Editor’s Column:

Lawyers should have BV standards handy for reference

by Shannon Pratt

This is the third in a series of editor’s columns based on Dr. Pratt’s recent book, The Lawyer’s Business Valuation Handbook (see p. 12 for ordering information). – LK

When you encounter a business valuation report or testimony, it is important for you to know whether it complies with current standards for business valuation work products (written or oral). This column tells you what standards exist, and how to obtain them for your files.

The “daddy” of valuation standards for all appraisal disciplines is the Uniform Standards of Professional Appraisal Practice (USPAP). It is updated annually by the Appraisal Standards Board of The Appraisal Foundation. The 2001 edition is now available.

The Appraisal Foundation is an “umbrella” organization with membership including leading professional organizations in all appraisal disciplines, such as the American Society of Appraisers (a multidisciplinary appraisal organization) and the Appraisal Institute (the largest real estate appraisal organization). While USPAP is required by law to be followed only in limited circumstances (e.g., a federally-related real estate appraisal), it is widely regarded as the gold standard in the appraisal profession.

Guest Article:

Minority discounts should be applied in family law cases

By Mark Kohn, CPA/ABV, CVA

There is disagreement among lawyers and appraisers regarding whether minority discounts should be applied in valuing an interest in a closely held company in the family law setting. In this article, Mark Kohn explains and advocates for the position that such discounts must be applied. On p. 4, we have included a sidebar showing actual court cases in which this issue has been addressed. — LK

If a person owns 100% of the stock of a corporation, he can operate the business however he so chooses. He may decide to sell new products or stop the sale of existing products. He may change the very nature of the business, so that instead of the corporation selling cars, for example, he may change it into a consulting business.

The 100% owner may operate the business frugally, or he may choose to operate extravagantly. Furthermore, he may choose to use the business as a means of paying for his personal travel and entertainment expenses, his home remodeling, his expensive auto, etc. The sole stockholder can do as he wishes, and while he may have concern for the tax laws, which may prohibit certain behavior, he may choose to ignore them and do as he pleases.

The nature of the minority interest

If, on the other hand, there are ten people who each own 10% of a corporation, then the situation is much different. Each of the ten stockholders has what is called a minority interest in the corporation.

Matters become complicated in the situation where, for example, one person owns 80% of the stock and another person owns 20% of the stock. The 80% stockholder has the ability to run the business as he wishes, because he owns the majority of the stock. The 20% stockholder has an ownership interest in the corporation, but he cannot control anything that goes on within the corporation.

The only real benefit that a 20% owner has is that if the controlling 80% owner decides to dissolve the corporation, the 20% owner will have the authority to run the corporation as he wishes. Each of the ten stockholders has what is called a minority interest in the corporation.

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spected by appraisers and courts as the leading set of appraisal standards.

USPAP compliance often violated

Many appraisers issue a statement in conjunction with their written appraisal reports to the effect that “this report complies with the Uniform Standards of Professional Appraisal Practice.” I have seen several reports with this statement that do not, in fact, comply with USPAP. Pointing out such discrepancies on the witness stand can have a significant effect on the court’s view of the appraiser’s credibility.

Even if the appraiser makes no claim about compliance with USPAP, the document represents good appraisal practice. The appraiser should be able to explain good reasons for any shortcomings in his own work compared with USPAP standards.

Organizations have own BV standards

Three of the professional business organizations publish their own sets of standards for business valuations. All of them are available from their respective organizations (see sidebar below).

The American Institute of Certified Public Accountants (AICPA), which confers the designation Accredited in Business Valuation (ABV), does not have business valuation standards. However, they have announced plans to start developing standards, probably about a two-year process.

Adherence to standards not universal

A little over ten years ago, business valuation standards did not exist. We’ve come a long way in a decade.

Unfortunately, there are still those who accept professional fees for business valuations but don’t adhere to any standards, resulting in very poor “expert” testimony and bad case law.

Lack of adherence disserves client

Worse than the bad case law resulting from poor appraisal work products (either written or oral) is that clients are not well served. On the one hand, the court may not accept an appraiser’s testimony that violates basic standards, resulting in a disservice to his or her own client. On the other hand, poor testimony sometimes goes unchallenged, resulting in a disservice to the opposing attorney’s client.

In The Lawyer’s Business Valuation Handbook, I have included, at the end
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...of most chapters, questions to ask the appraiser about his or her work relative to the subject matter of the respective chapter. Many lawyers have told me that such questions are something they have been looking for in their arsenal for some time.

Focused questions will reveal charlatans

I am now advocating going a step further. That is, obtain USPAP and the standards listed in the sidebar, and ask questions relative to USPAP or the appraiser’s professional organization’s own standards when they have been violated.

This focused examination of the professional appraiser’s work product will improve the appraisal profession by showing up the charlatans. Of immediate importance to you, it should help prevent a less than adequate appraisal product from unnecessarily harming your clients’ interests.

Best wishes,

Shannon Pratt

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A second opinion is that community assets should be valued at fair market value, which would likely include a minority discount. If the 20% interest were sold to an outside party, it would clearly sell for less than two million. It should therefore be valued at that lower amount.

The first opinion counters by arguing that law practices are valued at investment value, rather than fair market value, because a law practice cannot be sold. What governs, therefore, is the actual income stream from the law practice, and just as that continues after the divorce, so too will the salary paid to the 20% owner. Accordingly, the two situations should be treated the same. Investment value, measured by an economic substitute, should be the standard of value rather than fair market value.

The second opinion responds with two points:

First, fair market value, defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts, should be used when it is calculable. An economic substitute, such as investment value, should be used as a secondary alternative, not as a primary method.

Second, if one does use an economic substitute, then the valuation should be the economic benefit being received by that 20% owner, capitalized at an appropriate discount rate.

- Assume that the salary paid to that 20% owner was $200,000, that he could be fired by the 80% owner at will (creating considerable risk that the salary may not continue), and that the $200,000 salary were capitalized by 33%. This calculation would result in a value of $600,000. That amount is much less than $2 million, which was based on the total value of $10 million times 20%.

- Assume, on the other hand, the 20% stockholder’s salary was $1 million per year and that is capitalized by 33%, arriving at a value of three million. Here the resulting value is much greater than $2 million.

Unless the salary and the capitalization rate work out exactly to two million, the value determined by the economic substitute will never be $2 million, and so there will be either a discount or a premium to the $2 million amount. It is inconsistent to apply the ownership interest percentage...
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(20% in our example) against the total value (ten million in our example) and to then argue that an economic substitute for fair market value is being used.

Analogy to the patent
A useful analogy is the value of a patent owned by the community. Imagine a patent invented during marriage that has significant financial potential, but at date of trial, the patent was offered to sale to many patent investment companies, and it was clear from the various offers made that the patent could be sold for only $10,000. The fair market value is therefore $10,000. The investment value, if it could be determined, would be based on the potential future earnings from the patent, several or many years from the date of trial. Most courts would value the patent at $10,000 because that is the fair market value.

Analogy to rental property
Another useful analogy is the value of a rental property that is owned by the community, in which they have a very strong sentimental interest, and do not want to sell. If the rental property is valued at ten times the cash flow, based upon current economic factors, and the cash flow of the property is $100,000 per year, then value of that property is $1,000,000. If, however, the property is located in the middle of an area owned by a shopping mall developer, who is willing to pay $1,500,000 for the property in order to complete his development, most courts would value the property at $1,500,000 because that is the fair market value.

Business interests should be the same
The value of the minority interest in a corporation should also be its fair market value, and so a minority discount should be applied. A 10% interest in a corporation whose primary value to the owner is the possibility that the company may be sold many years from the date of trial should be valued at the fair market value at the date of trial. The marketplace should determine the value, and the marketplace would discount the value of that 10% interest significantly below a value that is 10% of the entire corporation.

If one is to consistently argue that there should be no minority discount in valuing business interests in family law cases, then one must also ignore the fair market value of assets such as patents and rental property. Such an argument is inconsistent.
More comments on the Tax Court and FLPs

by Arthur D. Sederbaum *

The following comments are a follow-up to the symposium on the Tax Court’s FLP trilogy that ran in the January 2001 issue. Art Sederbaum provides his perspective on the Shepherd, Knight, and Strangi cases, and their relationship to other Tax Court FLP cases. —LK

It would be redundant for me to attempt duplication of Ron Aucutt’s treatment of the new FLP cases, which ran in the January 2001 issue of this newsletter. Please permit me, however, to offer some random thoughts in a “concurring opinion” to Ron’s extensive comments.

Shepherd shows how not to
Shepherd v. Commissioner is a “how-not-to-do-it” case. The Tax Court concluded that the taxpayer’s contributions of the leased land and bank stock were allocated to his and his son’s capital accounts according to their respective partnership shares. If the taxpayer’s (i.e. the contributing partner’s) capital account had been increased by the amount of his contribution, thus entitling him to recoup the same amount upon liquidation of the partnership, a different holding, far more favorable to the taxpayer, would have resulted.

It is also this observer’s hope that IRS will finally throw in the towel in its contention that the discount for fractional interest in real estate should be limited to the costs of partition. That argument should have died with Williams v. Commissioner, T.C. Memo. 1998-59.

Knight and Strangi don’t disregard FLP
Knight v. Commissioner and Strangi v. Commissioner are both “glass half-empty” or “glass half-full” cases, depending upon your point of view and whether you are an employee of the Internal Revenue Service. Both cases refused to disregard the partnership form, notwithstanding the fact that, in each case, the taxpayer did not deal entirely at arm’s length with the partnership after its formation.

Knight limited the discounts to a total of 15% for minority interest and lack of marketability. The Tax Court thoroughly rejected the taxpayer’s expert’s testimony because the appraiser did not show that the companies in the studies were comparable to the Knight partnership or explain how he used the data to estimate the discount for lack of marketability. The appraiser also listed 19 purported business reasons for which he said the partnership was formed, whereas the taxpayer claimed only to have had five of those 19 reasons.

According to the opinion, the appraiser’s “erroneous factual assumptions cast doubt on his objectivity.” The lesson? Appraisers must be instructed that they are preparing “expert testimony,” and although the appraiser is retained and paid by the taxpayer (or taxpayer’s counsel), the appraiser must convince IRS (and if necessary) a trier of fact that he has prepared an unbiased report.

Kerr holds up as precedent
Knight also illustrates the precedential value of Kerr v. Commissioner holding that Code §2704(b) does not apply because Texas law restrictions on liquidation of the partnership were as restrictive as those in the partnership agreement itself. As Kerr stated, the restrictions to be examined for Code §2704(b) purposes are the restrictions on the liquidation of the entity and not the liquidation of an individual’s limited partnership interest. Knight is the second case decided by the Tax Court (Harper v. Commissioner, T.C. Memo. 2000-202 was the first) in which the Tax Court cites Kerr as controlling and refuses to discuss the matter further.

Strangi most important of trilogy
I find Strangi v. Commissioner to be, by far, the most important of the three cases. Approximately 75% of the assets transferred to the partnership consisted of cash and marketable securities. The partnership comprised over 95% of the decedent’s gross estate (the partnership was formed by the decedent’s attorney-in-fact, who also happened to be his son-in-law, two months prior to his death), the partnership paid personal expenses, and no active business was conducted by the partnership following its formation.

Despite all of these negative factors, the Tax Court recognized the partnership, since it satisfied all state law requirements.

Section 2036 still alive
However, the court invoked the specter of the Reichhardt v. Commissioner case, decided earlier in 2000, which held that the decedent’s continuing enjoyment of the assets after they had been transferred to the partnership resulted in the inclusion of the assets in his gross estate pursuant to the provisions of Code §2036.

The only reason why Code §2036 was not an issue in the Strangi case was because the Commissioner raised the issue in a proposed amendment to his answer, which was tendered shortly before trial. The Commissioner’s motion to amend his answer was denied because it was untimely. Does that mean that Code §2036 is alive and well in the IRS’s assault on family limited partnerships? Decidedly so. Just ask the Executors of the Reichhardt estate.

Fortunately, Strangi seems to inter the Code §2703 argument of the IRS, for the case holds that Code §2703(a) does not apply to the underlying assets in the partnership. The Tax Court notes that neither the language of Code §2703(a) nor the legislative history supports the IRS’s interpretation. It is to be hoped that Knight will be cited for this proposition as conclusively as Kerr is cited for the test on applicable restrictions under Code §2704(b).

As far as the discounts were concerned in Strangi, the Tax Court accepted the IRS appraisal reluctantly, noting that those discounts “may still be over-generous.” For this reason, the IRS will continue to maintain its assault on the amount of the discounts, as it continues to lose case after case on the viability of the partnership entity. The glass remains “half-full” for both sides after the Knight and Strangi cases.

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Tax Court considers QMDM and restricted stock studies in determining discount for lack of marketability

by Philip J. Schneider, JD, ASA, CPA/ABV


Key words: Gift tax, Fair market value, Net asset value, Adjusted book value, Minority discount, Marketability discount, Restricted stock studies, Quantitative Marketability Discount Model (QMDM), Growth rate, Holding period, Holding company, Bank stock

The Experts:
Grant Thornton (on gift tax return)
Gary L. Wahlgren (for petitioners)
Philip J. Schneider, JD, ASA, CPA/ABV (for IRS)
Philip Schneider & Associates, Inc.

In November 1992, the Petitioners gifted shares of St. Edward Management Company common stock to their children. Each gift represented approximately 5.3% of the outstanding shares of common stock. St. Edward Management Company (the “Company”) owned 94.6% of the common stock of the Bank of St. Edward (the “Bank”), a bank located in a small agricultural community in Nebraska.

In connection with the gift tax return, the Petitioners hired the accounting firm Grant Thornton to perform an appraisal. Grant Thornton determined the fair market value of the stock to be $21.22 per share on a non-controlling, non-marketable basis. In their appraisal, Grant Thornton applied a 10% minority interest discount, and a 20% marketability discount.

Expert reports for trial

Our firm, Philip Schneider & Associates, Inc., was hired by the IRS to perform an appraisal of the Company. My report was completed on Feb. 13, 1998. I determined the fair market value of the stock to be approximately $30.50 per share on a minority, non-marketable basis. This amount includes a 20% discount for lack of marketability.

At the Tax Court trial, the Petitioners did not provide testimony by Grant Thornton. The Petitioners’ expert witness was Gary Wahlgren. Wahlgren’s appraisal report was completed on Feb. 9, 2000 – approximately two years after my report was issued.

Petitioner’s expert uses QMDM

Wahlgren determined the fair market value of the stock to be $51.38 per share on a controlling, marketable basis. After applying a 10% minority interest discount, Wahlgren determined the fair market value of the stock to be $46.24 per share on a minority, marketable basis.

Using Z. Christopher Mercer’s Quantitative Marketability Discount Model (QMDM), Wahlgren determined that a 65.77% marketability discount was appropriate. Therefore, according to Wahlgren, the fair market value of the stock was $15.83 per share on a minority, non-marketable basis.

Experts agree on minority, marketable value

In my review of Wahlgren’s report, I noted that the Bank had certain loans that had been previously written off, but management believed that full payment would be received. The existence of these off-balance sheet assets was not disclosed in the information that had been provided to me.

After considering these off-balance sheet assets, I agreed with Wahlgren’s conclusion that the fair market value of the Company was approximately $46.24 per share on a minority, marketable basis. After applying a 20% marketability discount, I concluded that the fair market value of the stock was approximately $37 per share on a minority, non-marketable basis.

Only issue is marketability discount

Because both experts agreed that the fair market value of the Company was $46.24 per share on a minority, marketable basis, there was only one issue for the Tax Court to address. What is an appropriate marketability discount?

In my analysis, I relied upon various restricted stock studies and prior Tax Court decisions. The Tax Court criticized these studies as being too general. Because information was not presented regarding marketability discounts for this particular industry, or for companies with the same characteristics as St. Edward Management Company,
Tax Court considers QMDM, restricted stock studies in determining DLOM

Mercer developed the QMDM in an attempt to reduce the subjectivity associated with determining marketability discounts. However, it is clear that the Tax Court does not find the QMDM to be a useful tool. In the Janda decision, the Tax Court stated: “We find Mr. Wahlgren’s application of the QMDM model in the instant case not to be helpful in our determination of the marketability discount.” This comment is consistent with the Tax Court ruling in Estate of Weinberg v. Commissioner, T.C. Memo 2000-51.

In its rejection of QMDM, the Tax Court stated: “We have grave doubts about the reliability of the QMDM model to produce reasonable discounts, given the generated discount of over 65%.” I would offer the following interpretation of this statement. In concluding that a 65.77% marketability discount is unreasonable, the Tax Court must accept that, despite the inherent weaknesses, restricted stock studies provide at least a basic guideline for determining whether a marketability discount is reasonable.

Tax Court concludes 40% combined discount

The Tax Court concluded that a 40% combined discount (for lack of control and lack of marketability) was appropriate. Using Wahlgren’s conclusion regarding the controlling, marketable value of the Company ($51.38 per share), and applying a 40% combined discount, the Tax Court concluded that the fair market value of the stock was $30.83 per share.

The Tax Court did not provide any justification for the 40% discount. In addition, the Tax Court did not provide a separate minority interest discount and marketability discount. The ruling does indicate, however, that most of the discount relates to concerns over lack of control. The Tax Court stated: “[W]e also believe that most of the concerns regarding lack of marketability relate to the lack of control associated with any transferred block of stock.”

In the Janda decision, the Tax Court highlighted the problems with using generalized empirical studies to determine marketability discounts. However, the ruling also suggests that restricted stock studies provide a basic guideline for determining whether a marketability discount is reasonable. In addition, the Tax Court rejected (for the second time) the use of QMDM.

MERCER’S COMMENTS ON JANDA

The following comments are excerpted from Chris Mercer’s E-Law 2001-01: Janda v. Commissioner. These comments are included here to provide some balance to the discussion of marketability discounts. The full article by Matthew R. Crow, CFA, ASA, and Kenneth W. Patton, ASA, can be viewed at www.bizval.com. — LK

Mr. Schneider . . . quoted the restricted stock studies and pre-IPO studies listed in Shannon Pratt’s Valuing a Business, and a few court cases. In other words, Mr. Schneider used the usual benchmark studies. He then stated that he believed that “a bank would be a highly marketable business and that the stock would be highly marketable.” Based upon this, Mr. Schneider concluded that a 20% marketability discount was appropriate.

Echoing Daubert v. Merrell Dow Pharmaceuticals, Inc., 113 S.Ct. 2786 (1993), lawyers for the IRS also asserted that “there is no evidence that appraisal professionals generally view the QMDM model as an acceptable method for computing marketability discounts.” We do not agree.

We have sold over 2,700 copies of Quantifying Marketability Discounts. The QCMD has been written up in all major valuation publications. We have spoken to hundreds, if not thousands, of professionals in the appraisal community via dozens of speeches and seminars. We have used the model in thousands of appraisals. We have received hundreds of phone calls, emails, and other communications from valuation practitioners outside of Mercer Capital who use the QMDM regularly. And, yes, we have even been engaged by the Internal Revenue Service to perform valuations on their behalf using the QMDM (none of which have made it to the point of being a matter of public record). What else can we do?

The Court noted the IRS objection, but neither agreed nor disagreed with it. We have no interpretation regarding the inclusion of the comment in the opinion, but we are confident that the QMDM meets the challenges of Daubert.

* * * * *

Final thoughts

Winston Churchill once commented, “It has been said that democracy is the worst form of government except all those other forms ....”

The controversy about the QMDM may be much the same thing. On balance, the Court disagreed with Mr. Wahlgren’s use of the QMDM and seemed to be uncomfortable with the size of the marketability discount his analysis implied. We were encouraged and gratified that the Court apparently spent significant time understanding the model and devoted so much of the written opinion to it. As for the alternative, the Court dismissed benchmark analysis as subjective and irrelevant with little comment.

At the same time the Court criticized the QMDM, it reiterated the call for a fact-based valuation discount methodology. Given the choice between the QMDM and benchmark analysis, we know where we stand.
Goodwill value must exclude employee compensation, personal goodwill, and non-compete agreement factors


**Key words:**
Marital dissolution, Goodwill, Goodwill registry database, Employee compensation, Personal goodwill, Practice goodwill, Non-competition agreement, Dental practice

**The Experts:**
Howard Kaminsky (for wife)
SK&B Business Services, Inc.
Dana W. House, CPA (for husband)
Virschow, Krause & Company

The valuation at issue in this marital dissolution appeal involved the husband’s dental practice. On appeal, the husband challenged the trial court’s acceptance of the wife’s goodwill valuation of the practice, because it failed to distinguish the proper attributable goodwill or to figure the non-competition agreement into the valuation. The expert’s method overvalued the dental practice.

**Goodwill valuation flawed**

The trial court adopted the valuation opinion of Howard Kaminsky, the wife’s expert. His valuation estimated the amount of goodwill from the practice’s revenue, but did not reduce for the husband’s compensation. He estimated the husband’s goodwill by comparing his practice to practices with similar revenues from a goodwill registry database. He subtracted the practices’ physical assets from the sale prices in the registry to arrive at an average amount of goodwill. Multiplying the husband’s 1997 practice revenue by the registry average produced a goodwill estimate.

The appellate court ruled that this violated *Rogers v. Rogers*, 296 N.W.2d 849, 852-853 (Minn. 1980), which held that a valuation may not include salaries of employees and officers in a corporation’s income for valuation purposes.

In addition, the trial court failed to distinguish between the goodwill attributable to the practice and the goodwill attributable to the husband. This also violated *Rogers*, which states that, assuming the husband will remain with the corporation, is improper in valuing the husband’s share.

Finally, the wife’s expert’s goodwill valuation did not account for the husband’s non-competition agreement. The appellate court found the valuation problematic because of insufficient specificity regarding whether the non-competition agreement restricted the husband’s ability to practice dentistry. The court needed this information to apportion the marital and non-marital components of the dentistry practice.

**Revaluation required on remand**
The appellate court remanded the valuation finding at the corporation as a whole, because of the husband’s 50% interest in the corporation. He calculated goodwill using seven different methods that produced a range of $295,000 to $578,000, and concluded the value to be $350,000.

**Trial court has discretion to choose between competent valuations**


**Key words:**
Marital dissolution, Fixed asset value, Fair market value, American Medical Association guidelines, Accounts receivable, Goodwill, Net book value, Tax basis/tax incentive valuation, Intrinsic value method, Plastic surgery partnership

**The Experts:**
Garth M. Tebay CPA, CVA (for wife)
Tebay Mosley Associates LLC
Michael Heaton, CPA/ABV, CVA (for husband)
Heaton & Eadie

The issue in this marital dissolution was the value of the husband’s interest in a plastic surgery partnership, *Reconstructive & Aesthetic Surgeons, Inc.* (RAS). The appellate court affirmed the trial court’s decision to accept the valuation of the wife’s expert witness, which was based on the American Medical Association (AMA) guidelines.

Both the husband’s expert and the wife’s expert valued the husband’s interest in the assets of the surgical practice by considering the fixed assets, the accounts receivable, and goodwill. However, the valuations varied by 47%.

**Expert uses seven methods to value goodwill**

Garth M. Tebay, the wife’s expert witness, compared the list of tangible equipment and furniture provided by the RAS accountant to the AMA table, which estimates fair market value for medical equipment, to arrive at the fixed or tangible asset value. His accounts receivable value resulted from looking at the corporation as a whole, because of the husband’s 50% interest in the corporation. He calculated goodwill using seven different methods that produced a range of $295,000 to $578,000, and concluded the value to be $350,000.

**Net book value used for fixed assets**

Michael Heaton, the husband’s expert witness, valued the fixed assets using the net book value, or a tax basis/tax incentive valuation. This valuation results when the value of the assets satisfies all liabilities. However, a small corporation can write off 100% of its assets even if the value of an asset is not zero. This may result in a greatly reduced tangible asset valuation.

Heaton valued the accounts receivable by the “intrinsic” value method which analyzed only the husband’s income stream or collection rate.

**Survey used to determine goodwill**

Heaton valued the goodwill by comparing the historic cash flow or earnings to a “norm” established by the Medical Group Management Association’s national survey of plastic surgeons. He then applied a weighted average against the resulting excess to arrive at the husband’s interest in the goodwill of RAS.

**No abuse of discretion**

The appellate court affirmed the trial court’s acceptance of the wife’s expert witness’ valuation under an “abuse of discretion” standard of review. The court held that “an appellate court may not substitute its judgment for that of the trial court where there exists some competent and credible evidence supporting” the court’s findings.
Trial court has discretion to appoint an expert for marital dissolution


Key words:
Marital dissolution, Marital estate, Court appointed expert, Partnership valuation, Partnership bankruptcy Equitable distribution, Valuation date

The Expert:
Donald Thacket and Associates

The issues presented in this marital dissolution appeal concerned the chancellor’s appointment of an expert witness to value the marital estate. The expert’s selection of a valuation date other than the date of divorce was also at issue.

The case presented the valuation of a partnership, Heigle Farms. In the marital dissolution, the wife sought equitable distribution of the marital estate. The dissolution concluded during the partnership bankruptcy proceedings of Heigle Farms.

Trial court appoints an expert
The chancellor granted the wife’s summary judgment motion for equitable distribution of the marital assets and a motion for the chancellor to appoint an expert to appraise the marital estate. The husband opposed the motion because his counsel could not be present. The chancellor heard the motion without the presence of the husband’s counsel and appointed Donald Thacket and Associates to value the marital estate.

Valuation considers post-divorce figures
The chancellor ordered the valuation to be made “as of 12/31/91.” However, the expert calculated the current value of the marital estate, used a balance sheet dated January 19, 1998 in the valuation, and dated the report December 10, 1998. The court noted that marital property is acquired only during the marriage. This marriage ended in 1992, but the valuation clearly included figures from 1998.

Marital estate division
The chancellor also did not divide the marital estate. He granted the wife equitable distribution, which requires establishing fair market value of the marital assets.

The chancellor made no factual findings or conclusions of law on the marital assets. The court found this to be a manifest error.

The Supreme Court of Mississippi found that the chancellor did not abuse his discretion in appointing an expert.

Remand required
However, the court remanded the issue to the chancellor to provide the husband an opportunity to have input on issues such as the method of selecting the expert and the date used in the valuation.

The husband also appealed the value of his liabilities in relationship to the partnership liabilities. The court did not address this issue because of the remanded issues.

Business enterprise valuation showing solvency precludes fraudulent transfer claims


Key words:
Bankruptcy, Reorganization, Leveraged recapitalization, Subordinated notes, Fraudulent transfer claims, Insolvency, Business enterprise valuation, Going concern value, Net asset value, Discounted cash flow, Historic cash flow

The Expert:
Harrison J. Goldin (court-appointed examiner)

Goldin Associates

The issue in this Chapter 11 reorganization plan appeal involved the court-appointed examiner’s assessment of Bruno’s, Inc.’s leveraged recapitalization. W.R. Huff Asset Management Co., L.L.C. and HSBC Bank USA (Huff and HSBC), holders of $290 million in Bruno’s subordinated notes, appealed the District Court’s order to release the claims because the court found they had “little potential merit.”

The Bankruptcy Trustee appointed a creditors’ committee. This committee released any fraudulent transfer claims because the debtor’s counsel, Weil, Gotshal & Manges, concluded there were no viable claims. The District Court granted Huff and HSBC’s motion to appoint an examiner to evaluate the claims. Harrison J. Goldin performed a detailed financial analysis of the recapitalization to determine Bruno’s solvency and its ability to use capital resources to meet future needs, including debt payments and liability satisfactions.

Business enterprise valuation shows solvency
Goldin tested the company’s solvency by using two approaches. An asset-by-asset valuation compared the sum of each asset’s value to total liabilities.

The business enterprise valuation valued the business as a going concern and included intangibles such as relationships with customers and suppliers, and the name, profile and reputation of the business. Goldin applied the business enterprise valuation because participants in the recapitalization acquired Bruno’s as a going concern.

Of three formulations applied under this valuation method, all but one determined that Bruno’s was solvent at the time of recapitalization. Goldin compared the discounted cash flow to long-term debt and found that Bruno’s value exceeded its long-term debt by $270 million to $690 million. The asset-to-liabilities analysis, which compared total adjusted enterprise value from a discounted cash flow analysis to total liabilities, showed solvency by $215 million to $635 million. The only test that indicated insolvency analyzed sales earnings for comparable enterprises operating in the southeastern United States only.

Goldin then determined that any claims arising from the recapitalization were unlikely to succeed, but not because Bruno’s was undercapitalized. Historical cash flow, net sales, gross profit margins, and net profits and losses showed that the recapitalization did not leave Bruno’s with unreasonably small capital. Decisions on pricing strategy and closing one distribution center, among other “unfortunate decisions,” eroded the company’s customer base, which led to the bankruptcy.

Fraudulent transfer claims extinguished by valuation finding solvency

The Third Circuit Court of Appeals found that fraudulent transfer claims resulting from the subordinated notes had no probable value. The court accepted the examiner’s financial evaluations of Bruno’s that showed the supermarket chain was solvent after the recapitalization.
This note discusses the executive compensation test applied by the Seventh Circuit to a Section 162 corporate deduction in the *Exacto Spring Corp. v. Commissioner* (abstracted in the January 2000 issue of *J&L BVU*) appeal from the Tax Court.

The note surveys prior case law interpretations of the Section 162 two-pronged test for reasonable compensation. The second section of the note presents the facts of *Exacto Spring*, the Tax Court analysis, and the independent investor test applied by the Seventh Circuit on appeal.

The author discusses the lack of specificity in the circuit court’s independent investor test and its inconsistencies with the Treasury Regulation. She suggests more appropriate calculations and comparisons to provide more certainty to the taxpayer, which would align the test with section 162.

Some court circuits have adopted versions of the test but no circuit has explicitly rejected it. The note concludes by suggesting that practitioners include the *Exacto Spring* test in planning strategies for closely held corporations.

**THE AVAILABILITY OF LACK OF LIQUIDITY DISCOUNTS FOR TRANSFERS OF FAMILY LIMITED PARTNERSHIP INTERESTS**, Rowan, Marva J.

*The Tax Lawyer*, Summer 2000, Volume 53, Number 4

This article focuses on *Kerr v. Commissioner* (abstracted in the Feb. 2000 issue of *J&L BVU*) and how a lack of liquidity discount would be allowed in determining the value of transferred limited partnership interests.

The article begins by looking at valuation discounts and the framework behind section 2704(b). The next part of the article examines the facts of *Kerr*, the taxpayer’s alternative arguments, and the Tax Court’s ultimate decision. Lastly, the author analyzes the court’s decision and describes its implications for estate planners.

The author points out that *Kerr* did not determine the extent to which limited partnership interests can be characterized as assignee interests. If a classification is assigned, this will most likely lead to a decreased value to the interests when calculating the gift tax owed.
This article examines the responsibility of the board of directors to act with an “informed business judgment” when considering a proposed transaction and uses the 1985 court case of Smith v. Van Gorkom to illustrate the importance of this.

The business judgment rule is in place to protect and encourage the full use of the managerial powers given to directors. A judgment is considered an informed one if the directors have educated themselves regarding all material information available before making a business decision. In Smith v. Van Gorkom, the Delaware Supreme Court ruled that the board of directors did not seek the necessary information or take enough time to adequately approve the merger.

The article offers several suggestions of ways to adhere to the “informed business judgment” duty. The first step is for the board of directors to obtain a fairness opinion, which is a letter, prepared by a knowledgeable financial advisory firm, that states whether the proposed transaction is fair. The fairness opinion provides the decision-maker with the necessary information and acts as a document of proof that they used reasonable judgment in making the business decision.

After reviewing and questioning the methods used in the fairness opinion, the board of directors must select a qualified financial advisor, as well as understand the proper standard of value, for the proposed transaction. The board of directors should also have an understanding of the consideration to be exchanged and be able to compare the different forms of consideration to be used.

### FINANCIAL AND ESTATE PLANNING TECHNIQUES: Q & A, CCH


This insightful article, in question and answer format, draws on the knowledge of members of the CCH Financial and Estate Planning Advisory Board, including Owen Fiore, Tim Kochis, Bill Goldberg, and Arthur Sederbaum, among others.

Topics discussed in this Q&A were:
- Potential repeal of the estate and gift tax, and how it might affect practitioners and planners,
- The exercise of Crummey powers,
- Drafting family limited partnership agreements to avoid gift tax problems,
- Developments in Tax Court appraisals following Mandelbaum,
- Growth assets in an IRA,
- The use of aggregators and screenscrapers in the delivery of online financial planning services, and
- Advising clients regarding state tuition programs.

### ADMISSIONS TESTS

Hansen, Mark

ABA Journal, February 2001, Volume 87

According to a study conducted by the Federal Judicial Center, federal judges are more likely to exclude expert testimony in civil trials than they were less than a decade ago. The study suggests that the judges have become more cautious about allowing expert testimony since the Supreme Court’s decisions on the admissibility of scientific evidence, beginning with Daubert.

The study, “Expert Testimony in Federal Civil Trials: A Preliminary Analysis,” can be found at the judicial center’s Web site at www.fjc.gov.
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