

Litigation Related to Fair Value Accounting is On the Rise

Ever since the Financial Accounting Standards Board issued its Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157) in 2006, analysts, attorneys, auditors, and accountants have debated its merits and measurements. In the current economic downturn, critics blame fair value accounting for requiring write-downs that exaggerate and/or exacerbate asset value declines. By contrast, proponents contend that fair value accounting is the most transparent method of recording asset values and that to blunt its principle based requirements would simply prolong the problem.

Whatever the merits of either position, it is clear that FAS 157 and fair value accounting are having a substantial impact on banking and businesses, investors and industry trends, including accounting-related litigation and securities class actions. While the full consequences will not materialize for a few years, three important trends are already apparent:

1. Securities claims are rising. Prior to the promulgation of FAS 157, securities class actions appeared to be declining. Possible reasons included Sarbanes-Oxley reform and the general improvements made by the auditing and accounting professions. The relative absence of stock price volatility was also an important factor.

Beginning with the dramatic market downturn in December 2008, stock price volatility has once again surged, in part following the decreases in asset values brought about by fair value accounting. Shareholders and investors now have more information to assert that stock prices have declined because of prior misrepresentations of value to the market, and more incentive to bring these claims because the decline in stock price is a direct element of potential damages.

Such litigation is already on the rise. For example, 210 federal securities class actions were filed in 2008, representing a 19% increase from 2007 and a 9% increase over the average of filings during the ten years from 1997-2007. (Data from the *Securities Class Action Filings—2008: A Year in Review*, by Stanford

Law School Securities Class Action Clearinghouse and Cornerstone Research.) A substantial number of the current cases make fair value claims against financial institutions.

2. A focus on judgment. Fair value litigation will likely focus on the judgments that financial statement preparers, auditors, and others make in relation to FAS 157's fair value requirements. Litigants will aggressively second guess these judgments, alleging that the defendants' valuation models failed to account for deteriorating asset values, or failed to write down assets in a timely manner or with adequate disclosures. The recent U.S. Supreme Court decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (2007) has ensured that the focus on judgment will take place in the earliest phases of litigation.

That case holds that prior to discovery, a court must weigh the allegations in a securities lawsuit, and only when the suggestions of fraud are at least as strong as its absence may the case proceed. In fair value litigation, *Tellabs* compels courts to review the claims concerning accounting judgments, the inputs, disclosures, internal review systems, etc., and decide up front whether they suggest fraud or good faith. If the case proceeds, the focus on subjective accounting judgments will continue throughout.

Continued on next page...

IN THIS ISSUE

Litigation Related to Fair Value Accounting is On the Rise.....page 1

Expert's Conservative Assumptions Help Sustain Damages Award.....page 2

Tax Court Decision on Discounts and Embedded Taxes Hinges on Experts.....page 2

3. Litigation may inspire reforms. Even though fair value accounting is judgment driven, its measurements seek to give investors more timely and transparent information. At the same time, any increase in fair value litigation will subject corporate systems to increased costs, to the detriment of shareholder/investor values. Although more attention to the subjective accounting judgments is not necessarily a negative development, the resulting rise in litigation will continue to inspire the debate on fair value accounting and its potential for additional reform.

Expert's Conservative Assumptions Help Sustain Damages Award

Russo v. Ballard Medical Products, 2008 WL 5247934 (C.A. 10(Utah))(Dec. 18, 2008)

A medical inventor created a tracheal catheter that more than tripled the useful life of a prior design and marketed his innovation to Ballard Medical Products, the world's largest manufacturer of closed tracheal systems, under a two-year confidentiality agreement. Ballard agreed to pay a 3% royalty rate for licensing the new design, but it rejected the inventor's request for a guaranteed minimum annual payment of \$50,000 and broke off their negotiations.

The inventor asked Ballard to return his prototype and materials. The company was "unable to locate" them, but then used the inventor's work to secure two patents and develop a catheter that contained his essential design innovations. Ballard began selling the new, improved catheter in 2001. The inventor sued for breach of the confidentiality agreement and unjust enrichment.

At trial, the inventor claimed that the only material differences between the company's old and new catheters stemmed entirely from his innovations and exploitation of his trade secrets. Thus, he was entitled to the entire present value of the company's expected net profits from the new device over the 17-year life of the patents, which his financial expert estimated at \$32.3 million.

In addition, applying a 3% royalty rate and \$50,000 minimum annual payment, the expert projected the inventor's royalties to reach \$2.75 million (present value) over the life of the patents. This estimate was "conservative," according to the expert, because he used a 5% annual growth rate when the company achieved 42% growth from 2001 to 2005 and 17% growth in 2004-2005. Moreover, the expert calculated royalties only through the life of the patents, even though he testified that similar medical products have a "very long life." Lastly, the expert told the jury that any changes to his assumptions could yield damages

substantially greater than \$3 million. The jury found the company liable, and awarded the inventor \$17 million for unjust enrichment and \$3 million for breach of contract, for a total of \$20 million. The company appealed.

The truth lay between extremes. At trial, the company had argued that the inventor's contribution added little value to its independent creation and marketing of the new device, but the inventor claimed that the new device was entirely dependent on his trade secrets. "As is often the case, the jury found the truth to lie somewhere between the extremes," the appellate court said. The \$20 million damages award represented only 53% of the inventor's original request; in addition, the expert's use of conservative growth rates was another indication that the jury's assessment fell within the range of the evidence.

The company urged the court to limit damages to the two-year span of the parties' confidentiality agreement. After all, the inventor could have patented and licensed his device to a different company, it said. However, this argument was "a strain," the court noted. The parties' agreement did not limit damages, and further, the inventor presumed it would protect his ideas, enough that he did not market them elsewhere. Based on these facts, the jury could conclude that he "had a valid reason for waiting to patent his idea." Moreover, by reducing his original damages request, the jury must have accounted for some of the company's arguments—e.g., that at most, the trade secrets merely lent it a "head start" on its own achievements.

The company also argued that the court should limit the inventor's damages to a reasonable royalty, because unjust enrichment damages are appropriate only when the defendant usurps a trade secret to compete with a plaintiff. However, one of the functions of trade secret law is deterrence, the court said. The company must assume the risk for its wrongful acts, including paying the inventor a greater amount than it would have under a lawful licensing arrangement, and the court confirmed the entire \$20 million damages award.

Tax Court Decision on Discounts and Embedded Taxes Hinges on Experts

Estate of Litchfield v. Comm'r, 2009 WL 211421 (U.S. Tax Court)(Jan. 29, 2009)

The \$26.4 million Litchfield estate consisted primarily of minority stock interests in two family owned companies, Litchfield Realty Co. (LRC) and

Litchfield Securities Co. (LSC). The Internal Revenue Service (IRS) and the estate agreed on the net asset values (NAV) of the estate's interests. However, they aggressively disputed the discounts related to built-in capital gains taxes, lack of control, and lack of marketability.

Built-in capital gains tax would consume majority of NAV. When Marjorie Litchfield died in 2001, her estate owned a 43.1% interest in LRC, which held primarily Iowa farmland and marketable securities. LRC earned a marginal profit, but the company was not performing up to management expectations or the performance of Midwestern farmland generally. Historically, the company had sold portions of its farm holdings to raise cash.

To increase profitability and shareholder returns, LRC converted from a C corporation to an S corporation in January 2000. However, for the 10 years following conversion, if the company sold any of its former C Corp assets then it would incur corporate-level tax on the sale (per IRC Sec. 1374). As of the valuation date, LRC's total NAV of \$33.2 million included \$28.8 million in built-in capital gains tax liability—or 86.7% of NAV. Just over \$19.8 million of the built-in capital gains taxes related to its farm holdings and \$9.0 million to its marketable securities.

To prepare the estate's tax return in connection with its 43.1% interest in LRC, its expert appraised its share at a fair market value of \$6.5 million—after application of discounts for built-in capital gains taxes (17.4%), lack of control (14.8%), and lack of marketability (36%). On audit, the IRS valued the same interest at just over \$10 million, applying only a 2% discount for embedded taxes, 10% for lack of control, and 18% for lack of marketability. It assessed a deficiency of approximately \$3.8 million.

The estate's 23% interest in LSC, a C corporation that held primarily "blue chip" marketable securities and partnership investments, had a NAV of \$52.824 million. Like LRC, none of the LSC stock had ever been publicly traded and it was subject to substantial restrictions. Its investment strategy focused on continuing to maximize cash dividends to shareholders. In fact, in the late 1990s, the directors became concerned that elderly shareholders in both LRC and LSC would not have adequate reserves to pay for estate taxes and other obligations, and after the death of Mrs. Litchfield, they sold some assets in both entities to raise stock redemptions.

As of the valuation date, LSC's NAV included nearly

\$39 million in built-in capital gains, or 73.8% of its total NAV. *Note:* The capital gains tax applicable to both companies ranged from 35.5% to 39.1%. The estate's expert discounted its 23% LSC interest by capital gains tax as well as lack of marketability and control, but on audit, the IRS determined a deficiency of over \$3.0 million.

The Tax Court considered each of the experts' discounts in turn

1. Built-in capital gains taxes. The estate's expert reviewed historic asset sales for both entities along with board meetings and management plans for future sales. He estimated a 5-year holding period for LRC and 8 years for LSC to reach discounts of 17.4% and 23.6%, respectively. By contrast, the IRS expert used turnover rates based solely on historical asset sales, projecting a holding period of 53 years for LRC and 29 years for LSC to derive his discounts of 2% and 8%, respectively.

Given the "highly appreciating non-operating investment assets" that both companies held, the Tax Court considered it likely that a hypothetical buyer and seller would negotiate "substantial" discounts for the embedded tax liability. Further, the estate's expert based his asset turnover on more accurate data, in particular his conversations with management and review of current sales. By contrast, the IRS expert looked only at historic data and did not account for appreciation. The court adopted the estate's discounts for built-in capital gains tax, without adjustment.

2. Lack of control. To determine the discount for lack of control (DLOC) for LRC securities and farm holdings, the estate's expert reviewed data from closed-end funds as well as real estate investment trusts and limited partnerships. He then reviewed entity-specific factors, weighted for the combine asset classes, to calculate a 14.8% DLOC. He performed a similar exercise using closed-end funds to calculate an 11.9% DLOC for the estates interest in LSC.

The IRS expert claimed that because LRC's assets were performing well, a buyer would not expect a large DLOC. Without breaking down his analysis by asset class, he reviewed closed end funds, trimming the average, to calculate a 5% DLOC for LSC's marketable securities. For its farm holdings, the IRS expert reviewed a variety of public sales data to posit a range of 17% to 20% DLOC.

Because discounts for public takeovers are generally higher than those for "normal" sales activity, he said,

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LRC's farming assets merited a lower DLOC of 15%. Even though the farmland comprised the bulk of the firm's NAV, he averaged the two findings (5% and 15%) to conclude an overall DLOC for the estate's interest in LRC of 10%.

For LSC, the IRS expert used the "trimmed mean" from the closed-end funds. Because the estate's 22.96% interest was the single largest block of stock, its returns were good, and a purchaser would not want to change operations, a hypothetical buyer "would place no value on control," he believed, and a "nominal" DLOC of 5% was appropriate for LSC.

The court noted that both experts calculated similar DLOCs for LRC's farming assets (15.7% vs. 15%); and both used lower-than-average discounts for its securities. But only the taxpayer's expert used a weighted (instead of a straight) average to account for LRC's more significant holdings of farm property, and the court adopted his 14.8% DLOC. Similarly, the IRS expert failed to account for the taxpayer's smaller holdings in LSC, and the court adopted the 11.9% DLOC by the estate's expert.

3. Marketability discount. The estate's expert used data from restricted stock studies as well as weighted values for entity-specific factors to calculate a discount for lack of marketability (DLOM) for LRC of 36%. He used the same restricted stock studies

for the LSC interest, and after accounting for entity-specific factors and different asset classes, he applied a 29.7% DLOM.

The IRS expert looked at restricted stock studies, including three from the 1990s that the estate's expert did not consider, and private placement studies. He then adjusted for entity-specific factors, such as LRC's dividend-paying policy, the estate's sizeable interest, and stock transfer restrictions, to apply an 18% DLOM. He reviewed the same studies with reference to LSC, and because its assets were more readily ascertainable and saleable, its earning history was consistent and its management competent, he assigned it a lower than average discount of 10%.

This time, the court believed the estate's expert's DLOMs were too high, particularly when combined with his discounts for lack of control. In addition, some of his restricted stock data was aged, and, more notably, the estate's expert had determined "significantly lower" discounts for the same entities in connection with an earlier gift tax return. As a result, and without further discussion, the court concluded DLOM for the estate's respective interests in LRC and LSC of 25% and 20%. Overall, the court found that the fair market value of the estate's 43.1% interest in LRC was \$7.546 million, and its 22.96% interest in LSC was worth \$6.530 million.

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