



Valuation Case Update - April 2011

In this update we have four unique cases for your review:

1. In re South Canaan Cellular Investments, 2011 WL 52558 (E. D. Pa.)(Jan. 6, 2011): We thought this case would interest many of you as it contemplates the underlying assumptions in many Buy/Sells and operating agreements where opposing parties select an appraiser and then have a third “neutral” appraiser decide the deadlock.
2. Hollen v. Commissioner of Internal Revenue, T.C. Memo. 2011-2, 2011 WL 13637 (U.S. Tax Ct.) (Jan. 4, 2011): A case about a small ESOP and the issues surrounding administering and appraising within a small ESOP.
3. Estate of Adler v. Commissioner of Internal Revenue, T.C. Memo. 2-11-28, 2011 WL 300144 (U.S. Tax Court) (Jan. 31, 2010): Following the *Ludwick* case from 2010, more action on fractional interest issues.
4. Wordtech Systems, Inc. v. Integrated Networks Solutions, Inc., 609 F.3d 1308 (Fed. Cir. 2010): Another case where a party to a substantial lawsuit decided not to retain an accredited expert witness and lost the court’s confidence for not doing so.

Should Neutral Appraiser Be Kept 'Blind' to Parties' Competing Valuations?

In re South Canaan Cellular Investments, 2011 WL 52558 (E. D. Pa.)(Jan. 6, 2011)

To fund their plan of reorganization, the debtors agreed to sell their limited partnership interests in a wireless communications provider by May 2011. If the debtors were unable to find an acceptable buyer, then the plan permitted the limited partners (LP) to compel the debtors, as general partners, to purchase their interests.

To determine the price of the put, the partnership agreement required both parties to determine and then disclose their respective value of the subject LP interests. If these valuations differed by more than 10%, then under the agreement, the parties would jointly appoint an appraiser to determine the fair market value of the LP interests using a going concern premise of value. If the parties couldn't agree on an appraiser, then each would appoint its own appraiser, and within 20 days, these two would appoint a neutral third, who would make the ultimate determination of value. After this third appraiser reached an opinion of value, it would be compared to those that the debtors and LPs had initially exchanged. "The valuation proposed by the limited partner that is closest



to the value opined by [the neutral third appraiser] then becomes the agreed upon value of the limited partnership," the bankruptcy court explained, and the purchase price would be calculated.

Parties couldn't agree on anything. The debtors were unable to find a suitable buyer for the limited partnership and invoked the put provisions. The parties exchanged their valuations of the LP interests—which differed by more than 10%. After each party chose an expert appraiser, it took another two months (and threatened court intervention) to selection a neutral third.

Even then, debtors requested an appraisal "protocol," essentially asking the court to permit both parties to provide the appraiser with whatever information they believed to be relevant—except that neither party could disclose its prior, competing valuation. Further, all communications with the independent appraiser would be in writing, with copies served to the other side, and the appraiser could not interview the LP's key managers without all parties being present.

The court held a hearing on the proposal, at which the debtors' appraiser acknowledged the professional standards by the various business valuation organizations (including the AICPA and ASA). All of these standards admonished valuation analysts to be objective, independent, and impartial. They also required the analyst or appraiser to use "professional judgment," the court noted, and to "obtain all relevant financial and nonfinancial information." After this testimony, the debtors withdrew all but one request: that the court still precludes the independent appraiser from learning about the valuations exchanged by the parties.

In support, the debtors said that because the appraisal provisions required the appraiser to make his fair market determination of value before selecting the party's number that was closest to that value, the agreement contemplated "an appraiser who is blind to the numbers put on the table by the parties." Further, because the LPs and their affiliates presented an opportunity for "significant appraisal and transactional work in the future, given the numbers of wireless and wire line companies in which they have invested," the appraiser had incentives for producing "as low a number as possible," to benefit the LPs and "strengthen" this future opportunity. "Any disclosure that would allow the appraiser to know which party 'wins' if he moves his valuation one way or another by a few tens of thousands of dollars seriously risks tainting the independence of the appraisal process," the debtors concluded.

The LPs requested that the appraiser be permitted to see the parties' prior valuations, because they were carefully based on a "complex balancing of a number of factors," including various appraisals and value estimates based on several methodologies and the uncertainties regarding the numbers that each side might propose. Each side also knew the risks of the "baseball-like arbitration provisions" of the agreed-on appraisal process and would have hedged against the risk of an unfavorable result due to the "uncertainties" of the appraiser retention process. Finally, the entire process contained no provisions for a court-ordered "protocol," the LPs argued, but was silent on the type of information the appraiser could obtain, thus recognizing his freedom to "exercise his business judgment to obtain and use any information he believes relevant to his engagement."



Neither party called the independent appraiser to testify regarding the information he might request to make his value determination. Nevertheless, the court assumed that after the protracted selection process of a candidate from their own list, even the debtors believed that the third appraiser would be "competent, independent, objective, and fair in completing his valuation engagement." To the extent the debtors were concerned the appraiser could be influenced by knowing the LPs' prior valuation positions—that concern would have been present during the parties' negotiation of their agreement, "Had the partners intended to restrict their valuation provisions from being revealed, it would have been simple to include such a restraint in the agreement," the court ruled, and denied the debtors' motion to keep the independent appraiser "in the dark."

CVS Comment: Many buy/sells and operating agreements are structured with similar clauses. We think the Court was correct in looking back at the legal intent of their agreement.



Important Tax Court Reminder re: Small Firm ESOP Compliance

Hollen v. Commissioner of Internal Revenue, T.C. Memo. 2011-2, 2011 WL 13637 (U.S. Tax Ct.) (Jan. 4, 2011)

A private dental practice began sponsoring an employee stock ownership plan (ESOP) in 1987. The primary dentist, the firm's principal shareholder and corporate officer, served as ESOP administrator and trustee of its related trust. Two years later, in 1989, the trust borrowed nearly \$420,000 to purchase roughly 131,000 shares of stock in the dental practice. That same year, the firm distributed \$200,000 to the trust to repay a portion of the loan. In connection with that repayment, the trust allocated \$200,000 of common stock to participants' accounts, including \$150,000 to the owner/dentist.

Law requires independent appraisal. The ESOP was amended at the beginning of 2001 and retained a CPA to appraise the trust's stock that year and also in 2002 and 2003. Although the ESOP requested a determination from the IRS as to its qualified status, it withdrew that request in 2003. Five years later, the commissioner issued a final letter disqualifying the ESOP for all years since 1987.

The IRS also found the dentist was the primary beneficiary of the \$200,000 "dividend" distributed to the trust. Effectively, the dental practice received a deduction for the principal payment on the loan without recognizing any corresponding income. In turn, this increased the value of the stock held by the ESOP trust, primarily to the owner's individual benefit. As a result, the IRS re-characterized the \$150,000 in "earnings" as an annual addition to the plan, and the dental practice appealed.

In its final letter, the IRS determined the ESOP and its trust failed to comply with Sec. 401 (a) IRC and related provisions. The Tax Court, in an opinion by Judge Laro, confirmed the four asserted grounds for disqualification:

1. *Ineffective amendment.* The dental practice failed to amend the ESOP within the effective dates provided by statute and applicable to certain small businesses.

2. *Improper vesting schedules.* The ESOP, as operated, also failed to vest according to its own schedule. "Petitioner offers no explanation . . . why the vesting schedules on the ESOP's books did not properly reflect the provisions of the plan document's vesting schedule," the court observed. "Moreover, petitioner declined [the IRS's] offer to participate in a closing agreement program . . . which would allow for retroactive compliance."



3. *Unsigned appraisal.* Sec. 401(a) (28) (c) requires an "independent appraiser" to value all employer securities that are not readily tradable on an established market. "Independent appraiser" in this context means "qualified appraiser," the court explained, referencing Sec. 1.170(A)-13(c) (5) (1) of the Income Tax Regulations.

The petitioner claimed that its CPA was a permissible, qualified appraiser of the ESOP's stock held by the trust. But the ESOP failed to comply with at least two requirements of the regulations, the court pointed out. First, the appraisal letters covering the 2001 through 2003 plan years state that "The undersigned holds himself out to be an appraiser," but all the letters were left unsigned.

Second, the regulations provide that signing appraisers must list their background, experience, education, and membership, if any, in professional appraisal organizations. None of the appraisals submitted were signed, and the appraisal summary does not list the required information. Apparently, the petitioner did not offer any explanation for these omissions or assert substantial compliance, and the court concluded that the trust's holdings were not valued by a "qualified appraiser."

4. *Excess annual additions.* Finally, the court confirmed that the IRS properly re-characterized the \$150,000 of the \$200,000 dividend as annual addition to the owner's account, in excess of the limitations of Sec. 415(c) IRC. "Because the ESOP never took any action to correct this failure," the court held, "the ESOP was not qualified in plan years after that date [1989]."

Once again, it noted that the ESOP had an opportunity to amend its failure through the closing action program, but chose not to do so. The court also upheld the ESOP's disqualification in 1987 and 1988, finding no plan on record.

CVS Comment: ESOPs are very technical financial vehicles. Proper administration and valuation protocol is warranted to avoid IRS and third party liabilities. Smaller ESOPs with lessor resources seem susceptible to these issues.



Fractional Interest in Estate Tax Turns on Type, Timing of Gift

Estate of Adler v. Commissioner of Internal Revenue, T.C. Memo. 2-11-28, 2011 WL 300144 (U.S. Tax Court) (Jan. 31, 2010)

A father owned a California ranch on more than 1,000 acres. In 1965, he gifted undivided one-fifth interests to his five children as tenants-in-common, reserving his own "full use and control" of the property throughout his life. After the transfer, the father used the ranch and paid all its taxes, expenses, and costs of improvement—but not any rent to his children. None of the children lived on the ranch or interfered with the father's use.

Estate applies 48% combined discount. When the father died nearly 30 years later, the property had a fair market value of \$6.39 million. To reflect the decreased value caused by the children's fractional interest, the estate applied a 32% discount for lack of marketability and a 16% discount for lack of control at the time of death. During the father's life, the estate applied a 22% marketability discount and 16% minority discount to each of the undivided interests.

The IRS stipulated to the \$6.39 million fair market value of the property, but disallowed the discounts and assessed a deficiency. The estate appealed to the U.S. Tax Court, which began by reviewing the applicable statutes. If a decedent owns a life estate—i.e., a grant of property for the duration of his life—then at the time of death it has no value under Sec. 2033 IRC, the court explained. "But if the decedent gratuitously transferred a remainder interest in property and retained a life estate," then the full, fair market value of the property would be included in the gross estate pursuant to Sec. 2036.

Specifically, Sec. 2036(a)(1) includes the value of transferred property if: 1) the decedent transferred the interest during life; 2) the transfer was not a sale; and 3) the decedent retained possession or enjoyment of the property for life (citing *Estate of Bongard v. Commissioner* 124 T.C. 95 (2005)).

At the same time, "the owner of a fractional interest in property often lacks the ability to control the property or to sell the interest freely," the court noted, citing *Estate of Amlie*, T.C. Memo. 2006-76. Further, when a person dies holding a fractional interest in property, discounts are often appropriate to reflect the lack of control and marketability. Whether the property is valued as a whole or discounted "depends on when the interests are separated," the court held. If the ownership is split during the person's lifetime, the decedent's interest is valued separately. "If the split occurs only at death, the property is valued as a whole—without a discount."

The court gave the following examples. Suppose an owner of land gives a one-half interest to a child. When the parent dies holding the one-half interest, it would be valued separately from the child's half-interest. On the other hand, suppose that a landowner continued to own property until death, at which time each of two children took an interest. Because ownership continued until death, no discount would apply to the account for the fractional ownership acquired by the children at death.



Control is key. In support of its falling closer to the former example, the estate cited Estate of Mellinger, 112 T.C. 26 (1999), in which a husband and wife owned a block of stock. At the husband's death, he left the wife his interest in trust, for her lifetime benefit. When the wife died, she still owned her 50% interest, but the IRS also included the value of the other 50% interest held in trust. The Tax Court disagreed, however, finding that the interests should be valued separately, because "at no time did the wife possess, control, or have any power over the interest held in trust."

Unlike the wife in that case, however, the father in this case controlled the ranch property from his transfer of the remainder interests in 1965 until his death in 2004, the court found. Under these facts, the better precedent was Estate of Fontana v. Commissioner, 118 T.C. 318 (2002). There, the decedent owned two blocks of stock, one outright and one by a testamentary trust power of appointment. Because the decedent controlled the disposition of stock in trust, its value was aggregated with the stock he held outright.

For these reasons, the court considered that the ownership of the ranch was split up after the father's death. "Thus it was as if [the father] had retained the entire interest in the land during his life and transferred the property to his children at death," the court held, in finding that no discounts were appropriate to the \$6.39 million fair market value of the land.

CVS Comment: In terms of valuation issues, there is nothing hotter right now for the IRS than fractional interests. The fall-out from the IRS litigating the Ludwick case (Ludwick v. Commissioner, T.C. Memo. 2010-104, 2010 WL 1850223 (U.S.Tax Ct.) (May 10, 2010)) continues. Large discounts and reports without solid foundation will be scrutinized.



Plaintiff Provides Actual Licenses for Patents, but No Damages Expert

Wordtech Systems, Inc. v. Integrated Networks Solutions, Inc., 609 F.3d 1308 (Fed. Cir. 2010)

Just four months after deciding *ResQnet*¹, the U.S. Court of Appeals for the Federal Circuit applied its tougher evidentiary standard to the plaintiff's reliance on 13 actual licensing agreements to calculate a reasonable royalty rate.

Plaintiff failed to enlist an expert. In this case, the jury found the defendant liable for infringing the plaintiff's CD duplicating technology. To decide damages, the jury heard not from an expert but from the plaintiff's president, who introduced 13 prior licensing agreements involving rights to some or all of its patents in suit. He also submitted roughly 40 invoices showing the defendant's sales of 56 products that included the claimed invention. The jury awarded \$250,000 in lump-sum damages, and the defendant appealed.

The Federal Circuit noted several problems with the award. First, at trial, the plaintiff sought only a hypothetical negotiated royalty, and the jury received damages instructions for this theory alone. The plaintiff showed invoices from the defendant amounting to at least \$950,000, and asked for 12% of this amount, or \$114,000. "However, the \$250,000 verdict equates to a 26.3% royalty on the ... total alleged sales," the court pointed out. The plaintiff failed to explain why this higher amount would be "reasonable." Further, the alleged sales failed to account for the defendant's costs.

Apart from the invoices, the court considered the plaintiff's 13 licensing agreements in light of *Lucent*² and *ResQnet*. Like the jury in this case, the *Lucent* jury awarded a lump-sum amount based on eight actual licenses. On appeal, the court rejected four of the licenses, even though they were based on a lump-sum award, because they were too different from the patents in suit. It rejected the remaining four licenses because they contained running royalties, and the plaintiff provided no basis for comparing these rates to a lump sum.

Similarly, in *ResQnet*, the court overturned a running royalty rate based on seven licenses, "five of which had no relation to the claimed invention, and the other two of which arise from litigation," the court explained. "We stressed that comparisons of past patent licenses to the infringement must account for the technological and economic differences between them."

¹ *ResQnet.com, Inc. v. Lansa, Inc.*, No. 01-CV-3578

² *Lucent Techs, Inc. v. Gateway* 580 F. 3d 1301, 1327-28 (Fed. Cir., 2009).



In this case, the plaintiff's licenses suffered from the same flaws. The jury awarded a lump-sum verdict, but only two of the plaintiff's licenses were lump-sum agreements. The first paid \$175,000 for non-exclusive rights to two of the patents at issue. The second paid \$350,000 for non-exclusive rights to three of the patents on similar terms. The plaintiff claimed the jury verdict was reasonable because its \$250,000 award fell roughly between these two lump-sum fees—even though the plaintiff asked for only \$114,000, or less than half the verdict.

"This averaging theory is flawed because the two lump-sum licenses provide no basis for comparison with [the defendant's] infringing sales," the Federal Circuit held. "Neither license describes how the parties calculated each lump sum, the licensees' intended products, or how many products each licensee expected to produce." Indeed, when asked during oral argument whether the trial record supplied any evidence of actual or projected sales volume, the plaintiff's attorney told the federal panel, "none." Invoices showed the defendant sold 56 units involving the patented products, but without knowing whether prior licensors agreed to pay \$350,000 for the right to produce 100 units or 1,000 it was impossible to derive a rate from proof of sales alone.

In sum, without additional data, the plaintiff's lump-sum licenses offered the jury "little more than a recitation of royalty numbers," the court held, citing *Lucent*. Of the remaining 11 actual licenses, one listed per-unit fees of \$100 to \$195 instead of a running royalty. By contrast, the \$250,000 verdict reflects a per-unit fee that exceeds \$4,400 (\$250,000 divided by 56 units). The other 10 licenses stated royalty rates ranging from 3% to 6% of sales, far less than the jury's effective award of 26.3%. Evidence also showed that the plaintiff signed several of these lump-sum licenses after initiating or threatening litigation, and "litigation itself can skew the results of the hypothetical negotiation," the court said, citing *ResQnet*.

More reason to retain an expert on remand. Even if the plaintiff's licenses supported a high royalty rate under Georgia-Pacific factor 1 (present or past licenses involving the patents in suit), its use of the defendant's invoices raises doubts about the sales volume to which the jury could have reasonably applied a higher rate. The plaintiff's president, "who did not qualify as a damages expert," the court noted, calculated the \$950,000 gross sales figure by using "the second highest value" from the invoices "as a *phantom* value" (court's emphasis).

Moreover, the invoice dates also suggested the jury incorrectly apportioned damages among the three patents at issue, and incorrectly inferred a substantial portion of sales that pre-dated the issuance of the patents. The plaintiff's arguments amounted "to a pattern of guesswork," the court concluded. Its evidence failed to show how the actual "licensing environment" would influence the hypothetical royalty payments, and the court remanded the case for a new trial on damages.

CVS Comment: Corporate damages claims are often very complex and tough for triers of fact to understand. Having an accredited expert witness not only injects professionalism into the testimony of damage claims but as experts are usually better at organizing and conveying damage claims in a more sound and logical manner.