

Current Market Conditions Present Estate Planning Opportunity

The Wall Street domino has toppled just about everything in sight: U.S. stocks, large and small; foreign stock; oil and other commodities; real-estate investment trusts; and the formerly booming emerging markets like India and China. According to Morningstar Inc., 91 percent of all mutual funds in existence have lost money so far this year. As of the end of September 2008, the Dow Jones Industrial Average was 25 percent below the peak reached in 2007. The S&P/Case-Shiller home-price index, a closely watched gauge of U.S. home prices, showed home prices in 20 major metropolitan areas were 19.5 percent below the peak reached almost two years ago.

The decline is also true for many closely-held businesses. Even though their fundamentals may still be positive, the valuations are negatively impacted by market conditions. It wasn't long ago that potential buyers of businesses included not only competitors,

other industry players, suppliers, customers, and employees but also financial buyers. Bank financing was often used to accomplish transactions; it also enabled the buyer to pay the higher prices. This is no longer the case with the current credit crisis. Valuation multiples and prices are down.

Current market conditions present an opportunity for estate planning. The reduced valuations now allow the transfer of more assets than previously possible. What was priced at \$100 per share may now be transferred at \$75 to \$80 per share so a larger interest in a limited liability company, family limited partnership, real estate entity or closely held business can be gifted or sold to the next generation. Making a gift or sale now will transfer the potential appreciation from the parents' estate. This will help minimize the estate tax.

Pros & Pitfalls of Retaining a Joint Appraisal Expert

There are many contexts in which attorneys and business owners might jointly retain a valuation expert, during a merger or sale, for instance, a divorce, or a partnership dissolution. A jointly engaged appraiser can be a key player in a buy-sell scenario or a pre-litigation settlement. What follows are just a few of the ways to take advantage of jointly engaging an expert and a few potential pitfalls:

- **Cost.** A jointly engaged expert will most likely reduce the costs associated with an appraisal in any setting, but especially in those cases when opposing experts are so far apart that the parties have to hire a third, independent valuator. This situation arises most often in buy-sell scenarios, but also in divorce cases when the court is confronted with such disparate evidence of value that it appoints a third, "independent" appraiser, at the parties' cost. By deciding to jointly retain an expert up front, prior to any trial proceedings or sales negotiations, the parties can save significant costs related to the documents and information needed to value the business, the time spent investigating these matters, and the types of calculations performed.

- **Full access to information.** When the parties retain one valuation analyst, they will be more likely to provide greater access to information to support their respec-

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tive opinions of the business and its future prospects. The valuator will in turn share all of the information with the parties, electronic communication as well as paper documentation, so that everyone is on the same “page,” and greater objectivity is assured.

- **Experience.** When jointly retaining an expert, look for seasoned, credentialed business appraisers who have worked on joint assignments in the past. Joint engagements do present unique challenges (discussed below), and familiarity with the process, including how to administer these assignments between adversarial parties, can be critical to a successful result.
- **Payment.** The parties should establish at the outset how to pay for the joint appraisal. If they can’t agree on the typical 50/50 split, then they should address the issue along with any questions regarding scope of work so that, once again, everyone is in agreement.
- **Communication.** Preferably, the appraiser’s engagement will establish rules about communication (as well as payment and scope of work). These rules will encompass communications to and among the parties and their attorneys as well as access to key business personnel, meetings and management interviews, etc. When the meetings occur outside the presence of one or both parties, they (or their attorneys) can have access to the appraiser’s notes or summaries.
- **Draft report.** The parties should also decide whether to review a draft report (for factual accuracy, comprehensive inputs, e.g.) before the valuator issues a final conclusion of value. The purpose is not to alter the preliminary opinion but to ensure that the valuator has considered all relevant facts and information.
- **Objective mediator.** In many joint appraisal engagements, the expert can essentially become the “trier of fact” regarding valuation issues. As such, the valuator must inspire trust, demonstrating a high degree of integrity and independence by taking an even-handed, objective approach to the assignment.
- **Challenges.** Despite agreeing to jointly hire an expert, the parties may have very different interests at stake and perspectives on value. The appraiser must be prepared to balance any opposing pressures from the parties, such as conflicting input, preconceived notions of value, unrealistic expectations, to arrive at a truly independent conclusion. When possible, it might behoove the valuator to seek independent data and sources of information to mitigate a party’s opinion.
- **Educating the client.** In litigation settings, the standard of value will be set by statute and/or case law. Many buy-sell scenarios contain no definition of or provision for determining the standard of value, and in a joint engagement, the expert can help the clients and counsel understand the various standards, their application, and their implications as to value. Similarly, if the buy-sell provisions are ambiguous regarding valuation methods or accounting terms, the joint expert can offer alternatives and interpretative guidance.

- **Encouraging trust.** While the parties, especially those to an adversarial proceeding, may not trust each other, once again, it is critical for the jointly engaged appraisal expert to inspire them with trust in the valuation process and its outcome. A jointly engaged expert must always maintain neutrality, in act if not in appearance, and disseminate information equally. The more even-handed the administration of a joint valuation assignment, the more successful the outcome, and satisfied the clients.

How Analysts Can Help Cut Costs and Conflict in Valuing Small Businesses

It happens all the time: Your expert is retained to value business interests in a divorce with a limited budget, limited documentation, and limited timeframe. The analyst doesn’t have enough information (or funds) to do a formal conclusion of value under the applicable professional BV standards and so agrees to provide a calculation of value, purely for discussion purposes and with the hope of facilitating settlement. (A calculation of value typically is limited in scope as to the procedures the analyst will employ, and often these can be at the client’s or the attorney’s direction.)

The report containing the calculation of value is liberally sprinkled with caveats and limiting conditions and may state that a “calculation” of value is not a conclusion of value—which could be materially different. In most cases, the analyst will not want to testify without having performed a full, formal appraisal with a complete (and compliant) conclusion of value.

In the best-case scenario, the calculation engagement helps the parties settle, and you (and your expert) get paid. Worst case: Your analyst ends up in court testifying to a calculation of value, while also admitting that it’s not a “professional opinion” because it doesn’t comply with standards, and that it may differ significantly from a conclusion of value. How can attorneys avoid this situation and still obtain solid valuation analyses of small businesses in divorce proceedings?

- **Educate the client.** Many analysts consider calculations of value as “number-crunching” exercises, which certainly save money and help move the parties forward by demonstrating one or a range of possible values. But it’s critical to educate the client that a calculation of value is not the “final word” on an appraisal and does not come near to the comprehensive conclusions of a detailed appraisal, which meets all standards for disclosure and admissibility.
- **Scale down the report.** None of the professional

standards distinguish between valuing large and small businesses. Depending on the facts of the case, however, your expert may be able to reduce time spent on certain methods (guideline company method, e.g.) when developing a full-blown appraisal. Also consider asking your expert to tailor the requests for documents to meet the size and nature of the business, which can lower costs and boost cooperation from the other side.

- **Encourage the experts to meet.** In some cases, the experts can meet to discuss the nature of the business, the financial information they require, and the direction that a valuation will take. Often, this leaves the experts with some numbers to crunch and gaps to fill, but they will have significantly streamlined the process and may be able to avoid writing up full reports.
- **Non-litigation matters.** Because of BV standards, analysts will most likely not be able to support a gift tax appraisal with a calculation of value. But as in divorce settings, a calculation may be appropriate in other situations as a first step for informal discussions, in the sale of small businesses, for example, or when a long-time client wants to get a “ballpark” value for retirement or other purposes.
- **Consider a flat-fee calculation.** Some valuation specialists will agree to review basic documentation, such as financial statements and tax returns, and then provide the attorney with an opinion about whether the case justifies a complete business valuation. The one-time, flat-fee service may be restricted by several conditions in the engagement letter, including not testifying in court but it provides a good service to the legal community (and their clients) at a reasonable cost.

May a Dissenting Shareholder Claim Value of Company’s Projected Future Income?

MS Holdings, LLC v. Malone, 2008 WL 1700156 (Tenn.)(April 14, 2008)

Is a shareholder who dissents from a corporate action entitled to receive the projected benefits of the proposed action? One major factor, according to this Tennessee case, is how far along the company may be in its proposed new venture as of the date of dissent.

Company seeks celebrity brands

Up until June 2005, the plaintiff corporation was a distributor of several well-known meat brands. The defendant owned a partial interest in the business. When the company decided to explore licensing and selling products that bore celebrity likenesses, the

defendant objected. After the company’s members voted in favor of the new business plan (on June 6, 2005), the defendant demanded payment for his interest as a dissenting shareholder pursuant to local (Tennessee) statute.

The company paid the defendant \$27,000 for his shares, even though its analysis indicated that the value of his interest was zero. The defendant demanded nearly \$2.7 million. The company sought judicial appraisal to determine the “fair value” of the defendant’s interest and to assess all costs and attorneys’ fees.

Trial court rules on inclusion of future income

The court appointed an appraiser to determine the fair value of the defendant’s interest. The appraiser found that the interest was nominal if the value excluded the future business prospects. If he considered future prospects, “the most optimistic estimate of value would be in the \$100,000 to \$150,000 range.”

The appraiser asked the court to rule on whether the appraisal should include projected future performance. Citing a state Supreme Court decision, the trial court held that the defendant could not simultaneously dissent from the company’s future business but also seek to benefit from the projected income it might produce. The appraiser then submitted his report, excluding projected future income and finding the court appointed defendant’s interest to be worth the “nominal” amount of \$10,000 as of the date of the shareholder vote. Accordingly, the trial court ordered the defendant to pay back \$17,000 from the \$27,000 he had already received—as well as over \$63,000 in fees and costs. The defendant appealed.

Future earnings too speculative?

The defendant challenged the trial court’s exclusion of projected income by citing a Delaware Supreme Court case (Weinberger v. UOP, 1983), which permitted a court, in a statutory fair value appraisal, to consider business plans that are in place but not yet executed as of the valuation date. The Court of Appeals considered the case and found, even under Weinberger, that a judicial appraisal should not include future performances that are too speculative.

In this case, the new business venture “had not even been created on the valuation date,” the court observed. The company had not finalized the contracts and licensing agreements upon which the venture’s profitability would turn, and though it hoped the new business plan would be profitable, “as of the valuation date any future profits were just that, hope.”

VMI HIGHLIGHTS

- We are happy to announce that Robert Fetter, MBA, has joined VMI as a senior financial analyst. Bob brings 30 years of business valuation experience to VMI. His concentration is in purchase price allocation, intellectual property, goodwill impairment and other intangible asset valuations. He is a great addition to our team. Welcome, Bob!
- VMI sponsored the Philadelphia Estate Planning Council luncheon on September 16 at the Union League. The speaker was Samuel Donaldson of the University of Washington School of Law. His topic was, "Covering Your Client's S (Corporation)." Please contact us if you would like a copy of Mr. Donaldson's presentation.
- VMI was a conference sponsor at the 13th Annual Multi-State ESOP Conference Program on September 17-18, 2008 at the Hilton Scranton & Conference Center. Ed Wilusz led a session on Valuation Basics. Andrew Wilusz was on an "Ask the Experts" panel. In attendance were participants from New Jersey, New York, Pennsylvania and Delaware.
- VMI's Director of Business Valuations, Trish McMullen, presented an overview of the process used in estate and tax valuations to the Bucks County Bar Association's Orphan's Court Section on October 8 in Doylestown, PA.
- VMI will sponsor the Pennsylvania Bar Institute's 15th Annual Estate Law Institute held at the Philadelphia Convention Center on December 9-10. The PBI is the Commonwealth's largest and most trusted non-profit provider of continuing legal education programs.

If you are interested in having one of our analysts speak to your firm or give a presentation at a conference, please contact Susan Wilusz at smw@valuemanagementinc.com

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