Business Valuations

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Top Ten Ways to Succeed in A Judicial Appraisal Action

Judicial appraisal actions often involve sophisticated financial applications, analysis, and assumptions. To present appraisal evidence with the greatest likelihood of success, attorneys and their business appraisal experts will want to heed these "top ten" suggestions:

#10. *Be familiar with precedent and the judge's prior decisions.* Which valuation methods have met with the particular court's prior approval? A new or less-favored method requires a well-prepared explanation by the experts and persuasive reasoning by the attorneys.

#9. *Present an effective witness.* You'll want the business appraiser to tell a clear story about how the company makes money and how that ties into its valuation. The analyst needs to describe the approaches and methods, explain the inputs and assumptions, and determine an appropriate weight for each method. If a particular method is not appropriate, the expert should be prepared to explain, as mistakes and last-minute changes will surely undermine credibility.

#8. *Present an effective report*. The valuation report should be in plain, understandable terms, with ample use, where appropriate, of charts, graphs, and CDs with spreadsheets. Take advantage of available resources and technology—but don't bury the court with paper.

#7. *Decide whether to prepare a rebuttal report.* This is a tactical decision, for which sensitivity analysis is critical. If the court is not completely persuaded by your expert's report, then submission of a rebuttal or alternate valuation report gives the court a basis on which to rule (other than adoption of your opponent's expert report.)

#6. *Use reliable management projections.* By and large, courts prefer contemporaneous management projections, prepared in the ordinary course. Projections prepared when a fairness opinion, acquisition, or other major deal is in the offing are generally considered less reliable.

#5. *Be prepared to justify a DCF.* All inputs and aspects of a discounted cash flow analysis (DCF) will come under the court's scrutiny, including the discount rate and its inputs and the terminal value. Attorneys and their experts should make sure the analysis will "hold together" under cross-examination.

#4. *Check your 'reality-checks.'* In many appraisal actions, courts have found reality or "sanity" checks helpful, such as market prices, control premiums, evidence of a "thorough and fair auction," etc.

#3. *Don't forget interest.* If the parties bear the burden of proof in determining interest in a statutory appraisal action, make sure your experts assist with this calculation. Absent reliable evidence, courts will fall back on the statutory rate.

#2. *Expert should be skeptical.* The appraiser should also be sure to test any management assumptions and projections against a reasonableness or "reality" check.

#1. *Expert must be independent.* Business appraisers are important members of the "litigation team," but they must retain their independence. Experts who appear "too cozy" with their own side risk losing their credibility in the court.

Allocation of Stock Purchase Price to Non-Compete Must Be Clear, Unambiguous

***Becker v. Comm'r of Internal Revenue,* 2006 Tax Ct. Memo LEXIS 268 (December 13, 2006)**

The Tax Court reviewed the two primary rules governing the allocation of a portion of a stock purchase price to a covenant not to compete and found that the overriding standard—as in most contract construction cases—is the clarity of the provisions and, failing that, evidence of the parties' intent.

Family company buys out shareholder/son

Internecine disputes led the Becker Holding Corporation, a family owned, Florida citrus operation, to purchase all shares held by one Becker son for

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$23.9 million, payable with $5 million in cash and the remainder by an installment note. None of the purchase documents provided for an allocation of the price to a covenant not to compete, which the Becker son executed at the sale.

But in filing its tax return, the company allocated the $5 million to the non-compete, declaring an amortization deduction. The IRS asserted a deficiency, consolidating the action with one against the son, who'd claimed capital gains tax on the total consideration paid to him (and not ordinary income, as would have resulted from the company's characterization).

The relevant rules

In deciding the case, the Tax Court applied the standards of the 5th and 11th Circuits:

1. *'Strong proof rule' and 'mutual intent test'.* When considering tax allocation cases involving a covenant not to compete, the 5th Circuit adopted the "strong proof rule," which held that when the parties have set out the covenants with an assigned value, then only "strong proof" can overcome the declarations.

   Over time, the 5th Circuit departed from the rule, adopting the more specific "mutual intent test," where the question becomes: "Did the parties… when they signed the agreement, intend to allocate a portion of the purchase price to the covenant not to compete?"

2. Danielson *rule*. In cases where the parties do allocate a stated portion of the purchase price to the non-compete, then the rule of the *Danielson* case (3rd Circuit, 1967), adopted by the 5th and 11th Circuits, applies:

   > A taxpayer who enters into a transaction…to sell his shares and executes a covenant not to compete for a consideration specifically allocated to the covenant may not, absent a showing of fraud, undue influence and the like…challenge the allocation for tax purposes.

The *Danielson* rule holds true even if, as in that case, "the explicit allocation had no independent basis in fact or arguable relationship with business reality."

Both rules consistent with this case

Both the Becker son and the IRS contended that the *Danielson* rule applied, as the purchase documents clearly allocated the entire consideration to the stock. Therefore, the transaction should result in capital gains to the taxpayer, with nothing allocable to the non-compete, as the company argued.

The company claimed the "mutual intent" test controlled, because the parties intended to allocate some value to the non-compete, and thus the Court should independently determine its value. (Note: Neither party obtained an appraisal at the time of the stock purchase agreement.)

The Tax Court held that the outcome was the same under both standards. The purchase documents clearly allocated the entire price to the shareholder's stock (*Danielson* rule). Although the parties obviously considered the non-compete an important element of the deal, nothing in their transaction—including their discussions and negotiations—evidenced a mutual intent to allocate a portion of the price to that provision (mutual intent test).

Notably, the company had argued the parties' failure to obtain a formal valuation of the shareholder's stock had evinced ambiguity about allocating a value to the non-compete. But the Court firmly disagreed, stating that the "absence of a third-party appraiser does not render the purchase documents ambiguous," especially when the parties themselves clearly valued the stock at $23.9 million.

Another Court Considers The Distinction Between Personal vs. Enterprise Goodwill

***Gaskill v. Robbins,* 2006 Ky. App. LEXIS 364 (December 8, 2006)**

In this Kentucky divorce case, the wife was a successful oral surgeon, having opened two practices during the marriage, to which the husband had contributed his tax and accounting skills.

At trial, in valuing one of her practices, the wife's expert attributed a zero value to goodwill. In his opinion, the goodwill was all "personal"—that is, derived entirely from the wife's individual skills, reputation, and knowledge. He concluded that the fair market value of her practice was $114,000.

The husband's expert took the opposite view. Without distinguishing any separate components, he included goodwill in his overall calculations, concluding that the wife's practice had a fair market value of nearly $670,000.

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Trial court felt compelled to value goodwill

The trial court rejected the wife's valuation, saying, "[T]here is no reported legal authority for the distinction in goodwill" made by her expert. In fact, in adopting the valuation by the husband's expert, the lower court held, "[I]t is generally accepted in Kentucky that the goodwill of a closely held medical corporation should be assigned value in a dissolution proceeding."

On appeal, the wife contended that the family court "operated under the misconception that it was compelled to assign a goodwill value" to her practice, and the Court of Appeals agreed. While Kentucky law requires considering goodwill in the valuation of a medical practice, it does not compel its inclusion. Thus, the case merited remand.

A chance to join the majority

At the wife's urging, the appeals court also considered whether Kentucky law should join the majority of U.S. jurisdictions in distinguishing enterprise and personal goodwill in divorce actions.

The wife cited a survey from a 2003 West Virginia case, *May v. May*, in which the state Supreme Court found that twenty-five U.S. jurisdictions made the distinction, with only enterprise goodwill constituting divisible marital property. Kentucky fell into the minority of twelve that do not exclude the personal component from the overall goodwill of a business and/or professional practice. (The remaining states have not directly addressed the issue.)

After a brief discussion of the majority/minority views as well as related Kentucky law, the Court of Appeals in this case decided it was "not inclined to deviate from long-standing precedent by creating a wholesale change of law holding that 'personal' and 'enterprise' goodwill should be distinguished for purposes of property valuation in a divorce proceeding"—not even in the case of a sole proprietorship.

Precedent aside, principles of equity persuaded the Court to continue to hold that the "form of the business enterprise [cannot] defeat the [marital] community's interest in the professional goodwill." Any other ruling, it said, would ignore the contribution made by the non-professional spouse to the success of the professional—as in this case, where the husband had contributed his financial time and skills, among other things, to the wife's practice.

Leaves question for the state Supreme Court

As in the *May* case, which went through an appeals process to the highest state level, the Kentucky Court of Appeals may simply have deferred the ultimate question to the state Supreme Court.

In a dissent, a senior appellate judge opined that "'personal' goodwill should not be considered marital property to be divided between the parties." However, he added, "[T]his is a matter to be addressed to our Supreme Court," as both the trial and appellate courts had not erred in their rulings under current Kentucky law.

How to Avoid Post-Divorce Dissatisfaction: Hire Good Help

***Kojovic v. Goldman,* 2006 N.Y. App. Div. LEXIS 12518 (October 19, 2006)**

This is yet another case where the parties thought they could do it more cheaply and quickly themselves: The husband was CEO and minority shareholder (7-8%) of a closely held information technology company; the wife was a former financial analyst with an MBA. When the couple decided to divorce, they moved rapidly, exchanging simplified financial information and waiving further discovery. After retaining some legal and accounting assistance, they reached a comprehensive settlement within four months of filing.

Per the agreement, the wife received $1.15 million cash, plus annual maintenance of $87,500 for four years. She also signed off on conducting any further inquiry into the husband's assets, in particular his shares of the IT company.

Just over a month after the agreement was executed, however, the company sold for approximately $225 million, of which the husband received $18 million. The wife sued for fraud and rescission of the settlement, claiming the husband had affirmatively misrepresented the liquidity of his shares. She also asserted that it was the husband's obligation to disclose the value and potential value of his shares and that he concealed knowledge of the "imminent" sale of the company.

The husband moved to dismiss the wife's claims, relying on the settlement agreement waivers and New York precedent. But the lower court denied his motion, finding that the wife's assertion of affirmative

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misrepresentations distinguished the case from those upholding similar settlement agreements; and the wife appealed.

Disdain for such claims

"This Court does not stand alone in its disdain for post-divorce claims of concealment," the appeals court began. The Court found nothing irregular or unconscionable about the settlement agreement. The case did not involve the concealment of an asset, but rather its valuation and potential sale. Given the wife's professional background and her retention of an attorney and an accountant, "she should have been aware of the distinct possibility that [the company] would be sold."

That the wife opted for an immediate and certain payout over the risk of an eventual sale did not warrant setting aside the settlement, the court held. That the husband harbored a more optimistic assessment of the potential value of his minority interest than he disclosed—or even had additional information that he kept to himself—was "irrelevant." That the parties could have "freely availed themselves of any number of valuation and discovery procedures…but declined to do so," is the lesson from hindsight, which this case helps bring home to divorcing parties.

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