

Divorce Court: Round-Up

The recent divorce court decisions in some states suggest a trend of “common sense reality checks” on valuations.

Financial disclosure for ante-nuptial must be fair and reasonable. In *Stemler v. Stemler*, 2009 WL 1887435 (Ala. Civ. App.) (July 2, 2009), the court held that a financially naïve wife could not be reasonably considered to have “known” the value of her older, far wealthier, husband-to-be’s assets, though they had been living together and she had “observed his lifestyle.” Without a list of appraised values, she lacked the sophistication to make that assessment herself. The ante-nuptial (which limited her property claims to joint property only and her support to \$50,000) was invalidated for the husband’s failure to disclose his financial assets.

Buy-sell agreement value is binding, but valuation must be well founded. Another example of a court working to marry reasonable reality with valuations can be found in *Inzer v. Inzer, Inc*, 2009 WL 2263818 (Tenn. Ct. App.) (July 28, 2009). In this case, a couple invests in a Sonic Drive-In, but it is the husband who becomes the “working manager-member” and 24% owner of the franchise. However, at the time of purchase, the wife signs an acknowledgement of the buy-sell provision in the Operating Agreement, which set out a specific method of calculating the redemption price for the 24% share in the franchise.

Flash forward to their divorce, seven years later, and the husband’s expert comes up with a value of \$33,102, based on the buy-sell agreement, arguing that the value should be based on net book value without any consideration of goodwill or discounts. The wife’s expert valued the same interest without regard to the buy-sell agreement at \$509,000. At trial, the court found that the husband’s expert valuation defied common sense, given the husband’s annual earnings of over \$150,000. The court also found that the buy-sell provision did not affect value and that a marketability discount did not apply, coming to a (seemingly random) value of \$207,456.

On appeal, the court reluctantly found that the buy-

sell agreement bound the determination of value, but rejected the husband’s expert valuation. The case was remanded for findings of value that specifically followed the terms of the buy-sell.

Discounting minority interests. Here again, a husband’s actual earnings and assets are re-scrutinized by an appellate court concerned with the most “objective” result. In *In re: Marriage of Williams*, 2009 WL 2597950 (Mont.) (Aug. 25, 2009), father and son owned equal shares in a trucking business and a real estate holding company. The son’s actual annual income prior to the divorce had been between \$200,000 and \$300,000, but the court reduced it to \$100,000, on the theory that the son could not force the S Corp to pay out to him. The court then valued the real estate company at \$3.36 million, 50% of which was the son’s; but that amount was further reduced by 50%, because it was a non-controlling interest. The son had apparently bought a condo out of company funds and his father had taken away the company checkbook, and with it some of the son’s decision making powers.

The wife appealed both the discounted income figure and the discounted business value. The Montana Supreme Court held that “whether a discount is proper depends on the facts of the case, not the method used to ascertain the underlying value of the

Continued on next page...

IN THIS ISSUE

Divorce Court: Round-Up.....	page 1
Experts in Court: Round-Up.....	page 2
Another Taxpayer Win: Court Accepts 47.5% Discount for Formed (but not Funded) FLP....	page 3
Top Five Must-Haves for Tax Valuation Reports.....	page 3
VMI Highlights.....	page 4

stock.” The court found that in fact the son had say over the company’s finances and operations, and, as evidence of this, he used company funds for personal purposes often.

Furthermore, the son’s lack of control with respect to the payouts to himself was susceptible to substantial manipulation, and the trial court’s decision increased the potential and incentive for such manipulation. The case was remanded for an “objective determination of child support based on the husband’s actual tax returns, the company’s financial statements, and other relevant information.” Discounts were found to be improper, and the entire value of the husband’s marital interest in the real estate company was subject to apportionment.

Splitting the difference is not a decision. Though parties may not like the decision a court reaches, something is better than nothing. In *Brown v. Brown*, 2009 WL 1278430 (Ohio App. 12 Dist.) (May 11, 2009), more than six years after this couple filed for divorce, their case was remanded to trial. At issue was the valuation of the husband’s OB/GYN practice, where the wife had worked part-time to help with accounting. At trial, only the wife presented expert testimony from a CPA with experience appraising businesses and medical practices. He analyzed five years of accounts receivable, concluding that the practice was worth nearly \$98,000. The husband testified that the receivables were only 10% collectible, however, essentially placing a value on his practice of just under \$9,800. Neither party presented testimony on the practice’s goodwill.

Thirty months after trial, the magistrate issued final orders, valuing the medical practice at \$40,000. The magistrate did not provide any findings to support what essentially amounted to splitting the difference between the parties’ evidence. On appeal, the court found that the magistrate’s determination was not detailed enough to permit review. In remanding the matter, the court directed that the trial court provide an evidentiary basis for its valuation of the medical practice and debt.

Experts in Court: Round-Up

In many cases, the need for a valuation expert is obvious and inescapable, which raises a second question: how to choose and use an expert to the best advantage for your legal argument. Recent case law offers some tips in answer to these questions.

It doesn’t pay to skimp. In *Villaje del Rio, Ltd. V. Colina, L.P.*, 2009 WL 1606431 (W.D. Tex.) (June 8, 2009), the developer/plaintiff tried to cut costs by designating himself an expert to testify in regards to the value of his own real estate project, and supplemented his own with two experts’ testimony, based on appraisals they prepared in connection with the project’s financing, two years prior to the

insolvency at issue. The court struck the appraisal experts for their failure to consider the relevant facts and data of the actual insolvency, and the plaintiff as well, saying, “lay testimony results from a process of reasoning familiar in everyday life, while expert testimony results from a process of reasoning which can be mastered only by specialists in the field.”

A cost efficient compromise. Although a plaintiff often has no choice but to present an expert, the defendant may have other options. In *Sossikian v. Ennis*, 2009 WL 2106106 (Cal. App. 1 Dist.) (July 16, 2009) (unpublished), the defendant found an ideal solution, by using an expert for rebuttal purposes only to discredit the damages evidence offered by the plaintiff’s expert. This choice left the jury with no basis for a damages award and they awarded \$42,182 on the plaintiff’s \$800,000 claim.

Who is qualified? When you make the decision to incur the cost of an expert, you want to make sure it’s the right one. In *MDG Internat’l v. Australian Gold, Inc.*, 2009 WL 1916728 (S.D. Ind.) (June 29, 2009), an otherwise “supremely qualified” expert failed to satisfy the requirements of the Federal Rules of Evidence and Daubert. The expert, a professor of accounting and chair of an accredited MBA program deeply experienced in valuing public companies, was engaged to value a private company. The court concluded that he lacked the requisite “knowledge, skill, experience, training, or education” to testify regarding the value of the closely held business at issue, and went on to find that the expert’s opinions and methodologies were riddled with deficiencies. “Expert” is not broadly defined. It is critical to engage someone experienced in the particular issue of the case.

Of course, there are always outlier situations. *Chick-Fil-A v. CFT Development, LLC*, 2009 WL 1754058 (M.D. Fla.) (June 18, 2009) is one such case. At issue was whether Panda Express (the defendant), which was proposed to be built next to a Chick-Fil-A, would derive 25% or more of its gross sales from the sale of chicken (and thus be enjoined from opening under a restrictive covenant on the property). The plaintiff’s and defendant’s experts proposed alternative methods of calculating the 25%, and both parties filed Daubert motions, claiming the other’s expert was unreliable or irrelevant. In the absence of any precedents (legal or accounting) on how to calculate the percentage of sales from chicken (for example, does it include non-chicken ingredients in a chicken dish?), the court permitted both experts to testify, saying that “the certainty and correctness will be tested through cross-examination and presentation of contrary evidence.”

Watch your expert’s language. You’ve hired an expert. They’ve passed the hurdle of court acceptance. They give their opinion. It goes without saying (or does it?) that that opinion needs to be powerful, well

presented, and not based on speculation. In *Lucent Technologies, Inc. v. Gateway, Inc.*, 2009 WL 2902044 (C.A. Fed.) (Sept. 11, 2009), the plaintiff's expert's patent damages calculation, which resulted in a jury award of \$358 million, was thrown out (and the jury award reversed), based largely on the expert's testimony that to calculate a lump-sum amount (of damages), the parties might start by looking at the running royalty "and then speculating as to the extent of the future use" (emphasis by court). Perhaps it was semantics, (the expert might just as easily have said "estimate"), but the court held that what it dubbed the "lump sum speculation theory" improperly suggested guesswork, not rigorous analysis. The court went on to bolster its decision, finding that the expert's comparables had no probative value, as the technology at issue was unique and difficult to compare meaningfully.

The bottom line: it pays to hire an expert, but be sure it's the right expert doing the best job possible.

Another Taxpayer Win: Court Accepts 47.5% Discount for Formed (but not Funded) FLP

Keller v. United States, 2009 WL 2601611 (S.D.Tex.)

With the aid of longtime financial and legal advisors, a wealthy Texas widow established a family limited partnership (FLP), to be funded with \$250 million in corporate investment bonds. She wanted to protect the family's wealth, so she set up a limited liability company as the .1% general partner (GP), intending to fund it with \$300,000 from her personal accounts. The limited partners (LPs) would consist of two family trusts, each holding a 49.95% interest. Initially, she would own all of the GP, transferring her interests to family members after her death.

The 90 year-old widow gave her advisors "marching orders" to complete the FLP (for instance, her accountant urged her to allocate an additional \$110 million to the FLP, but she rebuffed him). Neither her doctors nor her advisors believed her death was imminent, but just days after signing the papers—and before she could effectively transfer the assets or capitalize the GP interest, the widow died. Her advisors "stood down," believing the failure to fund was fatal to the FLP.

One year later, a Texas federal court decided in *Church v. U.S.*, 2000 WL 206374 (W.D. Tex) to recognize an FLP even though the founder died days before funding. Believing Church breathed new life into their own efforts, the family advisors completed the transfer of the FLP assets on behalf of the deceased widow. Her estate paid taxes on the assets' full value by borrowing \$114 million from the

FLP, which was backed by a promissory note. The estate subsequently filed an amended return using discounted values and claimed a tax refund for the difference.

A bona fide business purpose. At trial, the federal district court (S.D. Tex) found that despite her failure to fund, the widow intended the \$250 million in corporate investment bonds to be partnership property, and the \$300,000 check she'd cut before her death (but had not deposited) was intended to capitalize the GP. As for the loan to pay the estate taxes, the FLP had already reported \$30 million in interest payments (at 5.07% per year). The court found this was "an actual and necessary administrative expense" and allowed the estate to deduct the interest. Thus the FLP became valid under state (Texas) law prior to the widow's death and its assets became partnership property.

Based on the same evidence, the partnership transfers fell squarely within the exceptions of both IRC Sec. 2036(a) and 2038(a) as a "bona fide sale for adequate and full consideration." The clear purpose of the FLP was to consolidate, manage, protect, and pass along the family's wealth. "Any estate tax savings that resulted from these partnerships were...merely incidental," the court observed. Her team of advisors conveyed her intent "with notable consistency" in forming the FLP. Finally, she retained well over \$100 million to support her personal living expenses.

After her death—and in accordance with the partnership agreement—the transfers to the LP trusts became assignee interests, proportionate to their respective contributions and as reflected in their capital accounts. Accordingly, their fair market values would reflect not the decedent's share of all the assets, but the value of the LP interests, including discounts for lack of control and lack of marketability.

Top Five Must-Haves for Tax Valuation Reports

Hiring an expert for a tax valuation? Is the expert you've hired following best practices? At a recent conference, the Honorable David Laro (U.S. Tax Court) joined the other panelists to come up with the following checklist for "best practices" in tax-related valuation reports:

1. Transparency. Valuation reports must be logical, rational, and clear, with transparent analysis by the lead appraiser of the company, the data, the factors supporting the conclusion, and the underlying rationale. If you don't understand a valuation report, chances are the judge won't either, and that makes it hard for the judge to reach a decision that will withstand review on appeal.

2. Credibility. In other words, the report is believable, reliable, experienced, well prepared,

sincere, and performed using peer-reviewed methods. The strengths and weaknesses of the good expert's valuation report should be self-evident, with clearly stated rationale for why areas or methods might have been ignored or omitted, for lack of data or lack of applicability. Though the lawyer's role is advocacy for a position, the role of the expert is the same as that of the judge—to arrive at the truth. Anything else will diminish the credibility of your expert.

3. Intellectual honesty. In case it wasn't clear from the above, your expert's opinion must be free of bias and advocacy, independently arrived at, and transparent. What about sitting at the attorney table? Are you passing notes with your expert during the opposing witnesses' testimony? Your expert may be offering guidance regarding what questions to ask the witness on cross-examination, but the practice can blur the line between independence and advocacy. "When I see that happening in the courtroom I put an end to it," Judge Laro said. The same caution applies when an attorney comments on drafts or otherwise assists in developing an expert's opinion. Allow your expert to be credible, ethical, and independent.

4. Complete. Rule 26 of the Federal Rules of Civil Procedure limits expert evidence to the content that is actually written or displayed in the report. Everything

your expert says on the stand needs to be in their report.

5. Credentialed. This point speaks for itself.

VMI Highlights

Ed Wilusz, ASA, CFA, VMI Managing Director, was recently named Chairman of Pearl S. Buck International (PSBI). PSBI is a private, non-profit organization with the mission of improving the quality of life and expanding opportunities for children, promoting and understanding the values and attributes of other cultures, the injustice of prejudice, and the need for humanitarianism throughout the world.

VMI will sponsor the PA Bar Association's Family Law Section Winter Meeting January 15 through 17 at the Hotel Hershey, PA.

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 or at 215-343-0500.

ABOUT VALUE MANAGEMENT INC. VMI is a financial consulting firm specializing in valuing businesses, corporate securities and professional practices. Our firm is built on the performance of more than 4,500 valuations. Appraisals are rendered for estate tax planning, litigation support, and many other situations requiring independent appraisal. Our newsletter is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to VMI's clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries on specific valuation matters are welcomed.

This publication is intended to provide accurate and authoritative information on the subject matter covered. It is distributed with the understanding that the publisher and distributors are not rendering legal, accounting or other professional services and assume no liability whatsoever in connection with its use.

©2009. No part of this newsletter may be reproduced or redistributed without the express written permission of the copyright holder. Although the information in this newsletter is believed to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal or consulting advice.

**Value
Management
Inc.** The Business Valuation Specialist

2370 York Road, E2 • Jamison, PA • 18929-1031

FIRST CLASS
U.S. POSTAGE
PAID
NEWTOWN, PA
PERMIT NO.43

Address Service Requested