



# valuation outlook

BUSINESS VALUATION, FORENSIC ACCOUNTING AND LITIGATION NEWS OF SUBSTANCE

## Jelke Overruled: 11th Cir. Approves 100% Discount For Imbedded Capital Gains

*Estate of Jelke v. Comm'r*, 2007 U.S. App. LEXIS 26477 (November 15, 2007)

The 2005 *Jelke v. Commissioner* decision has been described as “poor” for the taxpayer and frustrating for the appraiser. In that case, the Tax Court declined to adopt a dollar-for-dollar discount for a holding company’s built-in capital gains tax liability. On appeal two years later, the Eleventh Circuit reversed the *Jelke* holding, in a decision that includes a strong dissent.

### A long path to ‘economic reality’

The decedent in *Jelke* owned a minority (6.44%) interest in a closely held investment company that owned marketable securities. Citing IRS Revenue Ruling 59-60, the Eleventh Circuit found that the net asset value method was the most appropriate for valuing a stock holding company, which in turn relies on the “venerable willing buyer-willing seller test.”

In addition, prior to the Tax Reform Act of 1986, courts generally did not permit a discount for built-in capital gains tax liability unless a sale or liquidation of the investment company was either planned or imminent. The discounts were deemed to be too speculative. The Tax Reform Act made “dramatic” changes, according to the Eleventh Circuit. The new law required the recognition of corporate-level gains on distributions of appreciated property. Because an individual shareholder/taxpayer would no longer receive a step-up in basis to fair market value on the valuation date (for estate tax purposes, on the date of a decedent’s death), “it now became more important than ever for a taxpayer to be able to quantify his or her loss in value of the stock due to inherent capital gains tax liability in the corporation.”

Reform took place more slowly in the courts. In *Estate of Davis* (1998), citing Rev. Ruling 59-60 and “economic reality theory,” the Tax Court held that a hypothetical buyer and seller would take some account for imbedded capital gains tax. But rather than permit a separate discount, the court attributed approximately one-third of the allowed marketability discount to the contingent capital gains liability.

Further, in *Estate of Eisenberg* (2nd Cir. 1998) and *Estate of Welch* (6th Cir. 2000) the federal circuit courts concluded that a willing buyer and seller would negotiate a discount to account for the tax liability, despite no imminent liquidation or sale. But language in *Eisenberg* suggested that while a discount was permissible, it need not be on a dollar-for-dollar basis. Similarly, in *Estate of Jameson* (5th Cir. 2001), the court required consideration of imbedded capital gains liability on a 98% interest in a closely held interest that operated both a timber and an investment company. This overruled the Tax Court’s decision to allow a partial discount only in relation to the planned harvests of the timber property.

**Dunn ushers in new valuation era**

A year later, the Fifth Circuit went a step further in *Estate of Dunn* (2002). The decedent owned a majority (62.2%) interest in a family

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## More Credible Corporate Valuation Includes Non-operating Assets

**Callos Professional Employment, LLC v. Greco, 2007 Ohio App. LEXIS 4405 (September 17, 2007)**

Given the opportunity to invest in her company, an employee bought seven shares. When she resigned six years later, she relinquished her shares and sued for reimbursement. The case positioned the employee as a dissenting shareholder, who was entitled to the “fair cash value” for her shares under the relevant (Ohio) statute. In a demand letter, the employee requested “fair market value” for her seven shares. The parties submitted the matter to a special master, who found for the employee, awarding \$112,000 for her minority interest. A trial court confirmed the award, and the company appealed.

### Company contests valuation

In their trial to the special master, each party presented an expert—whose valuations were over \$1.2 million apart. The appellate court summarized the company’s approach:

The expert calculated the income of the corporation and valued it at \$225,000. He then adjusted the corporation’s book value to a market value, which resulted in an asset value of \$916,000. [The expert] then multiplied the income value by 85% and the asset value

by 15%, and added these amounts together, to reach a total value of \$329,000.

The shareholder’s expert “took issue” with this approach, particularly its omission of assets owned, but not used, by the business. He noted that its related companies owed the business nearly \$1.4 million, and by adding these non-operating assets to the income value, he arrived at a total value of approximately \$1.6 million.

The company argued that it was incorrect to include the non-operating assets, because the affiliated companies were worth only \$6,000, making their receivables “worthless.” However, the company couldn’t cite any place in the record to establish this fact. Moreover, prior to the litigation, independent auditors valued the receivables at the amount relied on by the shareholder’s expert and adopted by the trial court.

The appellate court also rejected the contention that the ultimate award double-counted some assets. Both the special master and the trial court rejected the company’s calculations and accepted the valuation methods used by the shareholder’s expert. “Accordingly, the trial court’s valuation...is supported by competent, credible evidence,” and the award was affirmed. □

## Recent *Daubert* Case Emphasizes Correct Measure of Damages

**Dering v. Service Experts Alliance, LLC, 2007 US Dist. LEXIS 89972 (December 6, 2007)**

In a suit over the purchase and sale of their heating and air conditioning business, plaintiffs presented expert testimony to support their breach of contract claims. In particular, the plaintiffs’ expert calculated: 1) the lost profits of the air conditioning business; 2) the amount of the defendants’ unjust enrichment; 3) the diminution of the business’ value; and 4) the amount of punitive damages.

In reaching his lost profits figure, the expert first projected the defendants’ service revenue based on historical growth. He then deducted this figure from their actual service revenues to arrive at the plaintiffs’ projected service revenues. Multiplying this figure by “the percentage of revenue that becomes income,” he arrived at lost profits of \$353,000. He calculated lost profits in this manner for a ten-year period, and reduced the total amount to present value for a final lost profits figure of \$1.93 million.

The unjust enrichment figure was even more significant: \$2.65 million. This was projected over a period of ten years and again reduced to present value. Defendants challenged his opinions under Rule 702 of the Federal Rules of Evidence (FRE) and the applicable *Daubert* standard.

### Discovery failures trump *Daubert*

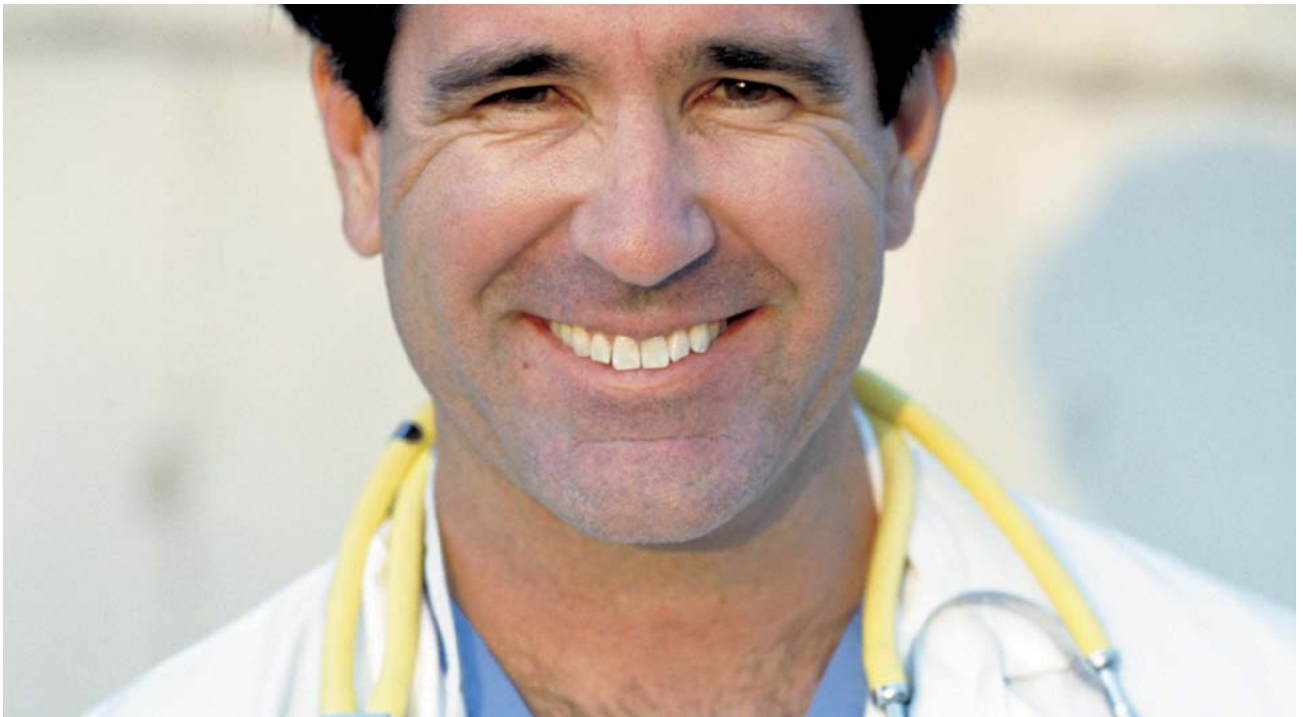
While noting that his “methods [were] reliable and his opinions relevant,” the U.S. District Court (N.D. Ga.) did not have to directly address the expert’s methodology,

due to defendants’ failure to provide plaintiffs with “any information that might [have aided the expert] in calculating the percentage of business revenue” that plaintiffs’ business would have captured absent the defendants’ wrongful conduct. Because their failure to provide information made a definitive calculation “impossible...[the defendants] cannot now complain that this supposed deficiency renders [the expert’s] calculations inadmissible.”

The court did, however, give closer scrutiny to the appropriate measure of damages. The expert compared the value of plaintiffs’ business at the time of trial (the “as is” value) to the value the business would have had absent defendants’ wrongful acts (the “but for” value). This diminution translated to the business losing net income of \$143,000. Using a summary of actual and projected net income amounts, the expert concluded a total lost business value of \$1.8 million.

### Correct measure of damages is critical

While plaintiffs argued that, under applicable law, the “but for” method of calculating damages was correct, the district court disagreed. “Under Georgia law, the measure of damages for a diminution in the value of a business is the difference in the market value of the business before and after the occurrence of the injury.” The court excluded the expert’s testimony on diminution of value, as it did his opinions on punitive damages. “The amount of punitive damages is to be determined by the enlightened conscience of an impartial jury,” the court held, and an expert opinion on these would invade the jury’s “sacrosanct role.” □



***Physicians Dialysis Ventures, Inc. v. Griffith*, 2007 U.S. Dist. LEXIS 78879 (October 24, 2007)**

In this *Daubert* challenge, the U.S. District Court (N.J.) articulates the qualifications that help protect a business valuation expert and preserve evidence of an appraisal.

To pursue counterclaims against an underwriter of a dialysis clinic in Newark, New Jersey, the defendant engaged a CPA with one of the largest forensic accounting firms in the New York area. In addition to being an author on lost profits calculations, the expert was “actively involved in the preparation of business valuations for more than seven years,” the court noted. She was certified by two valuation and appraisal groups, and held the CPA/ABV credential from the American Institute of Certified Public Accountants. At the time of trial, she was senior manager of her firm’s Business Litigation Group.

**Expert need not be ‘the best’**

Although this was the expert’s first experience valuing a dialysis center, she had appraised various medical and professional practices, as well as myriad other businesses and a minority interest in a family limited partnership. “She has developed specific expertise in the appraisal of business damages...both in the form of lost profits and lost business value.”

With regard to this case, the expert conducted a “hypothetical” appraisal of the dialysis center to calculate its value “but for” the alleged mismanagement. In addition, she provided a critique of the opposing side’s report, which posited a fair market value for the dialysis center before its foreclosure. The opposing party claimed this rebuttal report was unreliable for failing to conform with USPAP (Uniform Standards of Professional Appraisal Practice); specifically, that the expert critiqued the report using information that was not available at the time of valuation.

The court rejected this argument as well. The expert criticized the report for failing to use reasonable and rational assumptions in its valuation calculations—available at the time—instead of choosing to rely on what she considered to be biased assumptions. In her critique, the expert did refer to two dialysis centers that had opened after the date of the valuation report, but these “subordinate statements” did not render her methodologies or opinions unreliable. Any shortcomings in her critique, the Court ruled, went to the weight, not the admissibility, of her opinion.

Further, while she may not have been a “‘dialysis center expert,’ she is indeed an ‘expert...on the valuation of businesses,’” the court added. It would be an abuse of discretion to exclude an expert for not being the “best” qualified or the “most” appropriate, and the court ruled her testimony admissible under Rule 702 of the Federal Rules of Evidence and the applicable *Daubert* standard.

**Was it spoliation to destroy notes?**

The expert also defended against claims of spoliation; in particular, she admitted to destroying the notes she took over the course of the valuation engagement—but testified that she destroyed these in the normal course, following her firm’s policy. She had no reason to believe that she would be obligated to produce her notes; she never received a formal document request or any notice that the opposing party or counsel was interested in them. In fact, the opposing party did not ask for her notes until eleven days following receipt of her report.

Her opponents also had superior access to and control over information about the dialysis center—and they had three chances to depose the expert before trial. Under these facts, the court rejected the claims for spoliation. □

# Bankruptcy Courts ‘Required’ To Reject DCF Analysis When Market Cap Data are Available?

## ***American Classic Voyages Co. v. JP Morgan Chase Bank*, 2008 WL 792773 (U.S. Dist.) (March 25, 2008)**

This appeal of a bankruptcy case pits two common valuation approaches – the market capitalization method and a discounted cash flow analysis – squarely against one another. When an “objective” value for a company is available by reference to its price in the public markets, are bankruptcy courts (and insolvency experts) compelled to use the market cap method rather than a DCF?

### **New precedent intervenes after trial**

The original bankruptcy trial turned on whether the plaintiffs—a cruise company and their affiliates—were insolvent just one month after 9/11. Based on a discounted cash flow analysis by the defendants’ expert, the Bankruptcy Court found that the plaintiffs were solvent. It also rejected the liquidation values offered by the plaintiffs’ expert.

Meanwhile, one month before the Bankruptcy Court issued its final orders but after the parties had already submitted their final briefs, the Third Circuit decided *VFB LLC v. Campbell Soup Co.* (2007). That case upheld findings by the U.S. District Court that the public securities market provided the “most disinterested” if not “ideal data point” regarding the price of a publicly traded company at the valuation date. The District Court rejected expert DCF analysis, finding it flawed by hindsight and other “unreasonable” assumptions. “Absent some reason to distrust it,” the court explained, “the market price is a more reliable measure of the stock’s value than the subjective estimates of one or two expert witnesses.”



The same court (U.S. Dist. Delaware) would also hear an appeal in the *American Classic* case—and plaintiffs in *American Classic* seized on the *VFB* decision as the basis for review. They claimed “it was error for the Bankruptcy Court to rely upon expert testimony regarding solvency that was premised on [DCF] methods, where...a public market existed for the [Debtors’] stock.” The plaintiffs also reasserted their contention that the defendants’ experts based their DCF analysis on unreliable management projections.

By contrast, the defendants argued that *VFB* does not create a bright-line rule that “market capitalization is the only accepted methodology for considering valuation in solvency disputes.” Rather, *VFB* recognizes that DCF is an accepted methodology. Further, defendants supported their expert’s DCF analyses with SEC filings, management statements, and evidence of business dealings.

### **Valuation evidence consistent with market**

While the District Court’s discussion is brief, it confirmed the original findings of solvency. In particular, the Bankruptcy Court correctly credited the DCF analysis by defendants’ experts over the liquidation value by the plaintiffs’ experts. (Interestingly, the plaintiffs didn’t appear to introduce evidence of the cruise company’s declining stock prices until the appeal, contending that the common shares lost 94% of their value during the eighteen months prior to the transaction date. However, it’s not clear from the court opinion if the precipitous drop in market value occurred as the result of 9/11 and events in the tourism industry generally, or from company-specific factors.)

The District Court also declined to adopt the plaintiffs’ reading of the *VFB* decision:

In *VFB*, the plaintiffs made no attempt to reconcile the disparity between the testimony of their expert witnesses and the objective value of the company at issue in the marketplace...In contrast, the data and analysis accepted by the Bankruptcy Court in this case was consistent with the available marketplace data.

*VFB* does not “require” the solvency of a public company to be valued using a market capitalization method rather than a discounted cash flow analysis, it held. The defendants’ additional evidence concerning the companies’ business, including management projections, also supported the Bankruptcy Court’s findings, which correctly discredited the plaintiffs’ liquidation values. “In sum,” the District Court said, it could find “no legal error in the Bankruptcy Court’s use of the discounted cash flow analysis in the circumstances of this case.” □

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corporation but lacked a supermajority, two-thirds interest that could force liquidation under local (Texas) law. Because the family also planned to keep running the company, the Tax Court approved a 5% discount for built-in capital gains, reflecting the “small” possibility that a hypothetical buyer would liquidate. But the Fifth Circuit disagreed “emphatically.” A hypothetical buyer and seller must always be assumed to liquidate the corporation immediately upon the valuation date, triggering a tax on the built-in gains. The “likelihood is 100%,” the court said, and the appropriate amount for the discount was equal to 100% of the capital gains liability, dollar for dollar.

An era of valuation certainty had begun,” the *Jelke* court observed, turning to the facts of its own case. Given the minority interest at stake and the unlikelihood of liquidation, the IRS urged the Eleventh Circuit to ratify the Tax Court’s acceptance of a present value of the \$51 million capital gains liability, indexed over a sixteen-year period (the likely time when the assets would be sold), which came to \$21 million. The estate claimed this approach was both inconsistent and incomplete, given the likelihood that the value of underlying securities would change over time. It urged the application of *Dunn* and the certainty of a dollar-for-dollar discount—and the Court agreed.

“We are dealing with hypothetical, not strategic, willing buyers and sellers,” the court said. Thus it made a threshold, “arbitrary” assumption that a liquidation takes place on the date of death, freezing all assets and liabilities at that time. Whether a majority or minority interest is present “is of no moment.” Moreover, the Tax Court’s present value approach was “fluidly ethereal,” requiring courts to “gaze into a crystal ball, flip a coin, or at the very least, split the difference” between the respective approaches of the taxpayer and the IRS.

### Majority favors precision, despite sharp dissent

“We think the approach set forth by the Fifth Circuit in [*Dunn*] is the better,” the court held, in a two-to-one decision. By calculating the estate tax based on a “snapshot of valuation” on the date of death, the simple, logical *Dunn* rationale provides “practical certainty to taxpayers, appraisers and financial planners alike.” It is a “welcome

road map for those in the judiciary,” the court added, “not formally trained in the art of valuation.” The dollar-for-dollar approach also relieves courts from spending time and resources having to “wade through a myriad of divergent expert witness testimony, based on subjective conjecture and divergent opinions.”

Notably, the Court declined to rule on the Tax Court’s determination of discounts, finding no error in the assessment of a 15% lack of marketability discount and 10% for lack of control.

### A strong dissent

Like the *Dunn* panel, the *Jelke* majority anticipated that critics in the business appraisal community might call their methodology unsophisticated and overly simplistic. In assuming this risk, it quoted the Fifth Circuit’s observation in *Dunn* that opposite oversimplification on the methodology spectrum lies “over-engineering.”

A lone dissenting judge decried the adoption of the “rule of least effort.” “The majority gives in to the judicial equivalent of the doctrine of ignoble ease,” the dissent wrote. The Tax Court’s “real value approach” may not be perfect, and it depends on certain arguable assumptions—such as past rates of liquidation. But it produces a more accurate result than the majority’s arbitrary assumption method, the dissent argued, “because it more closely reflects the economic interests of those who control the company.” □

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