

## Revisions to USPAP SR-9 a 'Must Read' for Valuation Analysts and Attorneys

The 2006 edition of USPAP—the Uniform Standards of Professional Appraisal Practice—became effective as of July 1st of this year. Unlike prior updates, the revisions by the Appraisal Foundation (Washington, D.C.) are substantial and required reading for anyone conducting appraisals—or reviewing them in court.

In fact, the critical importance of USPAP compliance emerged in the recent *Kohler v. Commissioner of Internal Revenue* case (July, 2006). In discrediting the IRS's analysis of value, the Tax Court noted that its appraiser had omitted the customary USPAP certification. Without the certification, the Court could not be assured that "the appraiser has no bias regarding the parties, [that] no other person besides those listed provided professional assistance, and that the conclusions in the report were developed in conformity with USPAP."

### Credibility is the cornerstone

The overarching theme of the 2006 revisions is "credibility," which now appears as a defined term:

**CREDIBLE:** worthy of belief.

*Comment:* Credible assignment results require support, by relevant evidence and logic, to the degree necessary for the intended use.

Similarly, the newly-added "Scope of Work Rule" requires appraisers to explain what they have—and have not done—in an appraisal; it addresses both the application and the extent of the appraisal's development. As a defined term, "Scope of Work" has replaced the prior "Departure Rule," which focused only on agreed-upon departures from the guidelines, and addressed only the *application* of a specific requirement.

### Extensive revisions to SR 9

Standards Rule 9—pertaining to the conduct of appraisals—has seen significant overhaul in 2006 USPAP. In particular:

- *Business interest.* The opening of SR 9 now contains new language concerning the appraisal of "an interest in a business," thus clarifying that the coverage extends to business interests (as well as businesses and intangible assets), and conforming with the ASA's 2002 *Business Valuation Standards*, which apply to valuations of "businesses, business ownership interests, and securities."
- *Premise of value.* SR 9-2 now requires analysts to identify "the standard (type) and definition of value and the premise of value." Prior language noted only "type and definition." Without defining "premise of value," 2006 USPAP is nevertheless calling for greater specificity in the definition of assignments
- *Liquid and marketable interests.* 2006 USPAP adds "option agreements" to the list of features or factors that may influence value—including buy-sell agreements, stock restrictions, etc. Moreover, SR 9-2 now requires the appraiser to identify "the extent to which the interest is marketable and/or liquid."

Revisions to Standards Rule 9-4 parallel those to SR 9-2, and are worth quoting in full:

**SR 9-4(c)** An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of buy-sell and option agreements, investment letter stock restrictions, restrictive corporate charter or partnership agreement clauses, and similar features or factors that may influence value.

**SR 9-4(d)** An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of the extent to which the interest appraised contains elements of ownership control and is marketable and/or liquid.

*Comment:* An appraiser must analyze factors such as holding period, interim benefits, and the difficulty and cost of marketing the subject interest.

### Premiums and discounts

These revisions suggest that an appraiser consider the nature of control when valuing a majority

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interest, including estimating a control premium or capitalizing/discounting the cash flows. A discussion of the mergers and acquisitions market might also be helpful, to ascertain the degree of consolidation in the company's industry.

The binding comment to SR 9-4(d) also requires the analyst to consider the nature of minority interests, their lack of an active market and degree of liquidity (or lack thereof). Specifically, it lists three factors:

1. *Holding period.* When valuing the majority or 100% interest in a business enterprise, analysts effectively consider the holding period to be “forever” by discounting the expected cash flows *into perpetuity*. When valuing minority interests, however, analysts will need to become comfortable with a “most likely” concept of the expected holding period.
2. *Interim benefits.* In valuing minority interests, an interim benefits analysis estimates expected distributions or dividends, as well as the expected terminal value for the investment to be received at the expected exit (end of holding period). In these cases, a discounted cash flow analysis, which includes expected interim benefits and terminal value over the expected holding period, could help ascertain the effect on value, if any, of these two factors.
3. *Difficulty and cost of marketing.* In valuing controlling interests, analysts factor “difficulty and cost of marketing” into the prices paid by market participants. They may do so implicitly—by employing multiples based on guideline transactions; and/or explicitly, by considering it when developing discount rates.

When valuing minority interests, analysts could develop a similar “difficulty and cost of marketing” discounted cash flow analysis for the *interim benefits* (interim distributions plus expected terminal value) over the expected holding period.

#### **Final reconciliation**

Regarding the last major revision to Standards Rule 9, 2006 USPAP expands SR 9-5, requiring appraiser to reconcile the “quality and quantity of data” they used to reach their valuation conclusion, as well as the “applicability or relevance of [their] approaches, methods and procedures.”

All-in-all, these extensive revisions calls for more specific analysis, more consideration for the value-impact of key factors; and greater efforts to reconcile the various aspects of the appraisal process with the appraiser's conclusions. Without a careful review of

the new USPAP standard, appraisals will become more vulnerable to attorneys who *do* understand the revised requirements.

## **Value of CEO Non-Compete Determines Fairness of Class-Action Settlement**

### ***In Re Luxottica Group, S.p.A. Securities Litigation, 2006 U.S. Dist. LEXIS 6133 (February 17, 2006)***

Under Rule 23(e) of the Federal Rules of Civil Procedure, the court which originally certifies a class action lawsuit must also approve the “fairness and reasonableness” of any negotiated settlement. When the parties reach a proposed resolution of such a case, one might believe the “battle of experts” to be over—but often the parties have to take it this last round to end the war.

#### **CEO signs \$15 million non-compete on eve of takeover**

In early 2001, the Luxottica Group S.p.A. launched a takeover bid for Sunglass Hut International, Inc., intending to offer \$11.50 per share; the day before announcing the bid, Sunglass Hut's CEO signed a \$15 million consulting, nondisclosure and non-compete agreement (the “Agreement”), which provided for five annual payments of \$3 million. Not long afterward, Sunglass shareholders filed a class action suit against the CEO, Sunglass Hut, and Luxottica, alleging that the Agreement violated the Williams Act (a provision of the SEC Act of 1934), which requires that in a tender offer, shareholders receive the “highest consideration” for their stock.

Five years later—after protracted discovery, pre-trial motions, and settlement negotiations (and untold legal fees), the parties finally reached a resolution, involving an \$18.5 million pay-off to class participants. Pursuant to Rule 23(e), they submitted the proposal to the Court. Among several aspects to consider: “the reasonableness of [the] fund in light of possible recovery and risks of litigation.” As the plaintiffs' potential recovery fell somewhere between zero and several dollars per share, the Court turned to three expert reports for guidance.

#### **Fairness turns on value of non-compete**

Plaintiffs' expert considered three possible strategies to valuing an asset: cost approach (anticipated economic benefits of the asset); market approach (comparison with sales of similar assets); and income

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approach (anticipated economic benefits of the asset). He selected the income approach, due to lack of comparables and his belief that the best measure of the Agreement's value was its impact on Sunglass Hut's income.

Plaintiff's expert also considered the CEO's business expertise, his intent to compete, resources, relationship with customers and other businesses; his age and health; the potential damage to the buyer from his competition; the Agreement's duration, geographic scope, and enforceability; the "energy" with which the parties had negotiated the Agreement; and the effect of breach. His conclusion: the value of the Agreement to purchasers was between \$6.3 and \$7 million, and the original value of the five annual payments was nearly twice that, or \$12.23 million.

Defendants' expert analyzed the reasonableness of the CEO's severance as a whole. In assessing the non-compete, he found that its value approximated the annual payments, as it: (1) achieved the goal of the purchasers to prevent the CEO from competing; and (2) provided equal incentives for all parties to adhere. Finally, as its \$3 million annual payments "more or less" equaled the top salary for a CEO in the industry at the time, its five annual payments accurately reflected the cost to the CEO of not competing. Discounted to original value, the Agreement was worth about \$12.5 million, which approximated the present value of the five annual \$3 million payments, or \$12.7 to \$13.1 million.

Defendants also retained a rebuttal expert, who argued that plaintiffs' report only considered its value as a non-compete to Sunglass Hut, and not to the purchasers, Luxottica, as an agreement to consult. He also noted that plaintiffs had calculated the Agreement's after-tax (and not pre-tax) value. After correcting for these alleged errors, the rebuttal report posited that the actual, pre-tax value of the Agreement was the same as in defendants' original report.

### **Court's focus is fairness**

In considering the three reports, the Court noted that plaintiffs' report was based in part on conversations between the CEO and an Arthur Andersen analyst, which occurred prior to the filing of the class-action suit. "But [the CEO] likely knew that litigation was impending," the Court said, and if so, "he had reason to inflate the apparent importance of the Agreement by exaggerating his intent and ability to compete with [Sunglass Hut] absent the Agreement."

Plaintiffs also had reason to deflate the value of the non-compete to increase the alleged "share premium"

that the CEO would receive, in violation of the best price rule. But with the settlement, the plaintiffs would recover a "substantial portion of the present value of the payments" made under the Agreement, according to the Court, "especially when combined with the adjustments [that] defendants' experts assert are necessary."

In light of all expert reports, the Court found that the settlement was adequate—and so concluded a case in which, in the end, fairness won.

## ***Can a Disgruntled Director Sue the Appraiser for a Buy-Sell Gone Bad?***

***Wetmore v. MacDonald, Page, Schatz, Fletcher & Co., LLC, 2006 U.S. App. LEXIS 29365 (May 11, 2006)***

Buy-sell agreements can be a ticking time bomb, and when triggered, they can cause an already divisive situation—conflict between business partners or family members—to explode. Appraisers usually escape the fallout, except in this case, where the ousted director tried to pin the blame directly on the valuation firm.

### **Buy-sell called for appraisal at triggering event**

Plaintiff Wetmore owned 300 voting and 150 non-voting shares in Portland Shellfish Company, Inc., for which he also served as treasurer and a director. The company president and second director was Jeff Holden, whose wife owned the remaining 300 voting shares. When the Holdens reached a deadlock with Wetmore over the direction/management of the company, they invoked the buy-sell provision of its shareholders agreement, which required hiring defendant MacDonald Page & Co. (South Portland, ME) to value the outstanding shares. Once they obtained this value, per the agreement, the shareholders would call a meeting at which:

[E]ach. . . shall have the right to buy out the other shareholder(s) interest, at a price equal to or greater than the price determined by the accountant. The highest offer made by any shareholder. . . shall be binding upon the other shareholder(s). The shareholder who is acquiring the stock shall be required to close on the acquisition within 90 days of the meeting.

In its engagement letter, MacDonald Page stated that it would estimate the fair market value of a 100% common equity interest in the company, for use in connection with the buy-sell agreement. Its report

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estimated the value at \$1,090,000, and Donna Holden offered to purchase Wetmore's shares at this price. Wetmore resisted, offering \$1.25 million for her shares, contingent on her husband signing a non-compete agreement. Wetmore also offered to sell the company to a third party.

The Holdens rejected both offers, insisting that Wetmore was bound by the buy-sell agreement, and threatening suit if he refused. Wetmore "had no choice" but to accept the offer, selling his shares for \$700,705 (60% of \$ 1.090 million adjusted to eliminate a 7% marketability discount in the original value).

### **Director claims appraiser devalued company**

Having lost control of the company, Wetmore sued MacDonald Page, claiming that its valuation was "well less than half the actual value" of the company, resulting in a pay-out that was far less than fair market value. The accounting firm filed a motion to dismiss, claiming that it could not have caused Wetmore's losses, because the buy-sell agreement "on its face" permitted him to make an offer greater than its

valuation (which in fact, he had). Wetmore also could have challenged the appraisal in "any number of ways," it said. The agreement bound Wetmore only when he was unwilling to pursue these alternatives.

But had the MacDonald Page appraisal been accurate, Wetmore argued, the negotiating "floor" would have been at least two times higher than it actually was, forcing the Holdens to pay far more for his shares. But the trial court found this statement "purely speculative," and granted the motion to dismiss (affirmed on appeal). "If the valuation had been higher, there is no way to know whether Donna Holden would have made an offer at all or what the plaintiff might have done if she had."

Moreover, MacDonald Page had not breached any contract with Wetmore, as its engagement letter language did not "expressly acknowledge" that he would rely on the valuation to establish the buy-out price, only that he would use it in conjunction with carrying out the buy-out provisions. In this case, the valuation could not set the ultimate buy-out price, "only the shareholder could do that."

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