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VALUATION Trends

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Another 'Must-Read' Decision From Del. Chancery on the DCF, Discount Rate

***In re: Appraisal of The Orchard Enterprises, Inc.,* 2012 Del. Ch. LEXIS 165 (July 18, 2012)**

A private equity group sought to cash out its controlling interest in The Orchard Enterprises, an online music provider. When no prospective buyer agreed to pay a $25 million liquidation fee that the sale would trigger, the PE group engineered a going private merger at just over $2 per share. A group of dissenting stockholders petitioned the Delaware Court of Chancery for a statutory appraisal, claiming their shares were worth $5.40 per share.

To start, the court (in an opinion by V.C. Strine) found the $25 million liquidation preference was too speculative to include in any going concern valuation. It also rejected the market approach utilized by the company's expert, finding his selection of comparables and multiples was geared solely to "justify an outcome." As in recent cases, the court showed a distinct preference for the discounted cash flow (DCF) method, but made several important decisions related to the derivation of the discount rate:

- The court rejected the build-up method (BUM), finding that it was "larded with subjectivity" and failed to find support among the "mainstream of corporate finance scholars;"
- As a result, rather than average the experts' results under the BUM, the court used only the capital asset pricing method (CAPM);
- Since both experts agreed the underlying management projections were sound, any application of a company-specific risk premium was inconsistent with the CAPM approach and would, in fact, "infect" it with the subjectivity of the build-up model, the court said; and
- Given the "default" acceptance of the supply-side equity risk premium (ERP) in recent decisions such as *Golden Telecom* and *Gearreald v. Just Care*, the court rejected the historic ERP.

Finally, only the company's expert claimed—citing a 2008 article by James Hitchner—that using the supply-side ERP required an upward adjustment to Ibbotson's size premium. The shareholders' expert cited *Cost of Capital*, by Shannon Pratt and Roger Grabowski, to persuade the court that no such adjustment was necessary in this case, leading to its ultimate valuation of $4.67 per share.

5th Circuit Ratifies 47.5% Discounts to FLP Asset Values

***Keller v. United States,* 2012 U.S. Dist. LEXIS 20119 (Sept. 25, 2012)**

Business appraisers and tax specialists may recall the 2009 decision by the federal district court in which a wealthy Texas widow, with the

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help of longtime advisors, formed an FLP, but then failed to completely fund it with $250 million in corporate bonds before her death. She also filled out, but ultimately did not sign, the check intended to capitalize the general partner (GP).

Believing the administrative failures were fatal to the FLP, her advisors abandoned the effort, and the estate arranged to pay $114 million in taxes on the value of the corporate bonds. A year later, one of them attended a seminar on Texas partnership law that discussed *Church v. United States*, 2000 WL 206374 (W.D. Tex), aff'd, 268 F.3d 1063 (5th Cir. 2001). In that case, despite several defects in an FLP's formation—including failure to transfer legal title and set up the general partner—the 5th Circuit focused on the decedent's clear intent to establish the overall partnership and affirmed its formation as well as the discounted value of its assets for estate tax purposes.

Based on *Church*, the family's advisors completed the transfer of FLP assets. Since the estate now lacked the liquidity to pay the assessed taxes, it borrowed the $114 million from the FLP, backed by a promissory note, and filed a refund for overpayment based on its appraiser's application of 47.5% in combined marketability and minority discounts on the FLP interests. The government contested the formation of the partnership under state law and offered an undiscounted appraisal based on the marketability of the assets to family or related parties.

On review of the evidence, the court found the widow fully intended to create and fund the FLP before her death. It also found that she established the FLP for bona fide business (nontax) purposes and that the limited partners received adequate consideration in exchange for contributing the corporate bonds. The court also permitted the estate to deduct interest on the loan from the FLP as a necessary administrative expense and ordered a $115 million tax refund to the estate.

On appeal to the U.S. Court of Appeals for the 5th Circuit, the government decided to argue the legal issues concerning partnership formation and abandon any claims regarding the factual issues, including relitigating the valuation of the FLP assets. As a result, the 5th Circuit began with this brief but important restatement of partnership valuation principles, which acknowledges the acceptance of related discounts in its jurisprudence:

A decedent's partnership interest is not usually valued at the pro rata share of the property owned by the partnership. An estate is entitled to a discount on the value of that interest to reflect restriction on the interest's transferability and other burdens on the partnership interest.

As this case reveals, the court added, "a substantial valuation discount" hinged on whether the widow effectively transferred the corporate bonds and capitalized the GP account prior to her death. In this case, the evidence established the widow's clear intent to transfer the bonds to the FLP and complete its formation under state partnership law, notwithstanding her failure to sign the check capitalizing the GP account and otherwise complete the transfer of assets. Accordingly, the 5th Circuit affirmed the district court's findings in all respects.

Judicial Buyout at Fair Value Trumps Buy-Sell at Book Value

***Cardiac Perfusion Services, Inc. v. Hughes,* 2012 Tex. App. LEXIS 6134 (July 26, 2012)**

After founding a company that provided cardiac perfusion services (heart-lung machines), the owner invited another doctor to buy 10% of the company for $25,000. The parties also entered into a buy-sell agreement, which limited any repurchase of an employee/shareholder's interest to a pro rata percentage of the company's book value.

In 2006, the majority shareholder terminated the minority shareholder's employment and sued him in state court for tortious interference with business relationships. The minority owner countersued for shareholder oppression, claiming the controlling owner misused company funds, paid himself an excessive salary, and requested a judicial appraisal and buyout of his 10% interest at statutory fair value.

To support his claims at trial, the minority shareholder presented a business valuation expert who identified three categories of questionable expenses. First, the company paid over $325,000 in salaries to the controlling owner's college-age children, but did not hire any replacement for this work once the children left the payroll. Second, the owner charged roughly $64,000 for expenses that appeared to be "something other than legitimate business expenses," without reimbursing the company for the same. Finally, the expert analyzed the executive compensation data, including a survey of licensed and nonlicensed medical professionals, to conclude that an appropriate annual salary for the owner should have ranged from between $132,500 and $275,000. However, for the five years prior to trial, the owner paid himself an average of $775,000 per year.

To calculate the fair value of the minority shareholder's 10% interest, the expert determined the value of the entire company under two scenarios. Under the first, he assumed the salaries to the majority owner's children, as well as his expenses, were all legitimate and concluded that a 10% interest was worth just under $290,000. Under the second scenario, he excluded the same payments and concluded that the business was worth just over $296,000. In addition, he took 10% of the company's book value plus the owner's excessive salary to find the 10% interest equaled $290,000.

In response to this evidence, the controlling shareholder presented a rebuttal expert, who disputed the characterization of the owner's "bonuses" as dividends. He also criticized the minority shareholder's expert for failing to explain his analysis to the jury. Lastly, he said the expert should have considered the buy-sell agreement's provision of book value. After hearing from both sides, the jury awarded $300,000.

The majority owner appealed, claiming, among other matters, that the trial court erred when it instructed the jury to award fair value rather than book value, as stipulated in the parties' buy-sell agreement.

In this particular case, after the parties briefed the issues on appeal, but before oral argument, the appellate court issued its decision in another case, *Ritchie v. Rupe*, 339 S.W.3d 275 (Tex. App.—Dallas 2011). There, the court determined that "enterprise value" was the more appropriate method in shareholder oppression cases because it awarded the minority owner a pro rata share of going concern value, without minority or marketability discounts. Likewise, the trial court's jury instructions in this case specifically applied "the valuation method we sanctioned in *Ritchie*," the appellate court said, and were not an abuse of discretion. The appellate court affirmed the $300,000 award.

IRS Focus is More on Operations of FLPs, Says Porter

Recent Tax Court decisions have dealt "a significant blow to the lack of economic substance, lack of business purpose, and gift-on-formation positions taken by the IRS in the family limited partnership (FLP) area," says attorney John Porter (Baker Botts). "Subject to the continuing development of case law and IRC § 2036, if a partnership is valid under applicable state law and the entity is respected by the partners, the Tax Court will recognize that entity for transfer tax purposes," he says.

In light of these decisions—and in dealing with the IRS at the audit level and in litigation—Porter has seen "the IRS increase its focus on the actual operations of the partnership." For instance, the IRS now routinely asks to examine the partnership's books and records, its bank statements, and its operational documents to ask such questions as:

- Did the FLP make distributions according to the terms of the partnership agreement?
- Was the partnership operated as a separate legal entity or merely a second bank account for the decedent?
- In the formation, funding, and operation of the FLP, did the partners (and planners) dot

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the proverbial i's and cross the t's?

"The IRS attacks on partnership-based valuation discounts can be thwarted with careful planning, documentation, and operation of the entity," Porter observes. "This includes ensuring that the partners respect the entity and [obtain] qualified, supportable, and well-reasoned appraisals … when valuing the transferred interests."

Five Ways to Reduce the Costs of Financial Experts, According to New AICPA FVS Study

After 18 months of study and analysis by a special task force—including a comprehensive member survey—the AICPA's Financial Valuation Services (FVS) Executive Committee has just released its new study, "Another Voice: Financial Experts on Reducing Costs in Civil Litigation." Working with the Institute for the Advancement of the American Legal System (IAALS) (University of Denver), the FVS study proposes five basic reforms to maximize the effectiveness and efficiency of financial experts in the pretrial process:

1. Judges should manage cases early, actively, and consistently. Specifically, court continuances can drive up an expert's case preparation costs by 11% to 25%, the majority of FVS survey respondents indicate.
2. Clients and attorneys should involve experts early. One of the "major themes" to emerge from the FVS survey focuses on engaging the expert as early as possible in the litigation to reduce overall costs.
3. Attorneys should streamline expert depositions and discovery. For example, although expert depositions are a "valuable tool" in litigation, say FVS respondents, just about half (44%) of their testimony and time are wasted on nonsubstantive questions.
4. Daubert challenges should be timely and targeted. The use of Daubert-like challenges by attorneys can potentially reduce the time and total costs of cases involving financial experts, says the FVS study, but significant savings will only come with the implementation of all the recommended reforms.
5. Attorneys and the court should encourage opposing experts to cooperate. The vast majority (71%) of FVS survey respondents believes that allowing experts to talk with one another before the trial—and without attorneys—would decrease case preparation costs. A formalized system of expert collaboration is "vastly underutilized," one respondent said.

"Although the expert voice is not typically heard in connection with reforming civil pretrial processes," says the FVS task force, it hopes the new study will help "continue the conversation" with the bench, the bar, and rulemaking authorities.

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