

2004 Edition, Volume 1

## COURT CASE UPDATES

This edition of our newsletter contains five cases of importance in the business valuation community. The first three cases involve shareholder appraisal actions. The other two cases involve lost profits and divorce. This edition reviews these cases. The actual court case links are listed below.

### SHAREHOLDER APPRAISAL ACTIONS

Michael F. Taylor v. American Specialty Retailing Group, Inc. No. 19239 (Del. Chan. July 25, 2003)

The Delaware Court of Chancery considered the fair value of a minority interest in a retail sporting goods chain. Both parties presented expert valuation testimony regarding the fair value of the stock. Both experts utilized the same three methods: the discounted cash flow ("DCF"), comparable/guideline companies, and transaction method.

The court selected parts of each experts' opinion in arriving at its conclusion. In analyzing the DCF, it rejected a low projected growth rate used by the company's expert because it was significantly below projections that the company gave a bank. It also rejected this expert's projected profit margin because it went in the opposite direction of the company's projections. It rejected the discount rate selected by the plaintiff's expert because the risk premium was based on considering companies of dissimilar size.

In the guideline company approach, the court rejected the company's expert's selection of valuation multiples. This expert drastically reduced the multiple, which "demonstrated that he believes the guideline companies are not truly comparable."

The court's conclusion was based on recalculating the experts' values adjusting for the determined deficiencies.

In Re Cysive, Inc. Shareholders Litigation, No. 20341  
(Del. Chan. August 15, 2003)

The Delaware Court of Chancery considered the weight given to management projections in deciding the entire fairness of a going private transaction.

Cysive was a technology consulting company listed on the NASDAQ. Following the burst of the tech bubble, its revenue dropped significantly causing it to shift to software development. It developed one product and projected significant sales for this product. These sales never materialized and the company began to run out of money. It engaged an investment banker to find a strategic buyer. It was unable to locate one.

Cysive's founder offered to take the company private while continuing to look for a buyer. In connection with the going private transaction, it engaged a business appraiser to determine the company's liquidation value. The board and the founder eventually agreed to a sale of the company at \$3.26 per share. This was \$0.06 over the liquidation value and \$0.37 over the trading price of the stock.

Shareholders challenged the fairness of the transaction. They said the value was too low because the appraiser assigned no value to the software despite management's projected sales of the software. The court rejected this claim.

It found the projections were unreliable because the company never sold a single copy of its software. The commercial value and viability of the software was "intrinsically uncertain."

In Re JCC Holding Co., Inc. Shareholders Litigation, No. 19796 (Del. Chan. September 25, 2003)

The court considered whether the company, in its proxy statement, fairly disclosed the fairness opinion obtained from its investment banker in connection with a merger. The proxy statement disclosed that JCC was valued using a comparable company approach. It also noted that while a discounted cash flow method is commonly utilized, one could not be performed here because JCC had no reliable long-term projections (it had two bankruptcy reorganizations in the years leading up to the merger.)

Minority shareholders challenged the fairness of the merger, arguing that: (1) the proxy did not make a fair disclosure because it should have included analyses (e.g., discounted cash flow valuation) not performed by the investment banker; and (2) the analyses that were performed were performed incorrectly.

The court rejected these arguments. Under the first claim, it stated "Under Delaware law, there is no obligation on the part of a board to disclose information that simply does not exist..." With the second claim, the court stated that the board's duty was "simply to make fair disclosure of the material facts in its possession bearing on the fairness of the merger it was putting before the stockholders." It set forth a fair summary of the valuation work. Hence, it met its obligation.

## LOST PROFITS

Reading Radio, Inc. v. Molly S. Fink, et al., 2003 PA Super 353 (September 19, 2003)

The Superior Court of Pennsylvania considered several issues related to the admissibility of expert testimony. Reading Radio employed Molly Fink and another defendant (Ulrich) as sales representatives at its radio station, WAGO. They were subject to non-compete agreements. Reading Radio's station manager, Kline, was hired by a competing station. Kline solicited Fink and Ulrich to take employment with his new station, and failed to enforce Fink and Ulrich's non-compete agreements. Reading Radio then brought suit against Kline and the others for breach of fiduciary duty (among other charges) for the corporate raid. Reading Radio sought damages amounting to its loss in value.

Reading Radio submitted a radio media business broker as an expert to testify to its damages. Fink contested the admission of the expert because he was not a credentialed appraiser, was a good friend of the station's owner, and because he considered a joint sale of WAGO and its sister station. The trial court rejected Fink's arguments and admitted the testimony. The expert concluded a diminution in value of \$1.6 million as a result of the breach. The jury awarded only \$300,000.

On appeal, Fink renewed her arguments for excluding the expert. The Superior Court found the expert had the required skill and expertise to provide an opinion. It also found that any bias arising from their friendship went to the credibility of the expert rather than the admissibility of the expert. Finally, it found that the expert did determine a separate value of WAGO before and after the breach. Thus, it rejected the claim.

## DIVORCE

Jessie Anzalone v. James Anzalone (2003 PA Super 407)

The Superior Court of Pennsylvania reversed a Luzerne County Master's decision regarding the application of a capital gains tax to the appreciation in the stock of a closely-held business. The Master reduced value by applying a 20 percent capital gains tax to the appreciation of stock held by wife during the marriage.

On appeal, the Master's decision regarding the application of capital gains tax was reversed. The Court relied on *Hovis v. Hovis* (541 A.2d 1378 (PA. 1988)) and stated the following: "In order to insure a fair and just determination and settlement of property rights we favor predictability over the mere surmise in the valuation and distribution of marital property after divorce. Accordingly, we hold that potential tax liability may be considered only where a taxable event has occurred as a result of the divorce or equitable distribution of property or is certain to occur within a time frame such that the tax liability can be reasonably predicted".

## IRS DATA ON GIFT & ESTATE TAX RETURNS

Statistics from the IRS Data Book for Fiscal Year 2002 (the "Data Book") indicate that gift tax returns receive relatively less scrutiny by the IRS than estate tax returns. Also, the estate tax returns for larger

estates are the most scrutinized of all estate and gift tax returns. In fiscal year 2002, the Internal Revenue Service (the "IRS" or the "Service") reported receiving 122,412 estate tax returns and 303,800 gift tax returns. The Service recommended additional tax on a relatively high percentage of returns examined. However, it appears as though a small number of estate and gift tax returns were examined to determine additional tax due.

#### IRS Data

#### Fiscal Year 2002 Estate and Gift Tax Returns

#### Type of Return

#### Returns Filed

#### Returns Covered

#### % Covered

#### % Examined w/o Change

#### Rec. Add. Tax

#### Gift Tax

303,800

1,899

0.63%

20%

\$405.047m

#### Estate Tax

122,412

7,151

5.84%

15%

\$1.43b

#### Estate Size:

#### Under \$1m

56,704

1,241

2.19%

18%

\$33.863m

#### \$1m to \$5m

59,970

4,365

7.28%

15%

\$422.097m

\$5m and over

5,738

1,545

26.93%

14%

\$976.13m

For the 303,800 gift tax returns filed with the IRS in fiscal year 2002 (may include some returns actually filed in calendar year 2001), the Data Book reports that 1,899 returns received an examination. Those examined represent less than 1 percent (only 0.63 percent) of the total number of estate tax returns the IRS reports as filed. The Data Book figures show that 20 percent of the 1,899 gift tax returns examined were not changed. It was unspecified whether the 80 percent of the returns changed by the IRS all received a recommendation for additional tax. It did state that the amount of additional tax recommended for examined gift tax returns totaled \$405.047 million.

The IRS data seems to indicate that estate tax returns had a greater probability of examination than gift tax returns. Compared to the statistics for gift returns where 0.63 percent or 1,899 of 303,800 returns were examined, for estate tax returns 5.84 percent, or 7,151 of 122,412 returns were examined. The data would seem to indicate that the size of the estate increases the probability of an examination and (perhaps) a recommendation for additional tax.

Of the 122,412 estate tax returns filed, 56,704, or 46.3 percent, were for estates with a gross value under \$1 million. For this size estate tax return, only 2.19 percent or 1,241 were examined for additional tax. Of those, 18 percent were not changed or did not receive an additional tax recommendation. For the 82 percent changed, there was \$33.863 million of additional tax recommended by the Service.

The largest group of estate tax returns filed was for estates with gross values of between \$1 million and \$5.0 million. Of the 59,970 recorded by the IRS in fiscal 2002, 4,365, or 7.28 percent, were examined. The Data Book reports that 15 percent were examined without change. For those that were changed, total additional tax of \$422.097 million was recommended. For those that were changed, total additional tax of \$422.097 million was recommended.

The smallest number of estate tax returns filed was for the largest estates, with gross values of \$5.0 million or more. Not surprisingly, this group received the most attention, with 26.93 percent, or 1,545 of 5,738 being examined. Of those examined, 14 percent were not changed. A total additional tax of \$976.13 million was recommended for the returns changed.

## INTELLECTUAL PROPERTY GIFTS

Its not uncommon for large corporations to donate patents and other intellectual properties to charity (largely to universities). These gifts, however, are receiving increased scrutiny by the IRS.

The Service has been hiring outside experts to review the intellectual property for its uniqueness, limitations, and impairment, and to value the property. IRS Commissioner Mark Everson said, "We're seeing an increasing number of donations that don't pass the smell test. Donations that are overly inflated or made with strings attached are going to receive increased scrutiny." Taxpayers claiming improper deductions might be subject to penalties.

Any gift of intellectual property should be substantiated with an analysis of the assessment of the property attributes and of the value. Please contact us if these issues should arise.

## COURT CASE LINKS

Michael F. Taylor v. American Specialty Retailing Group, Inc. No. 19239 (Del. Chan. July 25, 2003)  
<http://www.corporate-law.widener.edu/documents/opinions/19239-047.pdf>

In Re Cysive, Inc. Shareholders Litigation, No. 20341 (Del. Chan. August 15, 2003)  
<http://www.corporate-law.widener.edu/documents/opinions/20341-092.pdf>

In Re JCC Holding Co., Inc. Shareholders Litigation, No. 19796 (Del. Chan. September 25, 2003)  
<http://www.corporate-law.widener.edu/documents/opinions/19796-055.pdf>

Reading Radio, Inc. v. Molly S. Fink, et al., 2003 PA Super 353 (September 19, 2003)  
[http://www.courts.state.pa.us/OpPosting/Superior/out/a15038\\_03.pdf](http://www.courts.state.pa.us/OpPosting/Superior/out/a15038_03.pdf)

Jessie Anzalone v. James Anzalone (2003 PA Super 407)  
[http://www.courts.state.pa.us/OpPosting/Superior/out/s46022\\_03.pdf](http://www.courts.state.pa.us/OpPosting/Superior/out/s46022_03.pdf)

The above court cases require the use of the Adobe Acrobat Reader®. If you do not already have it, you can get this free software by clicking the following link:

<http://www.adobe.com/products/acrobat/readstep.html>

Court-case links are active at the time of print. If a link becomes inactive or you would like to have a hard copy of the actual case, please e-mail us with you request at [courtcaseupdates@valuemanagementinc.com](mailto:courtcaseupdates@valuemanagementinc.com)

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