

Of Discounts, Taxes, and Subsequent Events: Three Hot Topics in Valuation

Some of the liveliest debates in business valuation are currently taking place around three topics: 1) when to include subsequent events in a valuation report; 2) whether discounts for lack of marketability apply to a controlling ownership interest; and 3) how to calculate deductions for built-in capital gains taxes. While discounts are a perennial “hot” topic, the other two have risen from recent events in the legal and appraisal communities.

Subsequent events

Earlier this year, the AICPA adopted its *Statement on Standards for Valuation Services* (SSVS 1). Among the many important provisions, the new standards clearly require valuation specialists to account for events that occur subsequent to the valuation date only when these events are “knowable or foreseeable.” Yet some analysts are uneasy about omitting a discussion of subsequent events from their valuation reports, particularly when a judge or jury—or even a client—will want to hear about them.

Many analysts resolve the problem of subsequent events by convincing the court (through their attorneys) to update the valuation report. Many times, the subsequent events won’t materially impact the original conclusions, and analysts are thus able to account for them without substantially altering the bottom line.

But consider the subprime lending crisis, which began as early as the summer of 2007—although the extent of the damage wasn’t felt in the banking and other industries for several months. When did the credit crisis (and its impact) become knowable and foreseeable? The answer may lie in evaluating what the economic experts and financial indicators were saying as of the valuation date. If this date falls in 2007, for example, when perhaps a few economic forecasters were predicting a downturn—but none as dire as the market declines that eventually took place—then the valuation would most likely omit the impact of these subsequent events.

That’s not always what a client or attorney wants to hear. In these difficult cases, it becomes even more important for the valuation specialist to educate the court and the client on the timing of market events and financial inputs. In fact, many believe that it’s the best “teacher” who will also make the best case for the trier-of-fact.

Discounts for controlling interests?

Is there a valid, conceptual basis for applying a discount for lack of marketability (DLOM) to a controlling interest of a private (closely held) company?

Probably not, as by definition, a controlling owner can determine the timing and terms of sale. But public markets are not entirely liquid, so many analysts believe that some transactional discount is appropriate, no matter what it’s called. (Some use the term “controlling non-marketable interest.”) Ultimately, the discount will turn on the facts of the case, as well as the analyst’s professional judgment.

Built-in gains

In *Estate of Jelke v. Commissioner* (2007), the Eleventh Circuit Court of Appeals reversed an earlier Tax Court ruling that applied a present value approach to potential future capital gains taxes. The current “bright line” rule, in both the Eleventh and Fifth Circuits, is to apply a dollar-for-dollar reduction for the entire unrealized capital gains tax, even if the business has no immediate plans to liquidate.

At the same time, many valuation analysts still prefer to apply the present value of the anticipated future tax. It’s more uncertain, but unless a sale of the business is imminent, there may be a stronger argument for measuring the estimated tax, recorded as a current liability. On the other hand, if there are several prospective buyers as of the valuation date, a better case can be made for deducting built-in gains taxes without calculating the present value of

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a hypothetical, future sale.

Clearly, *Jelke* recognized that the taxes on the sale of these business assets will eventually accrue; the only question is when and how much. Analysts and their attorneys should consider all relevant factors—and applicable law—when establishing the magnitude of imbedded capital gains.

A Tale of Two Experts: Court Compares Competing Valuations, Rejects the Worst

***Lyman v. St. Jude Med. S.C., Inc.*, 2008 WL 2224352 (U.S. Dist.)(May 27, 2008)**

This case from the U.S. District Court (E.D. Wisconsin) examines the very different approaches taken by the opposing valuation experts, emphasizing the need for independent verification and objective data—and the danger of relying on third-party documents.

A healthy sales agreement

Near the end of 2002, the plaintiff entered into a ten-year agreement with the defendant medical center (St. Jude) to sell and distribute cardiac equipment, including pacemakers and defibrillators. The agreement guaranteed four years of payments amounting to \$3 million; the remaining six-year term compensated the plaintiff by commission only. A separate agreement also contained a put option, requiring St. Jude to purchase the plaintiff's company for 20% of its net sales during the twelve months immediately prior to exercise.

St. Jude terminated the main agreement after two years, and the plaintiff sued. Both parties presented expert evidence on damages, and each challenged the other's expert.

Plaintiff's expert: Models A to E

The plaintiff's expert, a CPA who specialized in litigation support and business valuation, was challenged not on experience but on his methods and approaches. He prepared five different damages models, which the court characterized as follows:

1. *Model A* was based on the minimum sales quotas in the parties' agreements. The defendant argued that he should have used actual sales, but the court found the data reliable, since the plaintiff had been selling its products in the same region for eighteen years.
2. *Model B* was based on projections by St. Jude, which reflected the parties' agreed-upon expectations. The defendant claimed that the

expert "blindly" accepted the internal sales data, but the court pointed to their negotiated nature and the plaintiff's experience in the market.

3. *Model C* was a regression analysis based on the plaintiff's past sales at St. Jude, but the expert valued a sale as of the implant date (into a patient) rather than the sale date. St. Jude accused the expert of manipulating the data to avoid the impact of bulk sales and for using a flawed regression formula. But the court found that the implant date more accurately reflected the impact of sales and that the expert's statistical measures were sound.
4. *Model D* derived future sales from the projected sales revenues in Model A, multiplied by a factor of 1.65. This assumed that the plaintiff's sales would not only continue their historical increase by \$1 million per year, but also outpace quotes by 165%—as it had done in year two of the parties' agreement.
5. Model E took figures from the separate agreement, which projected that the plaintiff would post 2007 net sales of \$8 million. The court found that the assumptions underlying models D & E were not "inherently unreliable."

Accordingly, the court permitted the plaintiff's expert to present all five damage models, finding "no question" that they would assist the jury. Any deficiencies in his analysis were "best saved for cross examination at trial."

Defendant got data from counsel

The defendant's expert was a qualified CPA who prepared two sets of projections, weighted and unweighted. He claimed that both came from the plaintiff's alleged sales during two years under the agreement—but in fact, he obtained the data from a document provided by St. Jude's counsel. Not only did the expert fail to verify the data from an independent source, the court noted, but he failed to obtain independent, specific knowledge of the plaintiff's products and its customers. His methods proved the projections unreliable, and the court excluded his testimony as a direct expert and also on rebuttal, finding the basis for his criticisms to be lacking in independent verification and "similarly tainted."

Pros and Pitfalls of Retaining a Joint Appraisal Expert

There are many contexts in which attorneys and business owners might retain a joint valuation

expert—during a merger or sale, for instance, a divorce, or a partnership dissolution. A joint appraiser can be a key player in a buy-sell scenario or a pre-litigation settlement. What follows are just a few of the ways to take advantage of a joint valuator—and a few potential problem areas to watch out for:

- *Cost.* A joint expert will most likely reduce the costs associated with an appraisal in any setting, but especially in those cases when opposing experts are so far apart that the parties have to hire a third, independent valuator. This situation arises most often in buy-sell scenarios—but also in divorce cases when the court is confronted with such disparate evidence of value that it appoints a third, “independent” appraiser—at the parties’ cost.
- *Full access to information.* When the parties retain a single valuation analyst, they will be more likely to provide greater access to information to support their respective opinions of the business and its future prospects. The valuator will in turn share all of the information with the parties, electronic communication as well as paper documentation, so that everyone is on the same “page,” and greater objectivity is assured.
- *Experience.* When retaining a joint expert, look for seasoned, credentialed business appraisers who have worked on joint assignments in the past. Joint engagements do present unique challenges (discussed below), and familiarity with the process can be critical to a successful result.
- *Payment.* The parties should establish at the outset how to pay for the joint appraisal. If they can’t agree on the typical 50/50 split, then they should address the issue along with any questions regarding scope of work.
- *Communication.* Preferably, the appraisers’ engagement will establish rules about communication (as well as payment and scope of work). These rules will encompass communications to and among the parties and their attorneys as well as access to key business personnel, meetings and management interviews, etc.
- *Draft report.* The parties should also decide whether to review a draft report (for factual accuracy, comprehensive inputs, e.g.) before the valuator issues a final conclusion of value. The purpose is not to alter the preliminary opinion but to ensure that the valuator has considered all relevant facts and information.

- *Objective mediator.* In many cases, a joint expert can essentially become the “trier of fact” regarding valuation issues. As such, the valuator must inspire trust, demonstrating a high degree of integrity and independence by taking an even-handed, objective approach to the assignment.
- *Challenges.* Despite agreeing to hire a joint expert, the parties may have very different interests at stake and perspectives on value. The appraiser must be prepared to balance any opposing pressures from the parties—such as conflicting input, preconceived notions of value, unrealistic expectations—to arrive at a truly independent conclusion. When possible, it might behoove the valuator to seek independent data and sources of information to mitigate a party’s opinion.
- *Educating the client.* In litigation settings, the standard of value will be set by statute and/or case law. Many buy-sell scenarios contain no definition of or provision for determining the standard of value, and the joint expert can help the clients and counsel understand the various standards, their application, and their implications as to value.
- *Encouraging trust.* While the parties—especially those to an adversarial proceeding—may not trust each other, once again, it is critical for the joint appraisal expert to inspire them with trust in the valuation process and its outcome. A joint expert must always maintain neutrality, in act if not in appearance, and disseminate information equally. The more even-handed the administration of a joint valuation assignment, the more successful the outcome—and satisfied the clients.

Daubert Challenges Damages Expert for Failing to Verify Management Opinions

U.S. Salt, Inc. v. Broken Arrow, Inc., 2008 WL 2277602 (U.S. Dist.)(May 30, 2008)

The plaintiff, a producer of “solar salt,” sued the defendant for violating their agreement to ship salt. The court decided by summary judgment and scheduled a hearing on damages. The plaintiff relied heavily on its valuation expert to establish its lost profits, and the defendant challenged the expert’s

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testimony under *Daubert* and the Federal Rules of Evidence.

‘Riddled with unsupported assumptions’

The expert’s initial lost profits calculations were \$1.8 million; however, in a subsequent report, he revised his damages downward to a range of \$600,000 to \$1.06 million. The court provides few details regarding the initial or revised values but noted only that the expert “relied almost exclusively on the assumptions and estimates provided” by the owner of the plaintiff company.

Further, the court found that the expert’s reports contained “very little analysis and were riddled with unsupported assumptions.” In fact, when the expert was asked in deposition whether he had done anything to verify the accuracy of the information and projections that he relied on, he answered quite frankly: “Not that comes to mind.”

Without an independent, objective assessment of the management projections, the court characterized them as “nothing more than optimistic projections.”

And [the expert’s] wholesale acceptance of [management’s] projections without any verification of these estimates or any independent market analysis is simply too speculative to submit to a jury.

Accordingly, the court precluded the expert from presenting his lost profits calculations, and absent any reliable evidence of damages, the court dismissed the plaintiff’s claims.

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