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# Valuation Perspectives

*"Your Valuation Solution"*

Summer 2013

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## Valuation of Family Business Survives Expert's Deviation From Industry Standards

***Russell v. Russell*, 2013 Ark. App. LEXIS 151 (Feb. 27, 2013)**

The husband challenged the trial court's valuation of a family business, claiming there was no credible evidence to show it had a "fair market value" independent of the company's founder—his stepfather.

At divorce, the husband and wife agreed on the division of all property but disagreed about the value of his one-third interest in his stepfather's business, which he acquired during the marriage.

Both sides presented expert testimony, and both experts agreed that the value of 100% of the company was \$3 million, but their computations of the value of the husband's interest differed greatly.

In a pretrial deposition, the wife's expert, a CPA, issued a disclaimer: His valuation did not follow the industry standard or his own practice; he intended it only for himself and his client, not for third parties. Normally, he would discuss general economic conditions, industry-specific and company-specific risks, a standard value for the shares, and goodwill. Here, he did none of these things because he had agreed with the wife what numbers and discounts to apply.

He said he "dropped the Mergerstat average control premium of 29.6% to 10%," reasoning that the husband had some control over cash flow but admitting that a willing buyer of his shares might not think that control followed the purchase and may discount the value by 50%. He applied a 5% marketability discount even though he agreed that a buyer might aim for a much higher rate, between 30% and 40%.

Later, in his trial testimony, he said he discounted the company's value by 10%. Since the husband and his two brothers, who each also owned one-third of the shares, could take money out of the company, they all had a degree of control. Although he recognized that the average marketability discount was 35%, he

did not apply any. "Marketability and lack of control are not distinguishable," he stated.

To account for the risks related to the possible sale of the company's only client, he further discounted the value by 6%, a rate he thought was high. He relied on the wife's statements that the company had retained the client despite several earlier changes in ownership and that, to her, meeting the client's requirements "was extremely important and outweighed any personal relationship." Similarly, the husband had stated the client seemed to like the company because it could adjust to changes more quickly than competitors.

Because the stepfather no longer owned the business, the wife's expert did not discount for the founder's personal goodwill.

The husband's expert, a CPA, prepared a fair market valuation that complied with industry standards. Because the company was a going concern and he could not find comparable businesses, he used an income approach. Assuming a total value of \$3 million, the husband's interest was \$1 million. He also thought that the company's only client might be downsizing due to changes in ownership. The expert applied a 30% discount for lack of control and a 35% discount for lack of marketability, reducing the value to \$458,000, half of which—\$229,000—belonged to the wife.

He then discounted the goodwill of the company, assuming the enterprise goodwill was 50% and the personal goodwill attributed to the stepfather was 50%. The total value of the wife's share was no more than \$115,000, he concluded. The expert's goodwill determination assumed that the stepfather remained with the company.

The trial court found that the stepfather was the company's owner of record, but the husband and his brothers all owned an equitable interest in the business. It determined that, based on all evidence, the wife's interest in the business was worth \$273,000. In a motion for a new trial, which the court denied, the husband objected that the order included pay for nonmarital personal goodwill.

The husband then challenged the decision at the

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Arkansas Court of Appeals. The wife failed to prove that the company had fair market value independent of the founder's goodwill, he argued. Specifically, the trial court's valuation rested on "questionable" expert opinion.

The appellate court acknowledged that the lower court knew that the expert, rather than following industry standards, used discounts pursuant to his agreement with the wife. But, the reviewing court said, both experts agreed on the value of 100% of the company. Also, other competent evidence supported the trial court's valuation. For example, it heard about the wife's commitment to meeting the business needs of the firm's only client and the husband's belief that the client liked the firm.

Further, the husband failed to present evidence that might lower the value of the company, including proof that the client had reduced the assignments it gave to the firm or that it was downsizing, as his expert claimed. The Court of Appeals upheld the trial court's award to the wife.

## **Court validates expert's 'aggressively skeptical' disaggregation analysis**

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In a post-trial bid to upset the outcome in *Liberty Media Corp. v. Vivendi Universal, S.A.*, 2013 U.S. Dist. LEXIS 19485 (Feb. 12, 2013), Vivendi argued that no jury "should have been permitted to base a verdict" on the unreliable loss causation and damages testimony Liberty's expert gave. In particular, Vivendi took aim at the expert's disaggregation analysis.

Liberty sued Vivendi, alleging Section 10(b) securities violations and breaches of warranties related to a merger agreement. Vivendi, it claimed, had inflated the value of its stock, which it used in 2001 to acquire USA Networks from Liberty. Subsequent revelations showed that Vivendi was in a liquidity crisis, causing its stock value to fall. In June 2012, a jury found Vivendi liable on all claims and awarded Liberty 765 million euros (\$999 million).

In its motion, Vivendi claimed Liberty's expert had failed to prove loss causation—the cornerstone of proving damages in complex securities claims. Under this principle, Liberty could only claim damages for declines in Vivendi's stock price that resulted from Vivendi's misconduct.

The expert's disaggregation analysis separated

the effects the fraud ("materialization" events) had on the stock price from the effects that non-fraud-related factors ("confounding" events) produced. He examined 166 trading days between the date the merger agreement was signed and the date of the final alleged materialization event to isolate the effects of the fraud. After reviewing 16,000 news releases and thousands of analyst reports, he carved out nine days during which "everything had to do with the fraud," he said.

Vivendi criticized the expert for ignoring what it said were several items of negative non-fraud-related news during those nine days that should have been figured into his damages calculation. But the expert had testified that he didn't consider those news items to be material.

The court said that just because the expert "took an aggressively skeptical view of the significance of non-fraud-related news" on the nine days did not render his testimony unreliable. Additionally, the jury could have found that none of the confounding events Vivendi proposed were non-fraud-related and also affected Vivendi's share price. The court let the award stand.

## **Lone settlement agreement cannot support plaintiff's damages theory**

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After AVM sued Intel for infringing on one of its patents on a feature in microprocessors and its expert determined reasonable royalty damages between \$150 million and \$300 million "or more," Intel filed a *Daubert* motion to exclude the testimony (*AVM Technologies, LLC v. Intel Corporation*, 2013 U.S. Dist. LEXIS 1165 (Jan. 4, 2013)). Earlier, a federal court stated that it was inclined to rule in Intel's favor but wanted to hear from the expert in person before issuing a final decision. The court has now heard from the expert and issued a decision.

The expert initially relied on four Intel settlement agreements, but the court found three of them not comparable. This left him with only a single settlement agreement Intel reached with a third party in 2009 for a different patent to support his conclusion. In that settlement, Intel paid \$110 million to end the litigation and obtain the license.

The expert admitted that he didn't know anything about the agreement "other than [its] express terms and information from press releases." But he believed it related to patented technology that was

less important to “Intel’s commercial interests” than the technology at issue and that the royalty base for the former patent was “far less” than the royalty base for the disputed patent. The lump sum covering the patent-in-suit “should exceed” the payment under the 2009 agreement, he concluded.

His report lacked all analysis of factors that might affect the settlement amount, the court found. The conclusion did not rest on any methodology that explained why the 2009 agreement by itself could be the basis for an accurate conclusion about the value of the patent in issue. Recognizing that its decision eroded AVM’s evidentiary basis for its damages claim, the court vacated the trial date. But it also stated it could not grant Intel’s summary judgment motion of no damages at this time.

## Tax Court overturns penalty for overvaluing a tax shelter

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The Tax Court has overturned its own precedent in ruling that a taxpayer may not avoid the 40% gross valuation penalty for overvaluing a tax shelter. Taxpayers have been able to avoid the penalty short of trial merely by conceding on grounds unrelated to valuation or basis. But now, in *AHG Investments LLC et al. v. Commissioner, 140 T.C. No. 7 (2013)*, the court shifted gears and followed the majority rule in the appellate courts and sided with the IRS, which had waged a decades-long battle on this issue.

This ruling may trigger more trials focusing on valuation issues, since the value of the underlying assets is typically the fundamental issue in abusive tax shelter cases. Investors should be careful when presented with a business deal that promises tax benefits based on assets with a questionable valuation.

## Urge to converge upends lease accounting and reporting

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Valuation experts will never look at income statements and balance sheets the same way again under proposed changes designed to unite lease accounting around the world.

Almost all companies will be affected by the changes introduced by the agreement between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to create a new,

converged approach to lease accounting that would eradicate the old distinction between operating and capital leases.

**Exposure draft:** The new Proposed Accounting Standards Update—Leases (Topic 842): a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840) says that all assets and liabilities arising from leases must be recognized on the balance sheet. Critics of the current rules say they allow too many leased assets to be invisible, which means the books don’t accurately reflect a company’s true financial picture.

The implications of the rule changes should be understood now because it is likely that existing leases will not be grandfathered. The changes will affect virtually all firms because leasing assets is so common. Of course, companies that lease assets to others will especially be affected.

Here are the main implications on company financials from the proposed changes:

- Balance sheets will grow, and companies will appear to be more leveraged;
- Lease expense will fluctuate because the lease will be amortized using the effective interest method, so the expense will be higher in the early years and lower in the later years (under operating leases, lease expense stayed constant); and
- Certain financial ratios could be affected because EBITDA would change, as lease expense would be replaced with interest and depreciation expense.

The IASB and FASB have been working together since 2002 to achieve convergence of IFRS and U.S. GAAP. The new converged standard for leases is part of this effort and is designed to significantly increase global comparability, which it will do because of the number of organizations that use leases.

The new exposure draft can be found on the websites of IASB and FASB.

## DE Chancery warns against comparing ‘good’ apples to ‘bad’ in valuing distressed companies

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After trying to integrate several businesses, with disastrous results, a private equity firm “quit” and sold off most of its senior debt. For two months, the

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purchaser tried but failed to secure a single bid for the company's assets and ended up selling them to an affiliate—at an open auction—for just under \$92 million.

Without having made a bid, the PE firm sued the debt purchaser and affiliate in the Delaware Court of Chancery, claiming the sale process and price was not “commercially reasonable” under the UCC (*Edgewater Growth Capital Partners LP v. H.I.G. Capital, Inc.*, 2013 Del. Ch. LEXIS 54 (Feb. 28, 2013)). To show the company was worth more than the \$92 million paid at foreclosure, the PE firm's expert applied a DCF analysis as well as the guideline public company method, selecting three public comparables in the same industry but with stable, if not profitable, financials. After a rebuttal expert criticized his failure to use distressed companies as comparables—and accused him of overstating the EBITDA multiple for one company by 100%—the PE firm's expert revised his report but didn't change his overall conclusion that the company was worth \$110 million at auction.

That final value “makes no sense,” the Court of Chancery said. First, his market approach failed to

compare the company to other distressed firms. Second, his DCF was based on “stale, unrealistic” projections, formulated during the turnaround phase. Finally—even when confronted with “glaring mistakes” in his report—the expert failed to revise his original opinion.

## 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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