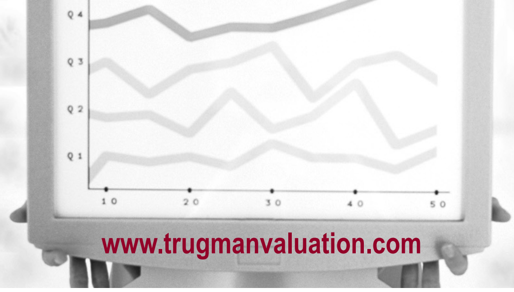

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Should 'Highest and Best Use' Govern Fair Value Standard in Dissenting Shareholder Case?

***Holiday Medical Center, Inc. v. Weisman*, 2008 WL 2677504 (N.J.) (July 10, 2008) (unpublished)**

The board of directors of a New Jersey nursing home wanted to sell the facility, its land, and other assets to a private, non-profit school for $8 million. The nursing home would net about $2 million from the sale, after paying off an existing mortgage of $3,075,464 and other miscellaneous items—including a $3 million donation to the non-profit buyer.

Liquidation value versus going concern. After the sale went through, a 5% minority shareholder dissented and sought a judicial appraisal of her shares. The judge appointed an independent appraiser, who found that the nursing home was "marginally financially feasible." Its value as a going concern was only $5,540,000 compared to a liquidation value of $7 million, which lay primarily in the real property assets. Neither the shareholder nor the board of directors disputed the appraisal, its alternate valuations, or its methodologies.

The shareholder tried to enjoin distribution of the sale proceeds, but by then the board had already distributed 80% to the remaining shareholders. The court ordered the board to pay the dissenting shareholder 80% of her share as well, or $80,000. But the shareholder still claimed she was owed over $116,000 based on her share of the appraised liquidation value ($7 million) minus the outstanding mortgage but not including any charitable donation to the buyer, for which she never received any benefit (in terms of a charitable deduction). In other words, she claimed that statutory fair value should be based on a "highest and best use" analysis.

The board objected, claiming that the going concern appraisal ($5,540,000) represented the fair value of the nursing facility; and that its $80,000 reimbursement constituted fair value of the shareholder's interest.

Asset approach violates fair value standard? The trial court agreed with the board, rejecting the "highest and best use" standard as controlling in a fair value accounting. When the board completed the sale, it stripped the dissenting shareholder of her ongoing interest in the nursing home, the court explained. The independently appraised values established a range of value for the facility, anywhere from the best case ($7 million liquidation value) to worst case ($5,540,000 going concern). Accordingly, given both parties' acceptance of the appraisal, the shareholder's interest ranged from $40,000 to $80,000.

The trial court was also satisfied that the arms-length sale of the nursing home established fair value for all shareholders, dissenting or not. But the shareholder appealed the decision, arguing that "as a matter of law" the fair value statute requires the "highest and best value" standard.

The New Jersey Superior Court, in an unpublished decision, rejected this contention. Under local as well as Delaware law, a corporation's going concern value is acceptable to determine the fair value of a dissenting shareholder's interest. In this case, the trial court did not adopt the going concern value but merely used it to corroborate the sales price, which—after deductions, including the charitable donation—resulted in a corporate value of $2 million.

However, the appellate court remanded the case for the lower court to provide its basis for accepting the sale transaction price, which included the charitable donation, over the going concern value—which did not. It should also clarify whether the shareholder could benefit from the charitable donation and how this would factor into the court's overall findings of fair value.

IN THIS ISSUE

Divorce Court Analyzes Built-In Capital Gains in Net Asset Valuation

***Fickle v. Fickle*, 2008 WL 3843846 (Tenn. Ct. App.) (Aug. 19, 2008)**

In the estate and gift tax arena, last year's decision in *Jelke v. Commissioner* (11th Cir.) established a 100% discount for built-in capital gains when appraising holding company assets at fair market value. Without citing *Jelke* or related precedent, the Tennessee Court of Appeals considered the same issue in the context of divorce—in particular, whether it should account for built-in capital gains and other tax considerations when valuing a closely held real estate holding company.

Husband's expert urges tax affecting and discounts. The husband in this case was the sole proprietor of a company that owned several parcels of farmland. The company was the husband's separate property and the land was its only asset. Before trial, the couple stipulated that the land had appreciated by $254,000 during the marriage, based on recent real estate appraisals, from $186,000 to approximately $440,000.

To value the appreciation of his holding company interest, the husband presented an expert who testified that, notwithstanding the stipulated increase in land value, the company stock was worth $139,380 prior to the marriage and $286,387 at trial. He explained that "several factors connecting with valuing corporate stock" influenced his conclusions:

1. Both the net asset value method and its fair market value standard contemplate a sale of the asset;
2. A sale would result in significant capital gains;
3. If the sale proceeds were distributed, the shareholder would incur dividend taxes; and
4. The closely held stock warranted a marketability discount of 15% to 25%. Further, the expert started with the appraised value of the land and then reduced this by corporate debt ($38,749 per the husband's tax return) and $64,000 in estimated taxes, and then applied a 15% marketability discount.

The husband testified (and his expert conceded) that he had no plans to liquidate the asset or sell the underlying properties. Rather than adopt the expert's valuation, the trial court concluded that the value of the holding company was "really the value of the farm land." Accordingly, it adopted the parties' stipulation regarding the appreciated land values, finding that the marital interest in the holding company was worth the same amount: $254,000.

However, "in this case, the trial court was clearly not persuaded by [the] husband's expert to adopt the lower stock value," the appellate court said. The evidence clearly supported the trial court's determination of value, especially in this case, in which the holding company's sole asset was real property, and the husband was the sole owner of stock.

Colorado Court Considers Fair Value Standard in Divorce

***In re Marriage of Thornhill*, 2008 WL 3877223 (Colo. App.)(Aug. 21, 2008)**

In this case, the Colorado Court of Appeals becomes the latest to rule on whether to extend the statutory fair value standard in dissenting shareholder cases. In particular, the court examined its preclusion of marketability discounts to valuing a business in divorce.

An oil and gas interest worth $1.625 million. After a 27-year marriage, the Thornhills executed a separation agreement, including the disposition of the husband's 70.5% interest in an oil and gas business. The husband's expert valued the husband's share at $1.625 million, after the application of a 33% marketability discount. The wife, who did not have the benefit of counsel when she signed the agreement, later disavowed it at the hearing on final orders. But the trial court ratified the agreement, despite her protest. The wife appealed.

The appellate court voided the agreement, finding that its provisions were unconscionable. The wife was not legally or financially sophisticated, the court contended, and had no access to counsel. More importantly, the agreement provided for the husband to pay the wife half of the marital assets (some $750,000) in equal monthly payments over ten years, without any provision of interest or security for the debt. The court remanded the matter to the trial division for a new determination and disposition of the assets.

Maintaining, "it may arise on remand," the court considered the wife's contention that no marketability discounts should apply to the value of the husband's business. She offered case law that precluded marketability discounts when determining the fair value of a dissenting corporate shareholder's interest pursuant to the applicable statutes, based on analysis of the relevant statutes in several jurisdictions and provisions of the Model Business Corporation Act.

Statutory fair value discourages squeeze-outs. Dissenting shareholder statutes are intended to protect minority owners from the vagaries and involuntary nature of cash-out mergers, the court observed. A rule that prevented minority shareholders from receiving less

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than their proportionate share of the firm's entire value would transfer wealth from the minority to the controlling shareholders and would encourage corporate squeeze-outs.

But those same considerations do not apply in a divorce case. First, the applicable marital dissolution statutes do not contain the "fair value" language of the business corporation statutes. Second, the "fair value" standard (in statutory fair value cases) does not equate to the "fair market value" standard in divorce cases; as a result, "the common practice of including a marketability discount in calculating fair market value is not permitted in dissenting shareholder valuations," the court held.

Finally, it declined to adopt *Brown v.* Brown (N.J. 2002), in which the New Jersey Superior Court of Appeals extended the reasoning of dissenting shareholder cases to hold that marketability discounts are not appropriate in marital dissolution proceedings. Instead, the court was persuaded by the decisions "of numerous other jurisdictions" that have applied marketability discounts when valuing interests in closely held companies for purposes of divorce.

The court expressed no opinion regarding an appropriate discount in this case, although it cited a range, from 10% to 35%, in other cases. Instead, it simply directed the trial court to make a clear record of its reasons for applying any discount, "to facilitate review on appeal."

Expert Evidence Helps Decide Partnership 'Divorce'

***Schuetzle v. Lineberger*, 2008 WL 2406825 (Wash.) (June 16, 2008) (unpublished)**

Like divorce cases, partnership dissolutions are often costly and conflicted. And in both settings, one party's qualified valuation professional can help decide the outcome—especially when the opposing party opts not to retain an expert.

Expert concludes club worth over $1 million. Two married couples formed a partnership to run an athletic club. After six years in operation, the majority owners (60% partnership interest) terminated the 40% owners. The minority partners sued for a dissolution and accounting of the partnership, and the court held a valuation hearing. The minority partners presented a valuation expert, who used the combined income, market, and asset approaches to conclude that the club was worth nearly $1.08 million. He also calculated $93,510 in unpaid distributions to the minority partners.

By contrast, the majority partners did not retain an expert appraiser or offer an alternate valuation. Rather, the couple's husband simply testified that the expert's value conclusions were "much too high" for "various reasons," including increased competition from other health clubs.

Not surprisingly, the trial court credited the expert's testimony, with a couple of exceptions. It rejected an adjustment to the club's income based on "minimally adequate staffing," as well as his optimistic view that the club would rebound from the increased competition and a stagnant growth rate. To reflect these concerns, the trial court discounted the expert's value by 25%, arriving at a final value of $807,000. The minority partners' 40% share amounted to $322,800, plus unpaid distributions. The majority partners appealed.

Hard to argue without alternative valuation evidence. In an unpublished decision, the Washington Court of Appeals reviewed the trial court's conclusions. Although the court didn't discuss the valuation evidence in much detail, it found the trial judge acted reasonably in accepting the expert evidence as a starting point—especially given the lack of a credible, alternative valuation from the opposing side. It was also within the judge's discretion to make appropriate adjustments, including the blanket 25% discount. "The trial court took the weaknesses of [the expert's] valuation into account and discounted his final calculation," the higher court held, in confirming the valuation conclusion as well as the unpaid distributions.

Most Common Reasons For Write-offs in Medical Practice Valuations

Like most small businesses, the majority of medical practices use the cash method of accounting. Thus, neither tax returns nor financial statements (if available) will reflect accounts receivable—that may comprise the single largest asset in the valuation. Medical accounts receivable also tend to consist of a large number of accounts with relatively small balances; each charge that arises from a single visit must be separately billed and accounted for.

Payment by an insurer should specify both the date the service was provided and the specific service. But third party payors (private insurance companies, Medicare or Medicaid) rarely pay 100% for all services. Further, these payors typically pay by a set fee schedule that may bear little or no resemblance to the physician's fees. Accordingly, a physician's billing department processes charges to reflect a payment, adjustment, or contractual allowance. Any unpaid balances involving an uninsured

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patient, a bad debt, or a third party payor's denial of payment often results in a "write-off" of these charges. It takes a lot of work to identify such uncollectible balances and get approval for the write-off—and many medical offices prefer to spend their resources on going after collectible balances rather than writing-off uncollectible ones.

The billing process in a medical practice is very complex, both in generating the charges and in recording the payment and adjustments for write-offs. This complexity can lead to errors, which in turn result in otherwise collectible balances not being collected, uncollectible balances not being written off, uncovered services being paid, and the same service being paid more than once (a credit balance).

What follows is list of the most common causes for write-offs or "bad debts" in a medical practice. While not exhaustive, it provides a quick checklist when reviewing a medical practice valuation and the analyst's categorization of write-offs.

1. Uninsured patient fails to pay.
2. Office personnel fail to collect co-pays at the time of treatment.
3. Practice fails to meet payor's contractual deadline for submitting a "clean claim"; i.e., one with complete and correct information (including coding) and compliance with deadlines.
4. Failure to meet an insurer's or other party's requirements for pre-authorization of the service.
5. Failure to obtain correct patient insurance information.
6. Failure to submit additional information with the claims, such as operative reports for certain surgical procedures.
7. Failure to timely appeal denial of claims.
8. Billing for uncovered services (those that are not covered by the patient's insurance).
9. Billing incorrectly for services, which are considered part of a package or "bundle" of services, such as pre-operative and post-operative visits considered part of the global fee paid for the surgery.