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Intangible Asset Valuations: Spot These Common Errors Before Going into Court

When reviewing your expert's intangible asset valuation—or the opposing party's—it's critical to identify the most common errors that can cause a court to discredit or even disregard a report. The following checklist serves as a quick guide to avoid the most obvious deficiencies:

- *Is the standard of value followed?* Has the analyst carefully disclosed and defined the applicable standard of value? Has the standard of value been followed consistently throughout?
- *Are all three valuation methods considered?* These include the income, market, and asset approaches.
- *Is the internal analysis consistent?* For example:
  - —Did the analyst match pricing multiples or capitalization rates to the wrong economic income measure?
  - —Are current intangible asset operational data matched to different time periods, without appropriate adjustment?
  - —Did the analyst "normalize" financial statements without also normalizing the corresponding data for selected comparable companies?
  - —Was a "highest and best use" analysis performed?
  - —Was an "actual use" analysis also performed?
  - —Did the analyst make extraordinary, subjective, or speculative assumptions?
- *Is there sufficient support for selected variables?* Any analyst should document the data used, the procedures performed, and the valuation conclusions reached. There should also be sufficient tracing from the data in the quantitative analysis to the intangible asset in the owner/operator financial statement.
- *Do the numbers add up?* Mathematical errors are more common than anyone cares to admit; check all numerical calculations for accuracy, and make sure rounding conventions are consistent.
- *Does the analyst rely too heavily on 'rules of thumb'?* These serve only as a "sanity check," not as a basis from which to derive substantial intangible asset valuations.
- *Is there sufficient data and research?* The analyst should have conducted all relevant research, clearly threading the data into the quantitative analysis and valuation conclusions.
- *Is there adequate due diligence?* The analyst should have reviewed all relevant contracts and corporate documentation, including internal financial statements and external marketing statements. Sales, licenses, contingent liabilities, and litigation should have also been considered.

'What Not to Do' When Structuring a 'Fair' Merger

***Gesoff v. IIC Industries, Inc., et al.,* 2006 Del. Ch. LEXIS (May 18, 2006)**

In a going-private transaction that was "marked with grave examples of unfairness," the Delaware Chancery Court found, among other flaws in the merger process, a "plainly unfair price" for the company's minority stockholders.

First mistake: Parent assumes all authority for attorney and appraiser

A foreign holding company owned 78% of a publicly traded U.S. subsidiary, which controlled various companies. To simplify its cost structure, the parent company sought to remove the subsidiary's minority stockholders by going private. In early 2001, the parent board authorized a bid at $13 per share, and approved funds for a fairness opinion and a special committee. All good so far: But then the parent CFO invited only one subsidiary director to the special committee, allowing him no authority to choose an attorney or investment banking firm as the financial advisor for the special committee.

The negotiations that followed were "entirely inadequate," according to the Court. An internal email between the CFO and the attorney dictated that the parent would make a "lowish" bid to the subsidiary board, which would hire the investment bank to evaluate the bid. The bankers would then recommend a "slightly higher" bid, which the parent would meet

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and the bankers approve, and "the door would then be open for [the parent] to make its tender offer for the shares of" the subsidiary.

The parent company adhered to the plan by dropping the initial offer to $10 per share. The investment bank conducted its appraisal but sent drafts with valuation ranges to the parent CFO without the special committee's knowledge. On September 10, 2001,the CFO and the special committee member agreed on $10.50 per share for the tender offer, and presented it to the subsidiary's board with the fairness opinion that same day.

The Court made short shrift of the parent company's defense in the unfair dealing class action suit:

> [T]he defendants unilaterally imposed on the minority a price of the parent's own choosing, established a deceptive negotiation between the parties, and left the minority's putative special committee almost entirely powerless against its parent. This muddled, dishonest process is emphatically not what the Supreme Court meant by 'fair dealing,' …and will not be tolerated here.

Particularly troubling was the free flow of "private" valuation information between the appraisers and the parent. This "sieve-like" separation contributed to a process so "transparently corrupt," according to the Court, that it could serve as a collective lesson to transactional planners and practitioners of how *not* to conduct a similar merger "by orchestrating a stylized mockery of arms'-length negotiations."

To calculate damages, the Court reviewed both parties' expert reports and then conducted its own DCF (discounted cash flow) analysis.

Among other things, they found that plaintiff's appraiser had relied on subjective financial forecasts that differed markedly from management's. He also used country-specific risk premia that were too low, incorrectly applied a control premia to DCF analysis, and overlooked a small-stock risk premium—such that the Court could not adopt his fair value conclusion of $20.17 per share for the subsidiary.

Defendants' valuation offers better framework

In contrast, the Court adopted the general framework provided by defendants' expert, which posited a fair price of $9.60 for the subsidiary's shares on the merger date. However, the defendant's analysis was still subject to several "material adjustments," primarily to the specific company risk premium—which the Court found too subjective; and the small-company risk premia, which the Court declined to apply to all of the subsidiary's foreign holdings, since the data had been developed from U.S. markets.

The Court accorded its own DCF analysis a 100% weight and awarded plaintiffs $14.30 per share.

5th Circuit Reverses McCord, *Confirming Original Marketability Discounts*

***McCord v. Comm'r of Internal Revenue,* 2006 U.S. App. LEXIS 21473 (August 22, 2006)**

In one of the biggest upsets in business valuation law, the Fifth Circuit Court of Appeals recently overturned *McCord v. Commissioner,* 2003 U.S. Tax Ct. LEXIS 16 (2003)(McCord I). Most analysts and attorneys know the 117-page *McCord I* for its determination of marketability discounts, where the Tax Court rejected the taxpayer's restricted stock analysis and endorsed the criticism of pre-IPO studies.

***McCord I* revisited**

In January 1996, the McCord family transferred all of their interests in a limited partnership to exempt and non-exempt donees by an Assignment Agreement. Rather than use percentage interests, however, they conveyed dollar amounts of the net fair market value of the partnership interests pursuant to a sequentially structured "defined value clause." In conjunction with the Assignment Agreement, the taxpayer's appraisal calculated that each donee would receive approximately $89,000 for each 1% of limited partnership interest at the time of the gifts. Approximately two months later, the donees signed a separate Confirmation Agreement, which translated the dollar value of each gift under the Assignment Agreement's defined value formula into percentages of interests in the partnership.

A procedural anomaly

The taxpayers used the appraisal to calculate their gift tax returns, including a 35% discount for lack of marketability based on their expert's analysis of restricted stock studies, as well as supporting data from pre-IPO studies. But the IRS assessed over $4 million in deficiencies. The Commissioner's valuation conclusion was nearly twice that of the taxpayers—and was based on its rejection of pre-IPO studies, including its expert's opinion that a 7% marketability discount was appropriate.

The parties originally tried the dispute before Judge Maurice B. Foley, based primarily on stipulations and the Service's argument that the "defined value gift clause" violated public policy. But Judge Foley held

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that the IRS had failed to meet its burden of proof on any contested issue and could not prevail.

Two years later, however, the Tax Court's Chief Judge retroactively took the case away from Judge Foley and reassigned it to what resembled an *en banc* panel. This uncommon proceeding ultimately produced *McCord I* from an eight-judge majority, with concurring and dissenting opinions from five other justices. The majority crafted its own interpretation of the Assignment and Confirmation agreements.

> [T]he majority in essence suspended the valuation date of the property that the Taxpayers donated in January [per the Assignment Agreement] until the date in March on which [per the Confirmation Agreement] the disparate donees acted, post hoc, to agree among themselves on the…partnership percentages that each would accept as equivalents of the dollar values irrevocably and unconditionally given by the Taxpayers months earlier.

The result was, as Judge Foley pointed out in his dissent, a "tortured" analysis of the Assignment Agreement that required the taxpayers to use the majority's valuation to determine the dollar value of the transferred interest, but its own appraisal to determine the percentage interests transferred. "There is no factual, legal, or logical basis for this conclusion."

The 5th Circuit agreed: This "unique methodology violated the immutable maxim that post-gift occurrences do not affect, and may not be considered in, the appraisal and valuation processes…"

As the Tax Court had correctly rejected the Commissioner's valuation—but incorrectly applied its own "imaginative" methodology—the values left were those which the taxpayers had filed with their original return. Affirming without discussing the calculation of marketability discounts, the 5th Circuit allotted the remainder of its analysis to the Tax Court's final legal error—its failure to apply a discount for the present negative value of the donees' assumption of estate tax liability under IRC Section 2035.

Harsh words for the Service

In its note that the IRS deficiency notices were almost twice what the taxpayer filed, the Court observed, "this exemplified a practice of the IRS that we see with disturbingly increased frequency, e.g., a grossly exaggerated amount asserted in a notice of deficiency."

It's anyone's guess whether the IRS will heed such reprimand from the "taxpayer friendly" 5th Circuit. But this reversal means that *McCord I* has lost most of its precendential value; and though the appellate decision is binding only on the 5th Circuit, analysts and attorneys are likely to cite it as support for traditional valuation approaches.

Reasonable Comp. Analysis Rejected for Lack of Reasonable Comparables

***Wechsler & Co. v. Comm'r of Internal Revenue,* 2006 Tax Ct. Memo LEXIS 175 (August 17, 2006)**

The taxpayer's tactical strategy in this case may have backfired, as it chose to present two expert witnesses—one a notable financial analyst, and the other a compensation expert.

A broker-dealer like no other

During the early 1990s, the taxpayer operated primarily as a broker-dealer and investor in convertible bonds, with a portion of its own portfolio in hedged positions. The privately owned Wechsler & Co. also functioned as "market maker" for thinly traded securities.

With the advent of electronic trading, the company's president and controlling shareholder (Wechsler) lost his advantage as an expert market-maker. The company went from listing approximately 350 securities per year to just 30 or 50; it had also reduced staff from a high of 53 employees (in 1992) to only 12 by 1999.

For all the years in question (1992-1997), the company paid Wechsler a base salary of approximately $390,000 per year and an annual bonus that varied from a high of $7.09 million in 1994 to a low of $1.3 million in 1997 (followed by another $7 million in 1998). It deducted all amounts as "reasonable compensation."

Upon review, the IRS disallowed deductions totaling $20,243,433.

Taxpayer's expert applies sophisticated analysis

The company's financial expert took data from 27 publicly traded broker-dealers and averaged the ratios of: (1) aggregate compensation to net revenues; and (2) aggregate compensation to pre-tax income before compensation for each broker-dealer. He then compared these to similar ratios for the taxpayer.

Overall, with the exception of one year (1994), the expert concluded that Wechsler's compensation was reasonable, as it fell within industry averages, and he was the driving force behind the business. Further, the taxpayer had enjoyed a 10.4% compounded annual rate of return on its common stock equity, adjusted for deferred taxes. Most equity investors would find this a "highly satisfactory" rate of return.

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Compensation expert may have hurt

But the company's second expert—a consultant with 25 years of executive compensation experience—testified that he couldn't find any broker-dealers "reasonably comparable" to the taxpayer. Given this gap, he had to analyze Wechsler's compensation under the remaining factors of the Tax Court's "multi-factor" test, including the employee's role in the company, the company's character and condition, conflicts of interest, and internal consistency. He concluded that the average compensation received by Wechsler over the years ($4,752,751) was reasonable.

But this expert did not analyze whether an independent investor would be satisfied with the rate of return on an investment in the company, as required by applicable 2nd Circuit precedent.

IRS offers simpler analysis

The IRS expert suggested an alternative method, based on incentive plans for hedge fund managers and a survey of financial companies. Under this approach, a disinterested shareholder would obtain most of the profits during the company's good years and absorb all downside during the bad.

Emphasis on appropriate legal standard

The Court analyzed the evidence under the multi-factor, independent investor test, but found "no strong linkage…between the [company's] financial performance in a given year and Mr. Wechsler's bonuses and total compensation for that year." The Court also agreed with the Service that the company's compensation practice would "highly" disadvantage an independent investor, with a 10.4% compounded annual rate

The IRS' percentage allocations were too low, however; Wechsler's annual bonus should reflect his "exclusive" responsibility for the company and be closely tied to its performance. A yearly bonus equal to 20% of the company's adjusted earnings before federal income tax (EBFIT) (before payment of bonuses) would be reasonable, the Court found, and also provide investors with a satisfactory, 16.3% compounded annual return.

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