



cmcnally@corporatevaluationservices.com

125 S. Wacker Drive, Suite 300
Chicago, IL 60606

Phone 312.238.8690 Fax 312.324.0376

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In this *Valuation Update* we have three cases that show the continued issues of valuation over a spectrum of engagements: Tax, Family Law and Corporate Fairness Opinions. With each case, there is a trier of fact wrestling with the credibility of valuation opinions.

1. *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, 2011 WL 2559847 (U.S. Tax Court - June 28, 2011) – US Tax case that deals with numerous valuation issues – tax affecting an S Corp, discounts for lack of control, lack of marketability, Weighted Average Cost of Capital, Public Company Guideline Method and earnings add-backs. Very interesting read.
2. *Hendrix v. Commissioner*, T.C. Memo 2011-133, 2011 WL 2457401 (U.S. Tax Court - June 15, 2011): Another U.S. Tax Court case – this one involves a defined value clause versus fair market value. In this instance the Court liberally construed the defined value clause in favor of the tax payer. Interesting analysis of the family setting in relation to the willing buyer / willing seller concept under Revenue Ruling 59-60.
3. *American Ethanol, Inc. v. Cordillera Fund, LP*, 2011 WL 1706823 (Nev. - May 5, 2011): Nevada case again showing the flexibility in construing *Fair Value*.
4. *Peterson v. Jackson*, 2011 WL 14519606 (Utah App. - April 14, 2011): Yet another case demonstrating the gravitas and credibility afforded to transactions involving subject company. This time it wasn't a sale but a buy-in from another partner that the Court assessed.

Tax Court Rejects Tax-Affecting, CSRP, Poor Comps, and More

Estate of Gallagher v. Commissioner, T.C. Memo. 2011-148, 2011 WL 2559847 (U.S. Tax Court - June 28, 2011)

In a detailed, comprehensive opinion by Judge Halpern, the U.S. Tax Court addresses nearly every aspect of private company valuation, including the application of the guideline public company method and income approaches, with particular focus on tax-affecting, adjustments to financial statements and cash flow projections, calculation of the rate of return, application of subsequent events, and of course—the determination of discounts for lack of control and lack of marketability.

Minority shareholder in private media company. The decedent owned 15% in a family-founded newspaper publishing company, which also owned a television station and a few special media providers. In 1996, the company converted to a subchapter S corporation, and just before the valuation date (July 5, 2004), it acquired a 100% interest in another small publishing company. In connection with this and other planned acquisitions, the company refinanced a \$400 million debt, for which it prepared certain financial forecasts. Finally, as of July 2004, the company had nearly 3,000 executive stock options outstanding, at an average price of roughly \$2,800 per option.



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The decedent's federal estate tax return valued her 80% share at \$34.9 million, based on an appraisal conducted by the company's president and CEO. In 2007, the IRS asserted the fair market value of the decedent's units was \$49.5 million. The taxpayer petitioned the Tax Court for a redetermination based on a new appraisal at \$26.6 million. Before trial, both sides enlisted new appraisers and closed the gap slightly: \$28.2 million for the taxpayer versus \$40.86 million for IRS.

In particular, the parties disputed four broad categories related to the valuation; the court discussed each in turn.

1. *Date of financial information.* The IRS relied on the company's internal financial statements for the period closing June 2004 and used second quarter (June 20, 2004) data for public comparable companies, even though this information was published after the July 2004 valuation date. In contrast, the taxpayer's expert relied on the latest financial information for both the company and guideline comparables prepared before the valuation date (dated March 2004), claiming that a willing buyer and seller would be unaware of the subsequently published information. The court found the June 2004 data more appropriate. Even though this information was not publicly available as of the valuation date, "that is not to say . . . that our hypothetical actors could not make inquiries of [the company] or of the guideline companies (or of financial analysts), which would have elicited non-publicly available information as to end-of-June conditions," the court observed. Moreover, the IRS expert testified that the June 2004 financial data more accurately depicted the market conditions on the valuation date, and the taxpayer's expert failed to allege an intervening event that would have caused the June 2004 data to be incorrect.

2. *Date of financial statements.* Both experts deducted non-recurring items from the company's historic financial statements, including a \$7.8 divestiture of assets. Only the taxpayer's expert deducted \$700,000 for a life insurance policy inherited through an acquisition and \$1.1 million for self-insurance claims, and eliminated \$11.7 million in pension overfunding. The court disregarded these adjustments, however, because the taxpayer's expert provided "no explanation" as to why the expenses were recurring and why the overfunded plan didn't provide an annual benefit to the company.

3. *GPCM.* Both experts used the GPCM but only the IRS's expert relied on its results, according it equal weight with his income approach. The taxpayer's expert declined to use the GPCM as anything but a reasonableness check, due to the lack of sufficient comparables. The GPCM is "generally accepted" for valuing stock of a private company, the court found, but in this case, only one of the comparables was "arguably" similar enough in size, products, and other aspects to the subject company. "A single company is insufficient on which to base the valuation method," the court ruled, and rejected the GPCM under these circumstances.

Court stakes a firm position on tax-affecting. Given the lack of sufficiently reliable comparables, the court agreed with the taxpayer's appraiser that the DCF analysis was the most appropriate for valuing the company in this case. In considering the fourth and final category in dispute, the appropriate adjustments to the DCF, the court isolated the following seven issues:



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i) *Cash flow discounts.* The IRS expert discounted the company's net EBITDA, but the taxpayer's expert discounted its net free cash flows. "The parties have not distinguished between these two economic benefits against which to apply the DCF method," the court said. It preferred to derive the present value of the company's net cash flow, but regretted the lack of financial statements in evidence. Since the taxpayer didn't object to the revenue statements on which the IRS expert relied, the court deemed these accurate, but constructed its own operating income statements and growth rate (discussed below).

ii) *Company projections.* Both experts prepared their own forecasts in lieu of using those prepared in connection with the company's 2004 debt refinancing, and so the court was limited to this evidence as well (implying that it might have preferred the more or less contemporaneous management projections). The IRS expert projected a 5.45% growth rate, based on the company's historic revenues. The taxpayer's expert applied a 4.6% growth rate, based on industry rates and also the long-term growth rates of his public company comparables. The court found the IRS rate to be more persuasive, particularly since the taxpayer's expert admitted his growth rate was significantly higher than the company's historic rates (0.6% to 1.1%). The IRS expert also included revenues from the 2004 acquisition in his calculations, which were foreseeable at the valuation date. The court disregarded adjustments by the taxpayer's expert for estimated newsprint costs, which led it to disregard his related operating margin projections and other expense adjustments as well.

iii) *Tax-affecting.* Not surprisingly, the IRS expert declined to tax-affect the S corporation's earnings before reducing them to present value. The taxpayer's expert applied a 39% income tax rate in calculating future cash flows and a 40% marginal tax rate to derive the discount rate. But he failed to explain his reasons for tax-affecting, the court said. "Absent an argument . . . to do so," it confirmed its ruling in *Gross v. Commissioner*, T.C. Memo. 199-254, that the "principal benefit enjoyed by S corporation shareholders is the reduction of their total tax burden." Thus it declined to impose "an unjustified fictitious corporate tax rate burden on [the company's] future earnings."

iv) *Cash flow adjustments.* The IRS expert based his capital expenditure assumption (2.8% of revenue) and working capital projections (-2.5% of revenue) on the company's historic financials. The taxpayer's expert made his own projections (capex at 2.3% to 3.1% and a fluctuating working capital) without adequate support or explanation, the court said, and disregarded the same.

v) *Rate of return.* "We have previously held that WACC [weighted average cost of capital] is an improper analytical tool to value a small closely held corporation with little possibility of going public," the court held. Nevertheless, since both experts used the company's WACC to determine a rate of return, the court adopted its use in this case, "although we do not set a general rule in doing so." The IRS expert calculated a 10% WACC, assuming a zero percent marginal tax rate, but the taxpayer's expert calculated a 12.3% WACC using a 40% corporate tax rate. Based on its tax-affecting ruling, the court rejected the taxpayer's approach and assumed a 0% tax rate in discounting the company's earnings.



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The experts also disagreed on the cost of equity capital. The taxpayer's expert used a CAPM formula to derive a 13.5% cost of equity; the IRS expert used the build-up method to reach his 20% rate. Specifically, he started with Ibbotson's equity risk premium (11.7%) plus its 5.22% risk-free rate and then subtracted his projected long-term growth rate (1%) to arrive at a minority cap rate, which he then converted to a market multiple and added a 20% control premium, a 4% company-specific risk premium, and a 2% S corp premium. The court approved of his method but rejected his analysis. "We do not understand why [he] included [the] firm-specific risk premium as the final step . . . rather than considering it along with the risk-free rate and [ERP]," it said, and modified his control premium from 20% to 30% to conclude an 18% cost of capital.

With regard to the average cost of debt, the court once again criticized the taxpayer's expert for failing to explain his 5% calculation and adopted the IRS expert's 6.6% as reasonable (even though the court wasn't entirely convinced of its accuracy). Finally, the court rejected the taxpayer's expert's reliance on guideline company comparables for debt/equity ratios for the same reason it rejected the broad application of GPCM, criticizing the taxpayer's expert for his "wavering stance." The court reluctantly adopted the constant 75/25 debt/equity ratio used by the IRS expert, even though "WACC is an improper discount rate too for a company planning to pay down its debt," and once again expressly excepted its finding from any "general rule." In sum, the court determined the appropriate WACC was 10%.

vi) *Earnings adjustment to enterprise value.* This time, the court criticized both experts for failing to provide enough support for their calculations of long-term debt, but ultimately adopted the figures from the IRS expert, because he based them on the more accurate June 2004 financial information. The taxpayer's expert "once again failed to explain" why he based his DCF working capital adjustment on a comparison to guideline comparables when he'd deemed these "not to be comparable" to the subject company, and when he'd adequately explained the need for the adjustment under the GPCM but not the DCF. "We lend little weight to his seemingly contradictory positions," the court said, and disregarded his \$9,000,000 working capital adjustment.

The taxpayer's expert also adjusted his DCF results by: 1) \$12.8 million to account for "S shareholder tax savings" on the excess of future projected distributions over tax distributions; 2) \$44.3 million to reflect the present value of the company's future deductible goodwill; and 3) \$6.7 million for an extra marginal debt shield. These adjustments reflected the full economic value of the company's S corp status, the expert said, citing *Gross*. "Although correctly cited," the court said, the expert misapplied the case, which found that the primary benefit to the S shareholders is "properly reflected through the imposition of a zero-percent corporate tax rate. *Gross* did not address the propriety of "these other adjustments," the court said, and without more explanation or justification from the expert, it rejected them.

Finally, the experts disagreed on how best to factor the financial impact of the company's outstanding stock options. The taxpayer's expert assumed they would all vest and subtracted the expected, in-the-money proceeds (\$12.1 million) from enterprise value. The IRS expert calculated the per-unit fair market value of the options by dividing the option holders' equity by the total number of outstanding units as of the valuation date, ultimately



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concluding that the money received from the exercise of the options would simply increase the number of issued units rather than the company's cash flows. He did so, however, "with no explanation," the court said, and adopted the approach by the taxpayer's expert but not his ultimate numbers.

vii) *Determination of discounts.* Both experts agreed that they should consider minority and marketability discounts. The IRS expert derived a minority discount based on the inverse of control premium data (Mergerstat). Specifically, he found that the median premium paid in all industries was 34.4% in 2002 and 31.6% in 2003, and those paid in the newspaper publishing sector ranged from 45.2% to 67.5%. From this, he concluded that a 20% control premium was reasonable for the subject company, which equated to a 17% minority discount. Interestingly, the taxpayer's expert declined to apply a minority discount to his DCF. His analysis already accounted for the cash flows that accrued pro rata to all equity holders, he said, and thus "the resulting firm value is on a minority interest basis and needs no further adjustment to reflect a minority interest value."

Because the court "generally" followed the IRS expert's DCF approach (which derived equity value on a controlling basis), it agreed that a minority discount applied. However, the IRS expert "only vaguely supported" his selected control premium, which fell 10 percentage points below the industry median and 20 points below those in the newspaper sector. "Without a more comprehensive explanation," the court rejected his conclusion, ultimately determining that a 23% minority discount was appropriate.

The experts were only 1% apart on their discounts for lack of marketability, 30% for the IRS expert compared to 31% for the taxpayer's. Both had reviewed restricted stock studies, with the taxpayer's expert also reviewing pre-IPO data, which reported a slightly larger average discount. He also noted that the subject company's stock was "significantly more" restricted, with longer holding periods more likely. "We have previously disregarded experts' conclusions as to marketability discounts for stock with holding periods of more than two years when based upon the above-referenced studies," the court noted. Given both experts' reliance on the studies, however, it accepted them as a "benchmark" and adopted the 31% discount.

Conclusion came close to original value. Based on all its findings, the court held that the decedent's 80% share in the company was worth \$32.6 million on the valuation date. Notably, this was not far from value stated on the taxpayer's return, based on its CEO's appraisal, which valued the decedent's interest at \$34.9 million.

CVS Comment: Most striking from the many valuation points analyzed is that there was no adjustments offered to the tax affecting of the S Corp issue. Despite the 2001 Gross Case, counterparties are still offering either fully tax affecting a pass through entity's earnings (i.e. tax payer) and the service is applying no tax affecting (i.e. the IRS). A decade later even with substantial monies at stake neither side appears to be adjusting the tax affecting.



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Chicago, IL 60606

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Tax Court Upholds Defined Value Clause

Hendrix v. Commissioner, T.C. Memo 2011-133, 2011 WL 2457401 (U.S. Tax Court - June 15, 2011)

A wealthy Texas couple wanted to transfer non-voting stock in their private S corporation to their three adult daughters (through trusts) and also to charity. Because the stock was difficult to value, their attorney suggested that instead of gifting percentages, they use a formula clause to establish a dollar value at the time of the transfer, which would also fix the value of the stock transfer for federal gift tax purposes.

Three times appraised. To make their charitable gift, the attorney also advised that they establish a donor-managed fund with a non-profit foundation that managed over \$270 million in assets for families, companies, and other non-profits. After retaining a reputable appraiser to estimate the value of the non-voting stock, the couple decided to give stock valued at \$50,000 to the foundation and nearly \$15 million worth of stock to various trusts to benefit their daughters.

Accordingly, on Dec. 31, 1999, they transferred nearly 288,000 shares of non-voting stock pursuant to the defined value formula clause. To value the gifts for federal tax purposes, the daughters' trusts retained the same appraiser, who assessed the fair market value of the non-voting stock as of December 1999 at \$36.66 per share. Given the nature of the gift, the foundation also required the donors to obtain an independent review of the appraisal and to assume responsibility for any taxes should the company fail to distribute sufficient funds to cover their pass-through liabilities. The foundation was also represented by independent counsel and had no previous ties to the donors. Following the assignment, the foundation and the trustees allocated the transfers amongst themselves according to the \$36.66 per-share value. The taxpayers were not parties to these agreements.

The IRS subsequently disputed the validity of the defined value clauses, claiming that the fair market value of the shares transferred to each party was \$48.60 per share. At trial, the IRS argued that the defined value clauses were not negotiated at arm's length and were contrary to public policy. The taxpayers argued that *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), rev'g 120 T.C. 358 (2003) was controlling.

As a preliminary matter, the Tax Court held that the IRS had the burden to prove that the defined value clauses were invalid. Since this particular case was also appealable to the 5th Circuit, the court also held that *McCord* applied. The government tried to distinguish *McCord* by claiming that it did not consider the same public policy and arm's length arguments presented in this case. The court agreed that *McCord* did not control those issues, but was "squarely on point" and "disposed of all other arguments" challenging the validity of the defined value clauses. Thus, it turned to the IRS's remaining challenges.

Close family doesn't necessarily mean collusion. Because the gifts in this case involved the charitable foundation, an independent third party without family or financial ties to the donors, the court declined to apply a stricter level of scrutiny to the transactions. Instead, to show that the transfers were not at arm's length, the court "must find credible evidence that the parties colluded or had side deals, or that the form of the transactions



cmcnally@corporatevaluationservices.com

125 S. Wacker Drive, Suite 300
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otherwise differed from the substance.” To meet its burden of proof, the government pointed to the close relationship between the taxpayers and their daughters (or their trusts). Since the daughters stood to benefit from the gifts, the parties lacked adverse interest and did not “thoroughly negotiate” the formula clauses, the IRS said.

However, just because the family was “close” and the daughters received some gain did not necessarily mean that the formula clauses fell short of the arm’s length requirement. In fact, “a finding of negotiation or adverse interests” is not an “essential element of an arm’s length transaction,” the court held. Moreover, in this case the taxpayers had no prior history with the foundation and its donor-advised fund assured that they could direct the course of their traditional gift-giving. In turn, the foundation assumed potential risks of receiving the gift, including the loss of its tax-exempt status if it failed to exercise due diligence; thus its insistence on independent counsel, an independent appraisal, and the donors’ assumption of any pass-through tax liabilities.

“We also note economic and business risk assumed by the daughters’ trusts as buyers of the stock,” the court said. That is, the trusts could receive less stock if it turned out to be overvalued. This risk placed them at odds with the taxpayers and the foundation, the court added. “We find no . . . credible evidence” that the form of the transactions at issue differed from their substance.

The court likewise dismissed the government’s public policy arguments. It distinguished defined formula clauses from “savings clauses” (which were found contrary to public policy in *Commissioner v. Proctor*, 142 F.2d 824 (4th Cir. 1944)). In *Proctor*, the 4th Circuit found that savings clauses discouraged the collection of tax and obstructed the administration of justice and federal court decisions. By contrast, “the formula clauses impose no condition subsequent that would defeat the transfer,” the Tax Court explained. They also further the fundamental public policy of encouraging charitable gifts, the court said, citing its similar finding concerning formula disclaimers in *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008).

For all these reasons, the court concluded that the formula clauses controlled the value of the transfers of the private company stock to the trusts and the foundation, and dismissed any contrary arguments as lacking merit.

CVS Comment: Most interesting was the discussion of the family still being acceptable as being able to be part of an arms-length transaction.



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Nevada Adopts ‘Flexible’ Approach to Fair Value, Supported by DE law

American Ethanol, Inc. v. Cordillera Fund, LP, 2011 WL 1706823 (Nev. - May 5, 2011)

In 2006, the Cordillera Fund purchased over \$580,000 shares of preferred stock in American Ethanol for \$3.00 per share. A year later, the company orchestrated a reverse stock merger with a biofuels firm, also at \$3.00 per share, and notified its stockholders of their rights to dissent under applicable (Nevada) statute.

All stockholders approved the merger except for Cordillera, which sued the company in state court, requesting fair value payment of its shares. The company offered book value, or \$0.15 per share. Cordillera rejected the offer and demanded \$3.00 per share. (*Note: It is not clear from the court’s opinion why the dissenting shareholder originally objected to the merger at \$3.00 per share, or why, post-merger, the company refused to pay it this price.*)

Issue of first impression at trial, the dissenting shareholder produced evidence of its 2006 purchase price (at \$3.00 per share) plus SEC documentation of the \$3.00 merger price. The company offered non-expert testimony that its book value was \$0.15 per share, which it also claimed was “fair value” for the stock. Based on this limited evidence, the trial court found that the merger price was the most reliable showing of value (even though it conceded that an offering price is not always the equivalent of stock value). It also rejected the company’s contention that book value equated to fair value, and ordered it to pay the dissenting shareholder \$3.00 per share, plus interest, for a total of nearly \$1.9 million.

The company appealed, obtaining an expedited review by the Nevada Supreme Court on an issue of first impression: which party bears the burden of proving fair value in a dissenting shareholder case. As a secondary matter, the company also appealed the trial court’s fair value determination, claiming it failed to comply with statutory and case law requirements.

Nevada’s dissenting shareholder statute is patterned after the 1984 Model Business Corporation Act (MBCA) (without subsequent amendments). The relevant portions of the state statute do not explicitly define “fair value,” the Supreme Court observed. Instead, it leaves the courts to work out “the details by which ‘fair value’ is to be determined” within the broad statutory outline. “Like other [MBCA] states, we conclude that, in determining fair value, the trial court may rely on proof of value by any technique that is generally accepted in the relevant financial community, but the value must be fair and equitable to all parties,” the court held, citing cases from Minnesota, Colorado, and New Jersey.

The court also noted that various jurisdictions have placed the burden of proving fair value on the corporation, the stockholder, or neither. Delaware corporate laws, like Nevada’s, leave the ultimate determination of fair value to the trial court. Rather than imposing the “no burden” approach (as in New York, e.g.), in Delaware, “both sides have the burden of proving their respective valuation positions by a preponderance of the evidence,”



cmcnally@corporatevaluationservices.com

125 S. Wacker Drive, Suite 300
Chicago, IL 60606

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the Nevada court explained. Even if one side fails to carry its burden, the Delaware courts may not simply adopt the other side's valuation without making specific, independent determinations of fair value.

The Delaware approach accords with concepts of judicial fairness as well as economy, the Nevada court found. It held that in a dissenting shareholder case, both sides have the burden of proving fair value by a preponderance of the evidence, subject to ultimate, independent determination by the court.

Shareholder claims company 'too difficult to value.' "Determining fair value in practice is not easy," the court added, citing the leading precedent that applied the Nevada statutory scheme, *Steiner Corp. v. Benninghoff*, 5 F.Supp.2d 117 (D. Nev. 1998). Although an appraisal would have been advantageous in this case, neither party has an affirmative statutory duty to provide one, the court said. Neither was the trial court under any obligation to appoint an independent appraiser. In fact, during oral arguments, counsel for the company maintained that it had retained an appraiser, but that the appraiser couldn't provide an assessment because the company's stock was "extraordinarily difficult to value." Counsel attributed this difficulty to several factors, including the nature of the preferred stock, the lack of trading on a public exchange, and the shareholder's minority status.

The company argued that the trial court erred by failing to follow the valuation factors outlined in the *Steiner* case, including: 1) the pre-merger market value of the shares, discounted for illiquidity; 2) the pre-merger enterprise value of the entire corporation; 3) the pre-merger net asset value; and 4) any other pertinent factor.

However, in this case, neither party presented the court with the evidence necessary to calculate and apply the *Steiner* factors. In this event, "the court may rely upon its own expertise and upon whatever evidence is presented" to make its independent fair value determination, the Supreme Court said, once again citing Delaware law. Under this "flexible" fair value approach, the trial court did not abuse its discretion to determine fair value according to SEC offering memoranda as well as the shareholder's 2006 purchase price, and the court dismissed the company's appeal.



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125 S. Wacker Drive, Suite 300
Chicago, IL 60606

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Experts Differ by Less Than 50% in Statutory Value of CPA Firm *Peterson v. Jackson*, 2011 WL 14519606 (Utah App. - April 14, 2011)

Three shareholders in a CPA firm couldn't agree over management and financial issues, and in 2006, one of the partners filed for judicial dissolution and the other two elected to purchase his shares under the applicable statutory fair value scheme (Utah). When the former partners couldn't agree on a price, they went to trial, each retaining qualified and credentialed experts to determine fair value of the CPA firm and the departing shareholder's 36.37% interest.

Court declines to take a 'Solomon approach.' Each expert applied the three traditional valuation approaches (income, market, and asset). The departing shareholder's expert also used "rules of thumb" from actual transaction price multiples, and divided the income approach into two analyses, one using capitalized cash flows and the other using net income. He then assigned a 60% weight to the market/rules of thumb approaches—20% to each of the income approaches, and 0% to the asset approach—to conclude that the fair value of the CPA firm was just over \$1.26 million, making the shareholder's interest worth about \$459,000. To this, he added the commensurate share of undistributed cash (36.37% of \$128,196, or \$46,626), yielding a total fair value in excess of \$505,000. He also declined to deduct the value of any personal goodwill, reasoning that the departing shareholder's two-year non-competition agreement effectively transferred his personal goodwill to the firm.

The company's expert reached a \$581,000 fair value under the income approach, a \$713,000 value under the market approach, and a \$618,000 value under the asset approach. After determining the asset method was the "most applicable," the expert rejected all others to value the shareholder's interest at just over \$224,000.

The trial court also heard evidence concerning a 2001 buy-in by one of the remaining shareholders. In that transaction, the incoming partner paid an amount equal to 90% of the firm's then-current gross sales multiplied by his percentage of stock (15.83%), to reach a price of just over \$106,000. Applying this same formula to the departing shareholder's interest in this case (36.37%), the trial court reached a value of nearly \$518,000.

"The court heard two very different opinions . . . from two very qualified individuals," the trial judge wrote in his 13-page memorandum decision. "Yet in the end, there was over a 50% difference in value between the two. The natural inclination is to take a Solomon approach and split the difference. However, . . . to do so would negate both expert opinions and require the court to pick a number out of thin air."

Instead, the trial court found that the departing shareholder's expert offered "a reasonable and educated explanation" for his assumptions in weighting his three approaches. Further, his market analysis showed a high correlation (0.92) to the subject CPA firm, and his exclusion of personal goodwill due to the non-compete was appropriate. "Where personal goodwill has become transferable, it is no longer personal," the court explained, citing the expert's testimony.



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125 S. Wacker Drive, Suite 300
Chicago, IL 60606

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In contrast, the trial court rejected the fair value conclusion by the company's expert, finding it was inappropriate to rely wholly on the asset approach when the firm was not being liquidated. The expert also valued the company in the hands of a specific owner or prospective buyer as opposed to a "fair value concept in which the ownership interest is valued as if it were placed on the open market for sale," the trial court said.

Finally, although "heavily influenced" by the 2001 buy-in price, the trial court decided to use it "as a guidepost," ultimately determining the firm's fair value at \$1.26 million. This was, in fact, the same value reached by the departing shareholder's expert, excluding any portion of the firm's undistributed cash. Despite finding this expert more convincing, the trial could not "find or determine what [the expert's] subsequent value would [have been] had the excess cash been included," and the court was not willing to speculate. Thus it awarded the departing partner 36.7% of the total fair value for his shares, or approximately \$459,000, and both sides appealed.

Company says court misunderstood R-squared. On its first issue for appeal, the company criticized the court's approval of the .92 correlation between the comparable companies and the subject CPA firm in the market approach used by the departing shareholder's expert. The court's finding misunderstood the "statistical term R-squared and the application of .92," the company argued. The court also should have discredited the expert's market approach for relying on comparables that varied by more than 271% in terms of gross revenues; and it should have excluded any personal goodwill from its ultimate fair value determination. Finally, the trial court erred by relying on the .9 multiplier in the buy-in formula when it should have used a .5 multiplier, the company said.

The appellate court rejected these arguments, and broadly confirmed the trial court's factual findings that the partner's expert provided the more reliable estimate of value while the company's expert "strayed from the clear guidance" of fair value precedent by relying exclusively on the asset approach. In addition, the shareholder's expert correctly gave considerable weight to the non-competition agreement, which "constructively affixed any of [the shareholder's] personal goodwill with [the firm] as an enterprise," the court explained. In effect, the trial court did not include any *personal* goodwill in its valuation of the firm, the court emphasized, because the non-competition agreement "converted personal goodwill, if any, to enterprise goodwill."

Finally, the company disputed the trial court's reliance on the .9 multiplier in the 2001 buy-in formula, but then made "no attempt" to demonstrate why a .5 multiplier was more accurate. In fact, the trial court did not determine the .9 multiplier on its own, but merely applied the "very formula that the parties themselves had used to value" the 2001 incoming partner's shares, which was "simple and easy" based on approximately 90% of firm revenues, the appellate court noted. As such, the trial court did not err by using the 2001 buy-in transaction as a "guidepost" in its fair value determination in this case.

Expert should have included alternative valuation, with excess cash? As a last matter, the departing shareholder urged the appellate court to award his pro-rata share of cash reserves as part of overall fair value. Historically, the CPA firm kept only \$10,000 in reserve from year to year, he said, but at the end of 2006 (the



cmcnally@corporatevaluationservices.com

125 S. Wacker Drive, Suite 300
Chicago, IL 60606

Phone 312.238.8690 Fax 312.324.0376

valuation date in this case), the firm had over \$138,000 in cash, of which \$128,000 was “excess,” entitling him to a 36.37% share.

“At first blush,” logic might support this argument, the appellate court said. At the same time, the company argued that the \$138,000 cash reserve was not unduly high, but in line with recommended amounts for firms its size; and was necessary to meet upcoming expenses. The company also said that the amount of cash reserves was one of the continuing disputes among the shareholders that eventually led to dissolution and that it had the right to change its business practices to conform to new consensus.

The departing shareholder maintained the trial court had erred as a matter of law, yet “even his own description of the issue bristles with factual questions,” the appellate court said, such as whether the remaining shareholders had acted oppressively, whether \$138,000 was an appropriate cash amount to keep on reserve for the subject firm, and whether the firm’s building of reserves was a result of changing business practices or litigation strategy. Moreover, although the shareholder’s expert had reduced cash in his adjusted balance sheet approach so as to avoid double counting the excess in his ultimate valuation, he did not offer an alternative calculation of value that included the cash reserves. The trial court’s unwillingness to recalculate the expert’s market and income approaches “was not error,” the appellate court held, and it declined to disturb the final fair value determination in any respect.

CVS Comment: Interesting that neither side recognized the gravitas of the buy-in from the other partner as a value indicator.