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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, ESOP and Corporate Fairness / Defined Value clauses. With each case, there is a trier of fact wrestling with the credibility of valuation opinions.

1. *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141, 2011 WL 2516168 (U.S. Tax Court, June 22, 2011)– US Tax case that deals with numerous valuation issues – weightings between DCF and Asset Approach, discounts and forecasts. Very interesting read.
2. *Christopher v. Hanson*, 2011 WL 2183286 (D. Minn. - June 6, 2011): An ESOP case concerning the sensitivities of these engagements and the conflicts of interest of a selling shareholder / ESOP trustee.
3. *Estate of Cohen v. Booth Computers*, 2011 WL 2694288 (N.J. Super.): Another case affirming defined interest clauses over fair market value.

Tax Court Rejects GPCM, Dissects DCF in Valuing Minority LP Interest

Estate of Giustina v. Commissioner, T.C. Memo. 2011-141, 2011 WL 2516168 (U.S. Tax Court, June 22, 2011)

A wealthy Oregonian owned a 41.1% interest in a longtime, family-owned limited partnership (LP) that held large tracts of local timberland. When he died at age 87, his estate reported his LP interest at \$12.67 million, based on an appraisal by a national valuation firm. On review, the IRS said the LP interest was worth closer to \$36 million and assessed a deficiency of \$12.66 million (or nearly equal to the estate's asserted value). The service also assessed an accuracy-related penalty under IRC § 6662 of just over \$2.5 million, and the taxpayer appealed.

Court accepts only two valuation methods. At trial, the estate retained a new expert to value the 41.1% LP interest at nearly \$13 million, or slightly higher than its original reported value. The IRS's expert came down to \$33.5 million—slightly lower than the amount in its deficiency notice but far from bridging the valuation gap.

As a preliminary matter, the U.S. Tax Court ruled that there were “only two appropriate” and “helpful” methods to value the LP interest in this case: the discounted cash flow (DCF) and net asset value (NAV). The former accounted for how much the partnership could be expected to earn if it continued timberland operations, and the latter valued the assets as if liquidated. The experts agreed the partnership's 48,000 acres of timber were worth \$143 million, which included a 40% discount related to expected delays in selling the large tracts. The experts differed on the weights to be accorded the two methods as well as the assumptions inherent in the cash flow approach.



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1. *Discounted cash flow.* The IRS expert estimated the partnership's annual cash flow the year following the decedent's death as close to \$10 million, and total future cash flows, once discounted to present value, at \$65.76 million.

The court found three reasons to reject the IRS expert's approach: 1) an inconsistency between his cash flow estimates and calculation of minority interest value; 2) his "unrealistic" assumption that the partnership's operating expenses would remain fixed even though he projected a 3% annual revenue increase; and 3) his reliance on the most recent year of cash flows rather than an extended period.

In contrast, the taxpayer's expert extrapolated his cash flow projections from the five years prior to the valuation date. At the same time, he should not have tax-affected his annual cash flow values by 25% because this contradicted his relying on a pretax rate of return, the court held, citing *Gross v. Commissioner*, T.C. Memo. 1999-254, *aff'd*, 272 F. 3d 333 (6th Cir. 2001).

As for the expert's 18% discount rate, the court accepted three components: the risk-free rate of 20-year Treasuries (4.5%), a beta-adjusted equity risk premium (ERP) (3.6%), and a small stock ERP (6.4%). The court rejected a partnership-specific risk premium of 3.5%, however. Even though the partnership's assets lacked diversity and geographic dispersion, this "unique risk does not justify a higher rate of return," especially when investors could eliminate the risk by diversifying portfolio," it added, and the court concluded that a 1.75% premium was more appropriate.

Accordingly, the court found the "correct" discount rate was 16.25%. (In a footnote, the court observed that this was nearly equal to the 16.22% rate calculated by the IRS expert, but it expressly rejected his method, based on a 4.25% risk-free rate and an 11.7% small stock ERP). Applying it to the DCF, the court accepted a 4% reduction by the taxpayer's expert, reflecting his assumption that cash flows would increase by 4% each year, for a final discount rate of 12.25%.

Under his DCF, the taxpayer's expert projected first year cash flows at \$4.56 million and the present value of total cash flows at \$33.8 million. After applying all its adjustments, the court concluded a total DCF value of \$51.7 million—or just about halfway between the estimates of both party experts. When it came to the discount for lack of marketability (DLOM), the court didn't split the difference between the experts. Both used restricted stock data, but only the taxpayer's expert relied more on the pre-IPO studies without sufficiently rebutting the IRS expert's accusation that the data overstated the discount. The court therefore rejected the 35% DLOM by the taxpayer's expert and adopted the 25% DLOM by the IRS.

Valuation involves 'boundless' assumptions. The taxpayer's expert accorded a 30% weight to his DCF approach compared to the 20% weight by the IRS expert—but the court rejected both. The cash flow method should reflect the value of the partnership as a going concern, and thus its weighting should be "equal to the probability that the partnership" would continue, the court said. The family-owned entity had a "long history" of acquiring and retaining timberland, the court pointed out. At the same time, an asset sale "today" would reap



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\$143 million, as opposed to the \$52 million (by the court's calculus) that current cash flows generated. Yet, a 41.1% minority interest holder could only force the sale of the partnership by creating a two-thirds voting block with other members.

The court was "uncertain how many partners would share the view" to sell the timber assets, the court said, but its uncertainty did not preclude an estimate of the probability of sale. In fact, "the entire valuation process is a boundless subjective inquiry," the court said, quoting a 1995 tax law review article. "To value an asset, the court has to make guesses or assumptions about the future [requiring] speculation about the composition of management." Based on this evidence and authority, the court concluded that there was a 75% probability that the partnership would continue to operate, and thus assigned a 75% weight to its DCF analysis.

2. *Asset method.* Given its exclusion of other valuation methods (see further discussion below), the court assigned a 25% weight to the net asset value, which included \$143 million for the timberlands plus approximately \$7.7 million for remaining assets. The court rejected a discount for lack of control (12%, as applied by the IRS expert) because its 75/25 percentage weighting already factored in the ability of a minority interest holder to effect the sale of the partnership. Likewise, the court declined to apply a DLOM to net asset value, because the stipulated \$143 million value for the timber already included a 40% discount related to its sale.

After taking 75% of its DCF value (\$51.7 million), discounted by 25% for lack of marketability, and 25% of its already discounted net asset value (\$150.7 million), the court reached a value for the family limited partnership of approximately \$66.75 million. Multiplying this by the estate's 41.1% share equaled \$27.45 million, or what the court called the "correct" fair market value of the LP interest.

Alternate approaches rejected. To clarify and complete its ruling, the court noted that in addition to his DCF method, the taxpayer's expert had calculated value under a capitalization-of-distributions method (weighted at 30%) and an asset-accumulation method (10%). But, "the cash earned by the partnership is a more reliable indicator of value than the cash distributed to the partners," the court found, in rejecting the first. Since the second method was essentially a "hybrid" of the asset method (already accepted by the court) and the capitalization of distributions method (specifically rejected), the court accorded it no independent weight.

Both experts applied the guideline publicly traded company method (GPCM) to value the partnership. The taxpayer's expert relied on two large public comparables, weighting his market approach 30%. The IRS expert selected the same two plus an additional pair of comparables, ultimately assigning a much greater (80%) weight to his conclusion. However, "neither expert appropriately considered that the other companies have assets other than timberland . . . and that they earn income from sources other than timber sales," the court said. "Because of this failure, and because other methods are available" (namely, the DCF and NAV), the court accorded no weight to the GPCM and stood by its ultimate conclusion.



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In a final step, the court considered the imposition of accuracy-related penalties under IRC §6662. In this case, the estate's executor reasonably relied in good faith on the original appraisal (\$12.7 million), despite its use of the market and income approaches and exclusion of NAV. "The partnership had been in operation for 15 years," the court said, and thus it was "reasonable" to conclude that it would not liquidate. Under these facts, even though the appraised value amounted to less than 50% of the court's "correct" value and "substantially" understated estate value, it dismissed any penalties.

CVS Comment: This case is interesting in the analysis of assigning probabilities of the entity being sold as a part of the overall weighting of the appraisal.

Was ESOP Appraiser 'Strong-Armed' by Owner/Trustee?

Christopher v. Hanson, 2011 WL 2183286 (D. Minn. - June 6, 2011)

From threadbare beginnings in 1998, an online embroidery design company grew its subscriber base to over 100,000 and its annual revenues to \$6 million. During that time, the company founder and CEO created an ESOP, selling a substantial amount of his (and his family's) shares to the ESOP and acting as trustee. An independent appraiser periodically valued the family-owned firm for purposes of ESOP share allocation; one of these appraisals approached \$15.2 million

Controlling shareholder wants to cash out. In early 2004, the CEO hired an investment banking firm to market the company. Several offers ranged from \$4 million to \$5 million, but nothing came close to the \$15.2 million value by the ESOP appraiser, and the owner abandoned the sales effort.

Instead, in early 2005 he began pursuing the option to sell and/or redeem his family's shares through the ESOP. The board of directors (including the owner, his wife and two adult sons) resolved to use "all available corporate profits" to purchase the family's shares until the ESOP was the "sole shareholder." The company's attorney advised the appointment of an independent trustee with independent legal counsel to negotiate the purchase at arm's length—but the owner declined to do so. In fact, in retaining his longtime ESOP appraiser to prepare valuation in connection with the proposed transaction, the owner neglected to tell him about his failed attempts to sell the company and allegedly supplied him with overstated projections.

Based on the resulting appraisal, the ESOP purchased the family's stock at just over \$168 per share for a total of \$2 million; the company redeemed more of the family's shares at the same price for a total of \$4.8 million. The



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company financed the transaction with bonds payable to the family owners and left the ESOP holding the majority (52.1%) of company shares.

Owner threatens the COO. Just a few months later, the owner told the president and COO (also an ESOP trustee) that he wanted to sell the rest of his shares to the ESOP for \$275 per share and that she must “make it happen” or be fired. As with the earlier transaction, the ESOP was not represented by any independent advisors, and this time, the deal included several restrictions as part of the financing agreement, including a bar on selling the company for three years.

The owner once again commissioned the longtime ESOP appraiser to appraise the value of company stock. Along with the overstated financials, he also supposedly provided the appraiser with a “target” value of \$275 per share and failed to inform him about the non-sale provision. This second deal closed at the end of 2006, with the ESOP buying 8,000 shares for \$2.2 million and the company redeeming 76,000 shares for a total of \$21 million. By then, the owner had resigned as ESOP trustee.

Within months, the new trustee sued the owner and family members on behalf of the ESOP, claiming breach of fiduciary duties under federal (ERISA) and state law. The defendants moved for summary judgment and the plaintiffs responded by presenting at least two appraisers, who testified that:

- The owner should have caused the company to retain an appraiser other than its longtime ESOP appraiser, due to the latter’s “history” with and “ties” to the company, its owner, and the ESOP.
- Providing an appraiser with a “target” value was “outside normal procedure” for ESOP valuations.
- The \$275 sale price should have included a 25% discount for lack of marketability to reflect the non-sale agreement and other restrictions.
- A second marketability discount should have reflected the nature of a closely held company. A 30% discount was the “norm,” reduced for ESOPs to factor in redemption obligations. In this case, an additional 5% discount would have been appropriate.
- The owner’s inflated projections predicted that sales would grow from \$10.5 million in 2007 to \$19.5 million in 2009. In fact, actual sales during the same time never topped \$10 million.
- The company’s stock was worth, at most, \$126 at the time of the first sales transaction and \$159 at the time of the second, based on the overstated projections. After “reasonableness” adjustments, the share values fell to \$100 and \$132, respectively.

The owner claimed that the ESOP appraiser was ultimately responsible for verifying the reasonableness of the projections, and indeed, the appraiser testified that he’d checked them against the past management projections before relying on them in his appraisal. The owner also argued that the prior failed attempts to market the firm would not have impacted its ultimate value at the time of the transactions.

That may be, the court said, but the evidence “still bears on whether [the owner’s] conduct was prudent.” Clearly, he had a pecuniary interest in obtaining “the largest possible payment” for his family’s shares, and this



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conflicted with his duties to evaluate the appraisals against reasonable financial data rather than providing projections that were “dubiously high,” the court said. Finally, the owner’s negotiations were flawed by his own manipulation of the ESOP trustees and his “strong-arm” tactics with the board. For all these reasons, the court declined to dismiss the complaint and set the case.

CVS Comment: There are several cases like these that underscore the abuse that can happen in an ESOP with a strong willed owner / seller and an inexperienced or pliable appraiser.

Is a Buy-Sell at Book Value Unconscionable, When FMV is 60x Greater?

Estate of Cohen v. Booth Computers, 2011 WL 2694288 (N.J. Super.)

After amassing a considerable fortune in publishing and other industries, a father created an income-producing partnership on behalf of his three children. His attorneys drafted the partnership documents and the beneficiaries, ages 19 to 27, signed the paperwork without consulting independent counsel.

Among other properties, the partnership owned an oceanfront estate in Palm Beach, Fla., originally purchased in 1976 for \$750,000. It also acquired two commercial warehouses in New Jersey and a real estate holding company in Massachusetts. In keeping with its closely held nature, the partnership agreement precluded the partners from transferring any shares and provided that, on their divorce or death, the remaining partners “shall” repurchase the divorced/deceased partner’s shares at the “true value” of the partnership, defined as “net book value” plus \$50,000. The buyout clause further provided that “net book value” would be “as shown on the most recent partnership financial statement” as of the date of valuation.

One of the partners divorced in 1994, but the two remaining partners declined to invoke the buyout provisions, because the divorce did not threaten the partnership. In 1997, one of the partners died, and at that time, the partnership paid the estate \$97,650 for the deceased partner’s one-third interest, based on book value plus \$50,000.

Palm beach property worth millions. When one of the two remaining partners died in 2007, the oceanfront property had appreciated to \$45 million. An appraiser for the deceased partner’s estate estimated the “full” or fair market value of the partnership at just over \$23 million, based on the net asset approach, which when added to the appraised value of all the real properties exceeded \$68 million.

Nevertheless, the partnership paid the deceased partner’s estate just over \$177,800, based on the “net book value” of the 50% interest as shown on the most recent balance sheet and income statement as of the date of



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death. The estate sued the partnership, requesting specific performance of the buyout provision but at its “true value,” based on its \$68 million in combined appraisals. Given the gross disparity between fair market value and net book value, any other interpretation was unconscionable and voided the buy-sell provision, the plaintiffs said.

At trial, the partnership presented a CPA expert, who concluded that the purchase price of \$177,800 reflected the partnership’s book value, as set forth in its financial records. These reflected the partnership’s cost value, he explained; determining its fair market value would require a full appraisal. Moreover, from an accounting perspective, it would have been “completely erroneous” for the partnership to reflect the fair market value of the Palm Beach property on its books, the CPA expert explained, because the tax code as well as generally accepted accounting principles require investment property to be recorded at cost.

The plaintiff’s appraiser argued the partnership’s financial records were “fraught with numerous errors,” but nevertheless the court accepted them, in particular finding that the partnership’s financial statements had never reflected the market approach to value but had consistently used a cost approach. This historic treatment of the partnership’s value comported with the “plain language” of the buyout provision, in which there was no reference to market value but rather a value clearly pegged to book value, as determined by standard business practices. The book value formula was properly applied when one of the partners died in 1997, the court noted. Applying any “fair value” or “market value” would invite “exactly the sort of disruptive family litigation” that occurred in this case.

Finally, there was nothing “inherently offensive” in the buyout formula at book value. Book value may be artificial, but it was easily ascertainable and applicable in this case to any partner who divorced or passed away. Under these facts, the trial court did not find the buy-sell provision unconscionable, and the estate appealed.

“We recognize the disparity between net book value and fair market value,” the appellate court observed, “yet the controlling factor as to which buyout method is applicable is the language of the partnership agreement.” That language was plain and unambiguous, and comported with standard definitions of book value (including the one in *Valuing a Business*, by Shannon Pratt, Robert Reilly, and Robert Schweihs, 4th edition, 2000). When a buy-sell provision is clear, the disparity between book value and fair market value alone was not sufficient to “shock the judicial conscious,” the court held, and affirmed the buyout at net book value.

CVS Comment: Another in a series of recent cases affirming defined value clauses. In this case Book Value over Fair Market Value.