TRUGMAN Valuation

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New York DLOM Ruling Has Valuators Abuzz

Zelouf v. Zelouf, *2014 N.Y. Misc. LEXIS 4341 (Oct. 6, 2014)*

When it comes to valuing a closely-held company, New York law allows for the use of a marketability discount and many times courts have applied it. But is it mandatory? This was a key issue in a recent New York ruling in a fair value proceeding.

Nahal Zelouf obtained a 25 percent interest in a family-run textile business from her husband after he fell into a coma. The other owners were her brother-in-law, Rony Zelouf, and her nephew, Danny Zelouf, who owned a majority stake. In 2009, Nahal made a books and records request and subsequently sued Danny and Rony for waste and misappropriation, alleging that the two men plundered the company for their personal gain.

During pretrial proceedings in 2013, the parties jointly hired a neutral appraiser to perform a valuation of the company for mediation purposes. However, instead of settling the case, Danny and Rony pursued a freeze-out merger, forming a new company for the purpose of buying out Nahal and rendering her unable to pursue her derivative claims. Ultimately the court allowed the merger on condition that the court would rule on Nahal's derivative claims as part of an appraisal proceeding and would allow for additional damages and legal fees if she won on those claims.

Nahal rejected the company's $1.5 million buyout offer and the appraisal proceeding went forward. Both sides agreed that the neutral valuator's appraisal should serve as the starting point of their analyses of what the fair value of Nahal's shares was. At trial, the parties' own experts focused on critiquing and adjusting the neutral appraiser's report.

The appraiser used the capitalization method under an income-based approach to determine the company's fair value as a going concern on a control, marketable basis. After making normalization adjustments to the company's net income, he arrived at a value of approximately $8.9 million. In the alternative, he calculated the value on a control, nonmarketable basis using a 30 percent discount for lack of marketability ("DLOM") to arrive at a $6.2 million valuation.

The DLOM became an issue. According to the neutral appraiser, "typically, a [DLOM] is usually only applicable for valuations of minority interests in closely-held companies under the assumption that a controlling owner would be able to force the sale of the company." It was inappropriate in this case, he said, but he applied it at the direction of counsel. The parties' experts argued over its application and the percentage it should take. In essence, Nahal's expert maintained that under case law, a DLOM was never applicable in this scenario; however, if the court allowed for one, it should not be more than 15 percent. The company's expert contended that New York law required a DLOM.

The court found Nahal's expert cited the wrong case, but it agreed that a DLOM was inappropriate here. The idea underlying a DLOM is that the recovery of a frozen-out, minority shareholder should be less to account for the difficulty of selling a closely-held company, especially in a niche business, as compared to a publicly traded company, the court explained. This rationale did not apply here, the court found, agreeing with the neutral valuator. It was unlikely that the company would or could ever be sold. A liquidity risk in this instance was "more theoretical than real," said the court. Risk was "a function of probability times the threatened harm." Here, although there would be harm in the form of a lower net purchase price, the probability that it would actually occur was "negligible." In the absence of a risk, a DLOM was inappropriate. Although many courts have applied a DLOM, "no New York case stands for the proposition that a DLOM must be applied to a closely-held company," the court said with emphasis. Based on the

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neutral appraiser's valuation, it awarded Nahal $2.2 million for her 25 percent interest in the company and another $2.2 million based on her derivative claims.

Takeaway: The court in this case hitches the application of a DLOM to the probability of a sale. Peter Mahler, a close observer of New York business divorce cases, raises important questions about the wider implications of the court's rationale for DLOM. Does it undermine the use of a DLOM in instances where a company is not for sale in the foreseeable future? As he sees it, "[s]uch a conclusion would rule out DLOM in most if not all fair value cases."

"Stunning" Personal Goodwill Amount Triggers Lawsuit

Potok v. Rebh, *2014 Phila. Ct. Com. Pl. LEXIS 318 (Sept. 16, 2014)*

How do you rationalize a $12 million personal goodwill claim when you already receive compensation for signing a consulting and non-compete agreement? This was the issue explored in a recent ruling in a dissenting shareholder case.

An advertising company was embroiled in a five-year litigation with a competitor over the legality of the competitor's business practices that threatened to ruin the company. One week into trial, the company accepted the competitor's settlement offer. The competitor insisted on buying the company's assets, not its stock, and wanted to eliminate the risk of future competition from the company or its four officers. In return, it offered $29.5 million on a "take-it-or-leave-it" basis. This amount was not based on any prior valuation of the company's assets.

The buyer specified that none of the money should be allocated toward the settlement, presumably so as not to admit liability for any of the claims in the lawsuit. It required the company and the four officers to execute a non-compete agreement and also entered into one-year consulting agreements at $1,000 per month for each of the individuals. Based on the buyer's instructions, the CEO of the company had to allocate the proceeds to the following categories: (1) retailer contracts; (2) inventory; (3) non-compete agreements; and (4) consulting agreements.

The CEO's valuation assigned $13 million to cover the value of the company's assets and inventory, over $4.45 million to cover the defendants' non-compete agreements, $48,000 to cover the consulting agreements, and $12 million to cover the four officers' "personal goodwill." A true-up from an appraisal firm did not occur until about eight months later. The CEO chose the appraiser and the buyer approved the selection. At trial, the appraiser explained that he was not allowed to create any new categories and was "solving back" to the purchase price. Under his analysis, the retailer contracts were only worth $9.3 million and the non-competes about $3 million. This left $16.7 million to cover the defendants' personal goodwill. The CEO ultimately adopted his figures.

The plaintiff, on behalf of the minority shareholders, sued the officers, who were majority shareholders in the company, alleging self-dealing. According to the plaintiff's expert, the company had little, if any, value, at the time of the transaction. Consequently, the non-compete and consulting agreements from the four defendants were worthless. The entire $29.5 million purchase price was in effect payment for settling the lawsuit and belonged to the company, the expert said.

The court agreed that there was no meaningful valuation. It also agreed that the deal was not an arm's-length transaction in an open and unrestricted market. However, in light of the potential the company had to offer to certain synergistic buyers, it was reasonable for the buyer to pay $13 million for the retailer contracts. This amount belonged to the company, the court determined. It also was reasonable for the defendants to be compensated for their consulting agreements and the non-competes.

But the court flat out rejected the 40 percent allocation to personal goodwill. Considering the company's financial situation, it would take a lot to convince a fact finder that it was appropriate for the CEO to award himself and the other officers an additional $12 million because "they worked so hard and deserved it," the court said. It found the personal goodwill agreements "stunning in that it is not clear that anything is being sold." It rejected the idea that personal goodwill could serve as a "plug" figure. The defendants were unjustly enriched by the $12 million allocation for personal goodwill, the court concluded, and ordered them to pay the amount to the company.

Takeaway: The court was well aware that there was no fair market transaction and there never was any intent on the part of the buyer to purchase any personal goodwill. In fact, by the CEO's own admission, the buyer seemed unfamiliar with the very concept of personal goodwill. To the extent there was any tradable personal goodwill, the non-compete and consulting agreements ensured that such value was transferred to the buyer and the buyer paid compensation for it. It should also be noted that without saying so, the court seemed to recognize that there is such a thing as "pure personal goodwill," goodwill that cannot be transferred by its nature and thus has no "market value."

DLOM Bounces Back in Big NY Fair Value Case

Ferolito v. AriZona Beverages USA LLC, *2014 N.Y. Misc. LEXIS 4709 (Oct. 14, 2014)*

Only a week after a New York trial court issued its contentious ruling that disallowed the DLOM in *Zelouf*, a different court pronounced on the same issue in another fair value proceeding that featured an "extremely successful company," extremely contentious business partners, and extremely well-known valuators.

The successful company is AriZona (of iced tea fame), founded in 1992 by the plaintiff and the defendant and now the largest privately-owned beverage company in the United States. Both partners were equal shareholders but a few years into the business venture, they started to have a falling out. For the good of the business, they decided that the defendant should take control of the day-to-day decisions. They also signed an owners' agreement limiting the transfer of shares in AriZona to a designated class of transferees.

At one time or another, two industry giants expressed an interest in acquiring part or all of AriZona. One was Tata, a global conglomerate and the second largest tea manufacturer in the world. In 2005, Tata estimated that AriZona might be worth as much as $4.5 billion, and it came up with similar estimates over the next 10 years. But Tata never performed due diligence on AriZona and never obtained board approval for pursuing an acquisition.

The other suitor was Nestlé. In July 2010, it expressed interest in buying the plaintiff's 50 percent interest for $1.3 billion, conditioned on Nestlé's ability to conduct due diligence, to eventually acquire the defendant's shares and to reach an agreement with both partners to control the company. After the plaintiff rejected the proposal, Nestlé increased the offer to $1.45 billion. Ultimately, discussions foundered. Nestlé's board of directors never authorized any acquisition of AriZona and Nestlé said it was unable to obtain "good financial data" from AriZona.

A few months later, the plaintiff, frustrated by the transfer restriction in the owners' agreement and the failed attempts to sell his shares, sued for the dissolution of the company. In return, the defendant decided to pursue a buyout. The court's valuation of the plaintiff's 50 percent interest drew on elements from both sides. No expert's analysis was the clear winner.

As to the valuation method, both sides agreed to use a discounted cash flow ("DCF") analysis and rejected the net asset value ("NAV") method. But the plaintiff's experts also advocated in favor of using a comparable transaction analysis, albeit weighting the resulting value at only 20 percent and assigning the remaining 80 percent to the DCF value.

The defendant objected that the proposed comparables were not sufficiently similar in size, timing and products and were "synergistic market transactions" that the controlling case law did not recognize. The court agreed. AriZona, it said, was "truly sui generis, and thus any attempts to find comparable companies are truly lacking." Also, the expressions of interest from Tata and Nestlé were unreliable indicators of the value of AriZona. Neither company had access to audited financials or was able to do due diligence and neither company's board of directors had approved an acquisition. The only method resulting in a reliable value calculation was the DCF, the court decided.

The parties' experts differed on a number of DCF components including the DLOM. The defendant's expert proposed a 35 percent rate. The owners' agreement was proof that the partners could not easily liquidate their shares. The plaintiff's expert maintained that there was no justification for a DLOM. The company had been successful and major companies had expressed an interest in buying part or all of it.

The court sided with the defendant. It quickly distinguished this case from *Zelouf*, in which the court ruled against the use of a DLOM, since there was no real liquidity risk because the business at issue probably would never be for sale. The liquidity risk in this case was real, the court said. The stalled Nestlé negotiations exemplified the plaintiff's difficulty of liquidating his shares.

At the same time, the defendant's own expert, a recognized authority on valuations, allowed that "smaller discounts are often appropriate for large and growing companies." This described AriZona, the court said, reducing the DLOM to 25 percent. The court's "back of the envelope" calculation suggested AriZona was worth about $2 billion on the valuation date.

Takeaway: Expressions of interest in a company are not bona fide offers and, by extension, are not reliable indicators of value. Also, New York courts continue to find a rationale for applying a DLOM in fair value proceedings despite the questions the recent *Zelouf* decision raised about the theoretical underpinnings of DLOM.

Harsh Ruling Due to Faulty Value Allocation in a Merger

Cavallaro v. Commissioner, *2014 Tax Ct. Memo LEXIS 189 (Sept. 17, 2014)*

So much for professional help! Hardworking taxpayers who built a successful business relied on estate planning professionals to effect a transfer of wealth that would minimize their tax liability. The resulting merger of two family businesses led to an IRS deficiency notice alleging that the couple was liable for making a $46 million gift to their sons.

In 1979, the taxpayer husband and wife founded a company, Knight, which built custom tools and machines. Eventually, the husband and a son used Knight's resources to develop a unique machine, CAM/ALOT, and formed another company, Camelot, to take the product to market. The taxpayers' three sons owned Camelot in equal parts. No contemporaneous documents showed a transfer of the rights to the machines from Knight to Camelot. Knight built the machines and financed the operations of both businesses. The two companies worked out of the same building and shared payroll and accounting services. When the taxpayers hired a major accounting firm for tax advice, the latter prepared tax returns that claimed research and development tax credits for Knight based on work that Knight engineers had performed.

In 1994, the taxpayers also retained a well-known law firm for estate planning purposes. Initially, the accountants and the lawyer had differing ideas as to which entity owned the technology and how to pass that value down to the three sons. The attorney set out to construct a narrative in which the value transfer from Knight to Camelot started at the time Camelot was incorporated. When told that real events did not bear out this story, the attorney said that in any history one had "to squeeze a few embarrassing facts into the suitcase by force."

Eventually, the accountants fell in line and the professionals structured a merger based on the premise that no gift tax was due because, on the merger date, Camelot already owned the CAM/ALOT technology. In 1995, the petitioners accepted a 19 percent interest in the new entity, while the three sons claimed the remaining 81 percent in equal measure. Effectively, Camelot was valued at four times the value of Knight. Six months later, the merged company was sold for $57 million in cash.

Fifteen years later, the IRS issued a deficiency notice claiming that the premerger Camelot had zero value and the merger resulted in a roughly $23 million gift from each parent to the sons.

The issue in Tax Court was whether the petitioners agreed to an unduly low interest in the merged company and the sons received an unduly high interest. The court considered valuation testimony from three experts. The taxpayer's two experts arrived at similar conclusions. Both appraisers relied on the assumption that, at the time of the merger, Camelot owned the value of the technology. They both used a market approach and valued the merged entity between $70 million and $75 million and Knight's portion of that value between $13 million and $15 million. Both said they were unable to perform a stand-alone valuation for Camelot.

In contrast, the IRS's trial expert assumed that Knight owned the technology. He based his valuation on a discounted cash flow analysis and concluded that the merged entity was worth $64.5 million, less than the taxpayers' experts stated. He determined that 65 percent of that value belonged to Knight, that is, $41.9 million. As a result, the IRS conceded some ground and lowered the gift amount to $29.6 million.

The court found that Knight owned the technology and the merger was not an arm's-length transaction. Because the taxpayers' valuations were based on the wrong assumption, there was no evidence to counter the IRS valuation. The court also said that the petitioners had a reasonable-cause defense and were not subject to an accuracy-related penalty. Since they had no formal legal or accounting background, they in good faith and to their detriment, hired professionals. "The fault in the positions [the taxpayers] took was attributable not to them but to the professionals who advised them," the court noted.

Takeaway: The conduct of the estate planning professionals raises serious ethical issues. The court noted there was "doctoring" of documents and filing of amended tax returns to "accommodate" the idea that Camelot was the technology's owner. Ultimately, the IRS was able to gain access to the damaging material and the taxpayers, who played no role in formulating or executing the strategy, paid the price.

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