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Valuation Perspectives

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New Tax Case Tackles Key Aspects of Private Company Value

***Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, 2011 WL 2559847 (U.S. Tax Court)(June 28, 2011)**

The decedent owned 15% in a private Subchapter S corporation that held various newspaper assets. When she died in July 1994, her estate valued her 15% share at $35 million based on an appraisal by its CEO, but the IRS said it was worth closer to $50 million. At trial before the Tax Court, both sides enlisted new appraisers and closed the gap slightly: $28 million for the taxpayer versus $41 million for IRS. In particular, they disputed four broad aspects of the valuation:

1. *Date of financial information.* The IRS expert relied on second quarter 2004 financial information, even though it was published after the July 2004 valuation date. In contrast, the taxpayer's expert relied on the most recently published financial data (March 2004), claiming that a willing buyer and seller would be unaware of any subsequent information. The court found the second quarter data more accurately depicted market conditions as of the valuation date, and that a hypothetical buyer was likely to elicit the non-public information in its due diligence.

2. *Adjusted financial statements.* The court disregarded any adjustments to financial statements for non-recurring expenses which the taxpayer's expert failed to adequately explain or support.

3. *Market approach*. Both experts used the guideline public company method (GPCM), but the taxpayer expert ultimately rejected it, due to the lack of sufficient comparables, while the IRS accorded it equal weight. The GPCM is "generally accepted" for valuing a private company, the court found. But in this case, only one of the comparables was arguably similar enough, and a "single company is insufficient on which to base the valuation method," the court ruled.

4. *Adjustments to the DCF*. Overall, the court agreed with the taxpayer's expert that the discounted cash flow (DCF) analysis was the more appropriate for valuing the closely held company. But it rejected his growth rates because they were based on industry data, preferring the IRS expert's rate (4.5%) based on company-specific revenues.

Not surprisingly, the IRS expert declined to tax-affect the S corporation's earnings, but the taxpayer's expert applied a 39% rate. He failed to adequately explain his reasons, however, and, based on prior case law, the court declined to impose "an unjustified fictitious corporate tax rate burden on [the company's] future earnings." For the same reasons, it rejected the taxpayer's expert's cost of equity that used a 40% corporate tax rate and his DCF adjustments based on "S shareholder tax savings."

As for the company's weighted average cost of capital (WACC), the court once again criticized the taxpayer's expert for failing to explain his calculations, particularly his determinations of a firm-specific risk premium and a control premium. The court also observed that WACC might be an improper rate to assign to a company that was planning to pay down its debt, but nevertheless adopted the debt/equity ratio (75/25) used by the IRS expert to conclude an overall WACC of 10%.

Discounts need supporting data. The IRS expert derived a 17% minority discount based on the inverse of control premium data for the newspaper publishing industry. Interestingly, the taxpayer's expert declined to apply one, because his DCF already resulted in a minority interest value, he said. The court rejected this approach and adopted a 23% discount, based on its findings that, this time, the IRS expert failed to adequately support his selection from industry data.

The experts were only 1% apart on their discounts for lack of marketability, and the court adopted the 31% used by the taxpayer's expert, given his slightly better review of the data and the holding periods at issue. Based on all its findings, the court held that the decedent's 15% share in the company was worth

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$32.6 million as of the valuation date—notably, not too far off from the CEO's original appraisal.

Attorneys, Appraisers May be Held Liable for Wrong Standard of Value

***Amboy Bancorporation v. The Bank Advisory Group*, 2011 WL 1533012 (C.A. 3 (N.J.))(April 25, 2011)**

Nearly 15 years ago, the plaintiff retained attorneys and financial advisors from two large, national firms to assist its reorganization into a Subchapter S corporation. To qualify, the board of directors (consisting largely of the company's majority owners) planned to cash out the more than 400 minority shareholders and, in connection with the merger, asked its financial advisors for a "fair market value" appraisal of the company's common stock.

Appraisal includes discounts. The appraisers determined a cash fair market value of $69.50 per share, which included a 25% minority discount and a 15% marketability discount. Relying on this valuation, the board approved the merger price of $73 per share, and its attorneys prepared a proxy statement for shareholders, which also relayed the board's belief that the $73 per-share price was "fair, from a financial standpoint," to shareholders. However, it failed to disclose that the value had been discounted.

The merger went through in 1997, with six shareholders dissenting and suing for a statutory fair value appraisal. The trial court found that the proxy statement contained material, misleading statements that failed to disclose the "true fair value and future prospects" of the company, in particular its omission of minority and marketability discounts. Under applicable law (New Jersey), the court also determined that the fair value of the stock was $90 per share and the company appealed.

On review, the appellate court affirmed that the proxy statement was materially misleading and remanded the case for additional fair value findings, denying discounts but including a control premium based on "market realities." After reconsideration, the trial court determined that the statutory fair value of the company stock was $114 per share, the appellate court affirmed, and the company ultimately paid about $33 million to its minority shareholders.

Consequently, the company sued its attorneys and advisors for professional negligence, breach of fiduciary duty, and breach of contract in failing to advise the board that "fair value" (and not "fair market value") was the proper standard in New Jersey, and claimed the $33 million in additional payout as damages. After several pre-trial motions—and the financial advisory firm's bankruptcy in 2007—the federal district dismissed all claims against the professionals. The advisers' role in preparing the proxy statement could not have been a proximate cause of damages, the court said, because the company had an independent duty under state law to compensate all shareholders at fair value. As a result, the misleading proxy statement was not a material factor in finding the company liable to its shareholders, the court held, and the company appealed.

On review by the U.S Court of Appeals for the Third Circuit, the court found that the "dissemination of an inaccurate or misleading proxy statement *in conjunction with* a cash-out merger that sets forth an inadequate cash-out price is sufficient to allow non-statutory dissenters to challenge the merger, or claim fair compensation for their shares." In essence, the misleading proxy statement is "the key that opens the courthouse door" to dissenting shareholders, the Third Circuit held. It also cited Delaware law for the proposition that an entire fairness review looks for fair price *and* fair dealing, including "the obvious duty of candor," the court held. "Stated otherwise, but for the misrepresentations in the proxy statement, shareholders who accepted the tender price would not have been entitled to recover."

For these reasons, the court remanded the case for further proceedings against both defendants, including a possible apportionment of liability (under New Jersey comparative negligence statutes) between the attorneys and the appraisers.

Divorce Roundup: the Challenges of Valuing 'Main Street' Businesses

A summary of recent divorce cases shows courts still concerned with inputs, assumptions, and discounts in the valuation of small to midsize private businesses:

In ***Kapadia v. Kapadia*, 2011WL 1849407 (Ohio App. 8 Dist.)(May 12, 2011)**, the wife owned 47.2% in a local chain of 13 sandwich shops. At trial, the husband's expert valued her interest at $1.6 million, compared to the wife's expert, who said it was worth $1.0 million. The difference: The wife's expert characterized the business as a "grilled sub sandwich" business akin to those in mall and airport food courts, but the husband's expert compared it to a national franchise such as Subway or Quiznos. The trial court rejected this "artificially high" earnings analogy, however, finding that "you could not compare a nationally based franchise, with the revenue it generates and the advertising budget it expends, with a smaller regional sandwich shop. It adopted the value by the wife's expert, and the husband appealed. *Held:* The trial court's decision was supported by "competent, credible" expert evidence and the appellate court confirmed the same.

In ***McRae v. McRae*, 2011 WL 1991725 (Conn. App.)(May 31, 2011)**, the husband owned a company that created software programs for healthcare providers. The wife's expert estimated its fair market value at roughly $377,000 compared to the husband's appraisal at $56,000. The trial court accepted the latter, adding an $88,000 undeposited check from one of the company's customers for a total value of $144,000.

The husband appealed, claiming that the check was for future services. Even so, he said, his expert had already included the check in his final value without factoring in related costs. *Held*: The appellate found sufficient evidence in the record, including testimony from the customer's accounts payable personnel, that the business had earned the check. Moreover, the husband's appraiser testified that he treated the check as both an account receivable (an asset) and a deferred revenue (liability), for a full offset (no added value); and that he also factored in approximately $37,000 in costs related to the business's future jobs. Thus the trial court correctly added the check to its ultimate valuation, and the appellate court confirmed the same.

In ***In re Marriage of Price and Turkanis*, 2011 WL 1783096 (Cal. App. 2 Dist.)(May 11, 2011)(unpub.)**, the husband sold his medical software company three years into the marriage for $9.45 million. At trial, the parties' experts disputed the value of the business at the beginning of the marriage: the wife's expert said it was worth nothing while the husband's said it was worth $6.25 million, based on comparable transactions that post-dated the valuation. The trial court continued the hearing to take additional evidence on comparable transactions, but the husband's new expert could still find only one similar, contemporaneous sale. He did find six transactions within a year of the marriage, including the sale of a direct competitor, which led him to value the husband's company at $6.25 million as of the marriage. After the trial court adopted this value the wife appealed. *Held*: The court of appeals affirmed, finding the use of subsequent comparable data appropriate in this case

In ***Wright v. Wright*, 2011 WL 1832801 (Cal. App. 4 Dist.) (unpub.)(May 11, 2011)**, the husband owned an accounting firm. Both of the parties' experts used an adjusted revenue/earnings method, reaching values that were only $7,000 apart ($330,000 for the husband's expert vs. $337,000 for the wife's). The trial court accepted the lower value, and then applied a 20% discount due to the attrition of the business. The wife appealed the application of *any* discount; she also argued that the $330,000 value already included a 20% discount. *Held*: The appellate court affirmed the application of the "attrition" discount, citing precedent that permitted a valuation to include the expected continuity of the business. Notably, both experts agreed that the firm was losing customers due to attrition, and this "was not a speculative event," the appellate court found. Further, there was no evidence that the appraisers (or the trial court) included an additional discount in the ultimate valuations.

Compare ***Keil v. Keil*, 2011 WL 2150009 (N.Y.A.D. 3 Dept.)(June 2, 2011)**, in which the husband owned a pool servicing business. The husband declined to present an expert appraiser, and the trial court accepted the $437,000 value by the wife's expert, based on various methods and assumptions. The trial court discounted the value by 20% due to the husband's age (67) and the uncertainty that he could continue to run the business. The wife appealed, claiming her expert had already factored in a "key man" discount to his valuation as well as the effects of the economic downturn. *Held*: The appellate court found no explanation in the record as to how the husband's age or health would negatively impact the market value of the business as of the divorce date, and reversed the 20% discount.

In ***K.B.R. v. E.P.R.* 2011 WL 2183858 (Mass. App. Ct.)(unpub.)(June 7, 2011)**, the husband owned a "lender of last resort" for companies and individuals, charging high interest rates for primarily real estate investments. At the time of the divorce, the firm held $1.4 million in outstanding loans. The husband's expert assumed a sale of the entire portfolio to a third party for a fair market value of only $175,000. In contrast, the wife's expert couldn't offer a "precise" value, but assessed a "weighted average collectability" for the loans of 70%; that is, in his opinion, the business

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would recover at least 70% of the $1.4 million in outstanding loans.

The trial court found the husband's expert value lacked credibility, but also found the wife's expert approach was "too optimistic given the economic realities of 2008, the bankruptcy of some of the borrowers, and . . . that all of the loans . . . were in default of some sort." Instead, it adopted a more "reasonable value" of $840,000 (or roughly 60% of the loan portfolio) due to the husband's past experience and the business's successful track record in collections, and the husband appealed. *Held*: The trial court's rationale was clear and there was no error in its valuation of the corporation.

About Our Firm.................

Our firm has years of experience assisting attorneys and business owners in determining value for litigation support, gift and estate tax planning, marital dissolution, buy and sell agreements, and business sale purposes. Whether you are determining the fair market value of a closely held business interest for sale, gift, or estate planning, knowing what your company is worth is one of the most important financial aspects of being in business.

In addition, you may use a business valuation as a management and planning tool. Besides acting as a scorecard that will help management determine whether the company is gaining or losing value, the valuation provides a better understanding of the real profitability of the business. Whatever reason you have for needing a business valuation, John R. Janicek, CPA P.C. is prepared to assist you in being your valuation solution.

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