arbitrary and he "thoroughly explained his reasoning and thus established a solid basis" for removing certain expenses.

Continued on next page...

In this issue

- Expert's Best-Effort Medical Practice Valuation Holds Up on Appeal
- Florida Court Rejects Active-Passive Framework in Appreciation Analysis
- Tax Court's Valuation of Trust's Interest in LLC Weathers Appeal
- New Jersey Ruling Cements Use of DLOM to Sanction Oppressing Shareholder
- Inadequate ESOP Valuation Vetting Gets Trustee Into Hot Water

Moreover, the husband alleged it was unprofessional for the expert not to consider information the husband had submitted the weekend before trial. The appeals court dismissed that argument as "wholly without merit." The trial court forbade the husband to make late submissions and it did not allow the expert to consider any late material.

The expert had a "complicated" job given the husband's refusal to follow discovery orders, the appeals court observed. He used the information available to him to produce a valuation the trial court duly considered and found credible. Accordingly, the appeals court affirmed the trial court's value findings.

Florida Court Rejects Active-Passive Framework in Appreciation Analysis

Bair v. Bair

When appraisers deal with the issue of appreciation of non-marital property, they often think in terms of "active versus passive." A Florida divorce case shows that the rigid adoption of this framework may result in an erroneous valuation.

The parties fought over the valuation of the marital portion of the husband's separate minority interest in a boat dealership. The company also owned real property whose value had dropped considerably during the relevant time.

In defining "marital assets," Florida law includes the appreciation in value of non-marital assets resulting from the efforts of either party during the marriage. Here, the trial court first had to determine the total appreciation in the company's value during the marriage and then specify the percentage of appreciation that was attributable to the husband's "marital labor." The trial court accepted the valuation that the wife's expert proposed, which was about $1 million higher than the value determined by the husband's expert. The court also largely adopted the expert's calculation of the marital labor. In valuing the company, the wife's expert "refused to include" the value of the real estate, believing that any change in value was passive in nature—that is, the result of market forces rather than the husband's management efforts.

The appeals court agreed with the husband that it was legal error to exclude the value of the real property from the company's valuation. Florida law requires that the valuation of a company include all of the company's assets and liabilities, the appeals court explained. "In other words, the sum of all parts, not a select few, is what encompasses a business's 'value.'" Further, it is improper to exclude the appreciation or depreciation of certain company assets as "passive" when one party's marital labor contributed to the change in value of the company as a whole. Even if some of the change in value of some of the company's assets was passive in nature, the overall appreciation here was the result of the husband's marital labor, the appeals court noted. Therefore, "the portion of the overall appreciation resulting from the marital labor was subject to equitable distribution."

The concept of active or passive appreciation might come into play if the husband, not the company, owned the real estate, the appeals court allowed. Then, the passive appreciation or depreciation might be excluded from the term "marital assets." But here the focus was on valuing the company, which the husband's marital labor "indubitably" increased. "Because of that marital labor, the law relating to purely passive increases in the value of nonmarital assets simply does not apply."

The appeals court also found other valuation errors related to double dipping and the treatment of undistributed passthrough income in the determination of alimony and remanded for a recalculation and reworking of the equitable distribution scheme.

Tax Court's Valuation of Trust's Interest in LLC Weathers Appeal

Estate of Koons v. Commissioner

The 11th Circuit Court of Appeals upheld a 2013 Tax Court ruling involving a revocable trust's interest in a limited partnership. The valuation turned on the marketability discount. The 11th Circuit opinion shows the Tax Court's decision regarding expert testimony was less focused on valuation methodology than on key assumptions underlying the experts' analyses.

In connection with a major asset sale in late 2004, the decedent formed a limited liability company ("LLC") and made a will in which he left the residue of his estate to a revocable trust. At the time of the decedent's death, the trust owned a 50.5 percent total interest in the LLC. The decedent's children, who were shareholders in the company, conditioned the deal on the LLC's' redemption of their shares. They

all accepted the LLC's redemption offers before the decedent died, but the offers closed after his death.

The case went to the Tax Court over the Internal Revenue Service's claim that the estate and trust had underpaid taxes. The crux of determining the fair market value of the trust's interest in the LLC at the time of death was the size of the discount for lack of marketability ("DLOM"). The estate's expert used a regression analysis involving 88 companies that produced an initial DLOM of 26.6 percent. Based on differences that the expert perceived between the LLC and the 88 companies, he adjusted the rate upwards and arrived at a 31.7 percent DLOM.

The IRS's expert rejected the regression analysis and instead considered the characteristics of the LLC to conclude that a 7.5 percent DLOM was appropriate. Above all, he assumed that the risk the redemptions would not go through was small. Owning a majority interest, the revocable trust would be able to force the LLC to distribute most of its assets once the redemptions closed. The Tax Court agreed with this key assumption. It concluded that a hypothetical seller would expect to be able to force a distribution of most of the LLC's assets. The majority interest holder would receive about $140 million in a distribution. Since the estate's expert valued the interest at $110 million, the court found that the IRS's expert's valuation of $148.5 million was more credible.

In their appeal, the petitioners argued that the Tax Court had improperly disregarded the estate expert's regression analysis, "a proven and scientifically valid method for determining marketability" and ignored other flaws in the IRS's valuation.

"While the Tax Court discussed the specific details involved in each of the experts' methodology, its decision mainly turned on a larger issue," the 11th Circuit noted—whether a hypothetical seller would anticipate being able to force a distribution of the assets. The IRS's expert held this view, as did the Tax Court. The estate's expert did not. This assumption, the Court of Appeals said, is the "fundamental reason" why the Tax Court adopted the IRS's expert's valuation. The estate failed to show that the Tax Court was wrong regarding this issue.

The 11th Circuit also upheld the Tax Court's determination that interest payments related to a loan to cover the tax liability were not a necessary administrative expense.

New Jersey Ruling Cements Use of DLOM to Sanction Oppressing Shareholder

Parker v. Parker

In 2016, in the *Wisniewski v. Walsh* case, the New Jersey Appellate Court used the marketability discount to punish bad behavior. A trial court decision in a forced buyout follows the same approach. The oppressor had created an "extraordinary circumstance which requires this court to apply a marketability discount" in order to achieve a "fair and equitable" outcome, the court said.

Two brothers, Richard and Steven, formed two separate companies, Plant Interior Plantscapes ("PIP") and Parker Wholesale Florists ("PWF"), in which each brother had a 50 percent interest. The companies did business from the same location and shared overhead, but were otherwise independent enterprises. Decades later, each brother filed suit, claiming he qualified as an oppressed shareholder. As the court put it: "Both litigants seek to have the court remedy every injustice they perceive has befallen them over the last 25 years at the hand of the other. This, of course, cannot be done."

The court found that Steven had engaged in shareholder oppression by allowing PWF to incur huge losses over 20 years and by "continually" withdrawing funds from PIP to cover the losses without obtaining Richard's consent. It ordered Steven to sell his 50 percent interest in PIP to Richard.

Under New Jersey law, courts tasked with determining fair value in a forced buyout have "substantial" discretion to adjust the purchase price to reflect a marketability discount. The resulting value must be "fair and equitable." The state Supreme Court has held that in "extraordinary circumstances," a DLOM may be appropriate to ensure that the shareholder instigating the problems does not receive a windfall as a result of his or her conduct.

In the instant case, the court found that Steven's wrongful conduct created an extraordinary situation. To calculate the price of Steven's interest in PIP, both sides' experts relied primarily on a discounted cash flow analysis and looked to IRS Revenue Ruling 59-60. Richard's expert used a 25 percent DLOM and a 15 percent minority discount saying he believed Richard to be the oppressed shareholder

and discounts “needed to be applied.” The court found this was a legal conclusion the expert was not qualified to make.

However, the court generally accepted the expert’s analysis, including the application of a 25 percent DLOM. Steven’s actions “were the cause of the lawsuit,” the court said. At the same time, the court noted that, while exceptional circumstances in this case justified a DLOM, they did not “automatically” entitle Richard to a minority interest discount. The court rejected the DCF model that Steven’s expert proposed, finding that the expert’s projections were problematic. Moreover, the court required Steven to account for any proceeds from the liquidation of his company, PWF.

Inadequate ESOP Valuation Vetting Gets Trustee Into Hot Water

Brundle v. Wilmington Trust N.A.

ESOP trustees have a duty to be engaged in the valuation process. As a court ruling shows, simply hiring an independent financial expert and relying on its analysis and value conclusion may expose the trustee to liability down the road.

This case involved a short-lived ESOP whose structure was unusual in that the sellers, the principal shareholders in a private security firm, agreed to sell 90 percent of their shares to the ESOP and exchange the remaining 10 percent for warrants. The warrants allowed the sellers to buy back equity in the company and keep control by appointing a majority of the board of directors.

Management hired a firm known for its ESOP experience to act as trustee. That firm in turn engaged a reputable valuation firm as a financial advisor. Seven months after the ESOP’s formation (in late 2013), the company sold itself to a competitor. The sale terminated the ESOP. Valuators at trial called the ESOP an “extreme outlier” given its brief duration. The Department of Labor opened an investigation into the conduct of the trustee and other fiduciaries and two plan participants filed a complaint.

The issue was whether the trustee had engaged in a prohibited transaction and, if so, whether it had an “adequate consideration” defense in that the ESOP paid no more than fair market value for the company’s stock. The court considered whether the trustee acted in accordance with its ERISA fiduciary obligations. To do so means investigating the financial expert’s qualifications, providing the expert with complete and accurate information and making sure reliance on the expert’s advice is reasonably justified under the circumstances.

According to the court, the trustee had no defense; it had caused the ESOP to overpay by almost $28 million. Had it done a meaningful review of the financial advisor’s valuation report, it would have noted deficiencies in the analysis and questioned the value conclusion. For example, even though the trustee knew that a different financial firm had valued the company only 11 months before the ESOP valuator did and had used the same methodology, the trustee never asked to see the earlier valuation for comparison. Had it done so, it would have realized that the earlier valuation stated an enterprise value that was almost $100 million below the value the ESOP valuator determined. A prudent trustee then would have asked to see the projections the ESOP valuator used and examined the assumptions it made, the court said.

Further, the trustee was aware of, but did not hone in on, the risk stemming from the company’s high concentration of revenues in just two contracts. The trustee did not question the ESOP valuator’s risk assessment reflected in a 0.7 beta. And, considering the lack of control the ESOP ended up having, the trustee should have probed the ESOP valuator’s addition of a 10 percent control premium in its guideline company method analysis and the failure to discount its DCF analysis for lack of control.

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