

Latest FLP disaster includes pulling discounts 'out of the air'

"It is a truth universally acknowledged that a recently widowed woman in possession of a good fortune must be in want of an estate planner." So begins the latest Tax Court memorandum opinion (by Judge Holmes) to address the effectiveness of family limited partnerships (FLPs) as an estate planning devices. *Estate of Hurford* (Dec. 12, 2008) follows the story of the devoted widow Hurford, whose husband died quite suddenly, leaving her to quickly learn estate management. Her burden was accelerated when she was suddenly stricken with cancer. "Two attorneys vied for her attention and she chose [one]," the court said. "She lost her life to the cancer. We must now decide how much of her estate will be lost to taxes."

Who can resist such an opening? Well, for one, the court's opinion is 85 pages long. And two, not all bodes well for the Hurford estate—or its attorney, whom the court criticized for many errors, including sloppy drafting of key documents and making "egregiously false" statements on tax returns. Notably, the attorney also declined to retain independent appraisals of the numerous interests at stake—three FLPs funded with a private annuity—bragging to the Hurford heirs that he had "experience obtaining 50 percent discounts in settlements on estates with the IRS." However, the method he used to pick the discount factors was "haphazard," according to the court, ranging from 25% to 42%, with no clear basis for the percentages.

The end of the story: At trial, the estate offered two independent experts, "to clean up some of the problems." Nevertheless, even their testimony, that the discount factors were within acceptable limits, could not save the mess that bad advice and poor execution had made of the widow Hurford's estate. Suffice to say that under IRC Secs. 2035, 2036, and 2038, the court recovered all of the property that the attorney tried to transfer out of the estate via the FLPs. It further found that the attorney "conjured the partnership discounts out of the air," and that a "careful attorney" would have had the assets re-appraised at the time of funding. Finally, the court offered a long list of factors by which to assess the non-tax purpose of a proposed FLP, including:

1. Adherence to partnership formalities;
2. The taxpayer's dependence on distributions;
3. Whether the taxpayer commingled personal funds with partnership funds;
4. The taxpayer's old age or poor health when forming the FLP; and
5. Whether the FLP functioned as a business enterprise or otherwise engaged in any meaningful economic activity. Considering the entities in this case, the court found that they existed only to satisfy the Hurfords' "drive for a discount."

10 Tips to Protect Expert-Attorney Communications

The vast majority of courts now adopt a "pro-discovery" stance regarding the disclosure requirements for a party's testifying expert as codified in Rule 26(2)(b) of the applicable rules of civil procedure (state and federal). An attorney's provision of information to an expert may be afforded some protection, under either the attorney-client privilege or the work product doctrine. However, a safer assumption to make—right from the beginning

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of a litigation matter—is that any correspondence or communication between the attorney(s) and expert(s) may be discoverable as information forming the basis of the expert’s opinion.

This general rule is broad enough to include discussions between attorneys and experts, emails, notes, voice mail messages and other recorded conversations. Consequently, attorneys and their experts—including financial analysts, business appraisers, and economic damages experts—should:

1. Remember that an expert’s entire file may receive very limited protection from disclosure.
2. Keep away from any discussion or exchange of documents that will allow an opposing party to question your independence in arriving at opinions.
3. Avoid any risk of waiving any protections (attorney-client privilege, work product doctrine) that might otherwise apply in all communications.
4. Be prepared in advance for such questions; depositions often provide fertile ground for delving into an expert’s communications with an attorney.
5. Know that any pre-engagement communications may also be discoverable. Because of this, engagement letters should convey the facts of a case without any “spin.” Indeed, both the expert’s and the attorney’s engagement letter should remain as neutral as possible.
6. Make sure attorneys understand that they should never provide documents or information that they would not want the opposing party to see during discovery.
7. Take care not to make handwritten notations on any hard copy drafts or send notes by email; draft reports can be discovery minefields. In addition, discussions regarding the drafts should not be written.
8. Understand that all expert communications are subject to discovery. This is particularly important in cases where multiple experts will be

working on a single report. Again, key is to avoid written communications whenever possible.

9. Alert attorneys of your prior publications and be prepared to handle aggressive questions at deposition and trial. Expert disclosures often require a list of prior publications and opposing counsel can use these materials to impeach the expert.
10. Discuss compliance to all the aforementioned provisions, especially given the recent amendments to the Federal Rules of Civil Procedure, regarding preservation of electronically stored evidence.

Does Buy-Sell Contract Trump Statutory Shareholder Remedies?

Kortum v. Johnson, 2008 WL 3931544 (N.D.) (Aug. 28, 2008)

When a closely held, private professional practice terminates the employment of a minority shareholder, there is often a clash between the “at will” doctrine of employment law and the broad equitable remedies offered by a state’s shareholder oppression statutes. Another key issue: Can a buy-sell agreement preempt the conflict by limiting the minority shareholder’s rights upon termination to a nominal sum?

In setting up their medical clinic, five physicians each contributed \$25,000 and received 5,000 shares in return; they later contributed another \$50,000 apiece to cover expenses, after which they shared equally in profits, lab fees and overhead contributions. Per the terms of the operating agreement, if shareholders “voluntarily or involuntarily” terminate their employment, “for any reason whatsoever,” they are to sell their shares under the terms of the paragraph in the operating agreement setting the purchase price. Under this paragraph, two different purchase prices are stipulated: \$0.04 per share, and \$1.00 for \$25,000. Additionally, Schedule A of the operating agreement states that “the shareholders have set the price of each share to be sold under this agreement, subject to the adjustments provided in this agreement as follows: . . . One share of common stock is valued at \$0.04, upon the retirement, disability, or other lifetime transfer of a share of stock.” The shareholders also agreed to review the stock price at the annual meetings, and if unable to agree, then the sale of any share would be at book value. No change in stock price was ever effectuated.

After three years in operation, the clinic terminated one of the doctor/shareholders, and offered her \$1.00 in return for her stock. She refused, and sued the shareholders for breach of fiduciary duty and for the

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Should ‘Highest and Best Use’ Govern Fair Value Standard in Dissenting Shareholder Case?

Holiday Medical Center, Inc. v. Weisman, 2008 WL 2677504 (N.J.) (July 10, 2008) (unpublished)

The board of directors of a New Jersey nursing home wanted to sell the facility, its land, and other assets to a private, non-profit school for \$8 million. The nursing home would net about \$2 million from the sale, after paying off an existing mortgage of \$3,075,464 and other miscellaneous items—including a \$3 million donation to the non-profit buyer.

Liquidation value versus going concern. After the sale went through, a 5% minority shareholder dissented and sought a judicial appraisal of her shares. The judge appointed an independent appraiser, who found that the nursing home was “marginally financially feasible.” Its value as a going concern was only \$5,540,000 compared to a liquidation value of \$7 million, which lay primarily in the real property assets. Neither the shareholder nor the board of directors disputed the appraisal, its alternate valuations, or its methodologies.

The shareholder tried to enjoin distribution of the sale proceeds, but by then the board had already distributed 80% to the remaining shareholders. The court ordered the board to pay the dissenting shareholder 80% of her share as well, or \$80,000. But the shareholder still claimed she was owed over \$116,000 based on her share of the appraised liquidation value (\$7 million) minus the outstanding mortgage but not including any charitable donation to the buyer, for which she never received any benefit (in terms of a charitable deduction). In other words, she claimed that statutory fair value should be based on a ‘highest and best use’ analysis.

The board objected, claiming that the going concern appraisal (\$5,540,000) represented the fair value of the nursing facility; and that its \$80,000 reimbursement constituted fair value of the shareholder’s interest.

Asset approach violates fair value standard? The trial court agreed with the board, rejecting the “highest and best use” standard as controlling in a fair value accounting. When the board completed the sale, it stripped the dissenting shareholder of her ongoing interest in the nursing home, the court explained. The independently appraised values established a range of value for the facility, anywhere from the best case (\$7 million liquidation value) to worst case (\$5,540,000 going concern). Accordingly, given both parties’ acceptance of the appraisal, the shareholder’s interest ranged from \$40,000 to \$80,000.

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statutory fair value of her stock. The shareholders asked the court to enforce the buy-sell provisions. The trial court found that, according to the operating agreement, the doctor was an “at will” employee and had bargained away any rights to shareholder oppression remedies. It dismissed her complaint and ordered the corporation to pay her \$1.00.

On appeal, the doctor argued that she was unfairly deprived of her entire investment in the practice, her continued earnings and employment, and her patient base and accounts receivable. She claimed entitlement to her pro-rata share of the medical corporation as a going concern. The shareholders reasserted their prior arguments, that she agreed to the repurchase of her shares at the contract terms and could acquire no greater rights simply by virtue of her minority shareholder status.

The appellate court agreed that the doctor was an at-will employee, adding that “within many closely held enterprises, it is not as easy to separate out the employment relationship from the ownership relationship.” In these cases, the inquiry is whether the minority shareholder had a reasonable expectation of continued employment. Accordingly, the corporation’s shareholders owed the doctor a fiduciary duty as a shareholder and a shareholder/employee. The trial court, in concluding the opposite, had relied on cases in which employees acquired nominal ownership as part of their compensation. In this case, the doctor helped form and capitalize the corporation; she made the same contributions and received the same shares as the other members. The buy-sell agreement did not relieve the shareholders of their statutory duties, and the trial court should have determined whether their conduct toward the owner/employee was unfairly prejudicial.

The court remanded the case for findings as to whether the doctor had reasonable expectations of continued employment. Signing such a restrictive buy-sell agreement could be some evidence that she did not. Still, other factors (such as whether a shareholder’s salary constituted de facto dividends and whether procuring employment was a significant reason for investing in the business) could support an alternate finding. If the shareholders acted unfairly, then she would be entitled to relief under the shareholder oppression statutes and the trial court would have broad discretion to fashion an equitable remedy. If the court found no unfair prejudice, then the buy-sell price of \$0.04 per-share, as listed in the text of the relevant section of the operating agreement and again as the per share price in Schedule A of the operating agreement, would apply, or \$200 for a total ownership of 5,000 shares.

The trial court was also satisfied that the arm's-length sale of the nursing home established fair value for all shareholders, dissenting or not. But the shareholder appealed the decision, arguing that "as a matter of law" the fair value statute requires the "highest and best value" standard.

The New Jersey Superior Court, in an unpublished decision, rejected this contention. Under local as well as Delaware law, a corporation's going concern value is acceptable to determine the fair value of a dissenting shareholder's interest. In this case, the trial court did not adopt the going concern value but merely used it to corroborate the sales price, which—after deductions, including the charitable donation—resulted in a corporate value of \$2 million.

However, the appellate court remanded the case for the lower court to provide its basis for accepting the sale transaction price, which included the charitable donation, over the going concern value—which did not. It should also clarify whether the shareholder could benefit from the charitable donation and how this would factor into the court's overall findings of fair value.

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