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TAF BV Roundtable: Could Joint Best Practices Guides Be the Next Step Forward for the Profession?

The April 23 meeting of The Appraisal Foundation Roundtable in Washington, D.C., was a unique and first-time attempt to get leaders from all the related valuation communities—including users—in one room. The 15-member panel and those who attended the roundtable invested four intense hours debating whether the profession faces a public relations or standards problem, and if so, what could be done about it.

“There may be a branding problem outside of the business valuation profession because most people don’t realize that the level of professionalism is as high as it is,” said Steve Sherman, chair of both KPMG’s Global Valuations Committee and the International Valuation Standards Board.

Led by Jay Fishman (FRA) and Tony Aaron (E&Y), this first-ever TAF event focused on three topics—standards, qualifications, and oversight and discipline.

Some of the most energized parts of the meeting came around the question of business valuation standards. “I don’t want to get into a word game, but I think we’ve got standards,” said Jim Hitchner (FGC). “What we’re doing now is coming up with procedures in areas of controversy. A lot of people probably changed how they were handling contributory assets after they read the [TAF report],” he pointed out.” Hitchner’s perspective was quickly seconded by Paul Beswick of the SEC: “Outsiders need to know that at least there’s consistency in the thought process, so there isn’t too much diversity in execution.”

An Update on Double Dipping for BV Practitioners

The question of double dipping is a constant challenge, both for the courts and for valuation experts. BVU recently interviewed two experts on the current state of the task of sorting out double counting of income and assets in marital dissolution cases. In this interview, Don DeGrazia and Stacy Preston Collins take on the issues of reasonable compensation and how different states view double dipping. They list some recent cases that indicate the courts are still grappling with the problem.

BVU: What are the issues appraisers face with double dipping today?

continued on next page...
Don DeGrazia: Over the past 40 years, the issue of double dipping has evolved from retirement plans into the context of business valuation and manifests in owner compensation, that is, whether owner compensation is in excess of “reasonable compensation.” Reasonable compensation, or what we often call a normalized compensation for business valuation, is what a business owner would be paid as an employee on the basis of their experience, expertise, and work effort. In determining this, we are trying to measure what a fair return on labor would be, not a return on investment (distributions or disguised dividends).

Stacy Collins: Double dipping is counting the same income stream twice, for the purposes of either dividing property or determining alimony or maintenance and child support. The main issue with double dipping is when you consider the income stream or available cash flow. Do you consider it in the valuation of a specific asset or type of asset? Do you consider it as spousal support? Do you consider it as child support or a subset of that? All of the above?

Don DeGrazia: Here’s a simplified example. A business owner makes $500,000 per year and draws $200,000 per year in salary. After analyzing the industry and the business, we conclude that reasonable compensation is $200,000. There is, therefore, $300,000 excess compensation that we have to consider as an add-back for purposes of valuation. We then have to determine what effect the reasonable compensation has on the value of the business, and whether there is the potential for double dipping.

As shown in Exhibit 1, the $300,000 add-back is what drives the company valuation from $500,000 to $2,000,000. The reported or economic income was $100,000 in this example. The add-back was $300,000 of excess compensation, creating two different income streams: one without an add-back of $100,000 and one with an add-back of $400,000. If we assume a 20% cap rate for this example, the difference is between $500,000 in value and $2,000,000 in value. Here is where the question of double dipping comes up. Should that $300,000 in
An Update On Double Dipping For BV Practitioners

Stacy Collins: One of the key points from the recent *McReath* decision in Wisconsin was that in a case involving liquidity problems, the money to pay off the nontitled spouse may need to be borrowed. In that case, the titled spouse will have to pay back that debt plus interest over time. Take, for example, a titled spouse whose income is being paid out partly as equitable distribution and partly as maintenance/child support and who, on top of that, has to pay down debt that was incurred to pay off the spouse. Resolution in a case like this is made that much more complex.

BVU: Is there any consensus in the courts?

Stacy Collins: States vary widely on this issue. Some states don’t consider double dipping an issue at all because the main concern is the standard of living of the nontitled spouse or if a child is concerned, the child’s needs. But other states say that there is a potential for double dipping and that it is inappropriate. In many states, personal goodwill is excluded from value for divorce purposes, whether it is community property or equitable distribution, which minimizes the potential for double dipping. In New Jersey, it depends on what type of asset is being valued, whether it is an asset for retirement purposes, a pension, or an interest in business or stock options. The issue is occasionally less significant when the business owner has the potential to recoup the money after divorce. In other states, the effect is minimized because the nontitled spouse receives less than 50% of the value of an asset.

Don DeGrazia: The one area where there seems to be consensus across states is in child support. In a couple of decisions, the courts have ruled that equitable distribution, the one component they split into the assets, was property division. And in community property states, it is between the spouses and not between the mother and/or father and the children. Therefore, double dipping is impossible with respect to child support because the child has no involvement in the distribution of assets.

BVU: Do risk-adjusted rates of return to each party complicate the issue?

Don DeGrazia: This is an important issue. Generally, we speak of closely held businesses and family businesses as being much riskier than a well-diversified portfolio of investment assets, and the spouse who gets the business has to operate that business after the divorce. The result is that, as mentioned, the nontitled spouse is theoretically getting a lower-risk portfolio of investments that doesn’t have to be operated in the same way and therefore, may warrant a lesser distribution.

Let’s turn to Exhibit 2, which is the previous example in which the $300,000 of excess earnings was added back to get the $2,000,000 value. If we do a 50% split here, each spouse would get $1,000,000 of value. But let’s consider the practical impact of that and how the money is used. The titled spouse receives $1,000,000 as equitable distribution in the form of the business and is essentially going to borrow $1,000,000 to pay off the nontitled spouse. We assume there is debt service simplified at $250,000, half of a $500,000 return, that the titled owner can receive. The math is simple: $2,000,000 times the expected 25% rate of return. As a result, there is a $250,000 balance after debt service. But from that $250,000, the titled owner has to pay taxes, alimony, and child support and then meet living expenses. The question thus becomes whether the alimony should be based on the $500,000 of actual income with $200,000 that was deemed reasonable compensation for the titled spouse’s efforts.
It is clear from the courts that child support will be based on the $500,000. The divergence of use from the courts arises with the measure of spousal support. By investing the $1,000,000 in a diversified portfolio, say with a 7.5% return of $75,000 (which is a precrash long-term expected rate), the nontitled spouse will earn substantially less than what the titled spouse can earn and complains that he or she cannot live on that return. The titled spouse complains that debt service is being paid, taxes are being paid, alimony is being paid, child support is being paid, and then he or she has to live on whatever is left. The questions then become: "Does the standard of value matter?" and "How does that affect the issues of double dipping, asset allocation, and expected earnings?"

**BVU: What impact does the standard of value have on the potential for double dipping?**

**Stacy Collins:** There are a few potential relevant standards of value that come up in matrimonial cases. It depends on the state, but generally speaking, the types of standards of value in the context of divorce are fair market value, fair value, and investment value. Fair value is sometimes defined as fair market value without discounts, but it depends on the jurisdiction. New Jersey, for example, has fair value. Value to the holder, which is similar but not necessarily the same, is value without the assumption of exchange or transfer. How do you value an asset that is not going to be sold under the presumption that the business owner is going to continue to work there and receive the existing economic benefits? It may be that value to the holder will be higher than fair market value, particularly if there is the potential for personal goodwill. This assumes that fair market is defined as value in an exchange when only enterprise goodwill is considered, not personal goodwill. If you are valuing a business under value to holder compared to fair market value, the fair market value could exclude personal goodwill. Value to holder most likely includes personal goodwill, so it could result in a higher conclusion.

If you end up in a fair market value context with book value or a small element of enterprise value, is the answer different than if you end up with value to holder, or fair value without regard to discounts? It depends on the context, but there could be a link. Illinois, for example, is a state that excludes personal goodwill. In the *Zells* decision, although personal goodwill was not considered in the court’s valuation of the business, it was a factor in examining income potential. That is one example of linking the standard of value with this issue and the potential for double dipping.

A bill was introduced this year in the California Senate specifically to eliminate so-called double dipping when determining spousal support. The bill proposed that the court should consider the extent to which income for support was already capitalized and paid to the other spouse to avoid double counting the income when the result would be inequitable based on all the circumstances presented. I believe that this bill has been tabled, but it is interesting to look at the ways states try to deal with this issue.

**Exhibit 2**

<table>
<thead>
<tr>
<th>Value of the company</th>
<th>$2,000,000</th>
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<tbody>
<tr>
<td>(Based on Value to Holder)</td>
<td></td>
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<tr>
<td>Risk adjusted discount rate</td>
<td>25%</td>
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<tr>
<td>to determine value</td>
<td></td>
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<tr>
<td>Division of Assets:</td>
<td></td>
</tr>
<tr>
<td>Titled spouse</td>
<td>50%</td>
</tr>
<tr>
<td></td>
<td>$1,000,000</td>
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<tr>
<td>Non-titled spouse</td>
<td>50%</td>
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<tr>
<td></td>
<td>1,000,000</td>
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<tr>
<td></td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>2,000,000</td>
</tr>
</tbody>
</table>

**Don DeGrazia** is a licensed CPA in New Jersey and Pennsylvania. He is a senior shareholder in Gold, Gocial, and Gerstein, where he specializes in federal and state taxation, multistate taxation, matrimonial taxation, and tax nexus issues. **Stacy Preston Collins** is a managing director at Financial Research Associates, with offices in Pennsylvania, New Jersey, and New York. She specializes in marital dissolution cases, corporate litigation, and estate planning valuations and transactions.
TAF BV Roundtable
...continued from front page

How do we get there? “We need, as a profession, to get faster at identifying best practices and at sharing them,” said Greg Forsythe (Deloitte Financial Advisory Services). Or, as Paul Barnes (Duff & Phelps) agreed, “The profession is looking for places it can take out the noise created by confusion.”

Why it may not happen. There are many roadblocks to the process of coming up with shared best practices. To list a few:

• “Valuation standards have been written as a set of guides for valuations no matter what the purpose,” said Carla Glass (HSSK). “But as soon as you get into different purposes, for instance tax valuations, you’ve got different practices.”

• Unlike procedures at FASB and elsewhere, there isn’t a common methodology for exposure drafts established in BV.

• Multiple associations and groups are working independently, with only rudimentary communication.

• There’s no clear enforcement arm or communication method through the certifying associations to get members to follow best practices once they’re agreed upon.

And one way, at least, that it might. A suggestion was made that all groups outsource their best practices work to TAF. Many in the room laughed—until Beswick, the senior regulator in the room, asked, “But why not?” In that spirit, Fishman proposed a simple but weighty vision of the next chapter in BV’s growth as a profession. “I think a good first step would be for all the organizations to recognize the AICPA’s IPR&D guide, and TAF’s Contributory Assets advisory as best practices,” he summarized. “And there could be a group set up to recommend professionwide adoption of other best practices documents as they become available.”

“If we can’t do that, I worry there is little hope of doing anything else,” he told BVU.

Aaron commented that there is in fact some coordination when it comes to best practices—among TAF, IVSC, the AICPA groups, and others. So it’s not quite as bad as it seems. But it’s still not what you’d call “cross-referencing.”

Public perception of the BV profession needs some polishing. “In contrast to the accounting profession, some people perceive that there is inadequate infrastructure for the business valuation profession,” Fishman observed.

“We’ve got the PCAOB and FASB and SEC represented here,” said Aaron, “not as an inquisition, but because we need their input.”

Some highlights of the debate:

• Should there be stiffer qualification standards? Aaron directed the discussion to Bill Holder, the dean of the school of accounting at USC. “Many schools now recognize the need to broaden education to better understand accounting valuations, at least for those involved in the financial reporting process,” Holder said. “The ability to offer valuation specialists as professors is not common, however, at least not in accounting,” he admitted. He described a redesign of USC’s curriculum to include more financial valuation components in the core instruction.

Wendy Pirie from the CFA Institute commented, “I can’t think of a single profession that doesn’t require an undergraduate degree, though the question is whether you need to specify the discipline.”

Barnes agreed that the commonsense approach would seem to mandate an undergraduate degree, with a quantitative focus of some sort.

“At the least,” said Forsythe, “you might hold the expectation that someone have a degree by the time they consider certification within the profession.”
Don Charles (E&Y) pointed out, however, that there are people who find engagements, supervise engagements, and do the work. “These individuals may all have different education, concentration, and work experience expectations,” he said.

• Importance of valuation. Holder continued that “every asset south of cash has a valuation implication,” so most accounting curricula spend time with entry-level professionals talking about valuation of goodwill or in-process R&D. “But now we see that it’s pervasive, and this requires changes in the training approach.”

One of the issues is that “it would be almost impossible to prepare someone through an undergraduate degree for the variety of business valuation experiences and demands,” said Barnes. So, while a degree might be a minimum requirement, professional experience will be more important.

“Any one of us has probably hired people from any of the quantitative undergraduate disciplines, including the liberal arts,” added Hitcher (FVG). “We generally require that new people get a CFA or an MBA, however, as part of their work experience, if they don’t have finance or economics or accounting in their backgrounds.”

• What is the public perception of BV credentials? “Should members of our profession work toward certification?” asked Aaron. Hitcher responded: “I think the profession spends a lot of negative energy, perhaps more than the users, in designation wars. But they all require an exam, a certain number of hours of education, and different levels of professional experience.” So Hitcher agrees that designations are good, but that professional experience is what matters.

• “Most users see what firm you’re from and assume you have the necessary credentials and experience to perform the job,” said Barnes. “Designation is creating more confusion than clarity for the users,” he theorized—an idea that was seconded by Beswick, who said, “I’m not sure we know the difference between the designations, and I’m not sure most consumers do either. Glass agreed: “I still spend a lot of time educating users on what a business valuation certification means.”

• Where is the profession most exposed? “Most of the public outcry on fair value has come from the world of financial instruments,” said Barnes. “That’s where you’d say that the profession has let down the consumer. Perhaps we need to keep that in mind when considering the right answer.”

• Is continuing education sufficient? “It’s now widely available and it’s getting more sophisticated,” said Hitcher. “I don’t think this is a problem, and one of the advantages of being part of a certifying organization is that they all require CPE.”

• Should there be a certification expressly for valuation for financial reporting? John Glynn and Mark Zyla agreed that this question needs to be answered. On the other hand, “you can lose track that you’re valuing a business if you specialize too much,” said Glass. “You can learn something from every time of valuation exercise, so we need to be very careful about too much specialization in both our training and in our certifications.”

Many audience members and panelists noted that the disciplines of measuring intangibles or financial instruments are in fact creating specialists, whether or not a separate certification program exists.
Like other professions, does BV need an enforcement arm? “The enforcement we have now is that practice aids from the AICPA and TAF and others are perceived to be authoritative, no matter their actual standing,” said Hitchner. Not to say that business appraisers don’t find themselves continually under review—and even attack. So you can obviously get various oversight and enforcement agencies, not to mention the courts and clients, rapidly questioning whether you did wrong—a point repeated by several participants.

But strenuous oversight and harsh punishment are not formalized in the realm of business valuation for financial reporting. Or at least some users of valuation reports may perceive that they aren’t. “If there’s never been a sanction, you can only come to one conclusion; either every one’s perfect, or there’s no enforcement,” Aaron commented.

Since there is no formal enforcement of valuation standards, is audit (or other) review sufficient? Some would argue that the informal oversight that exists works. Glynn pointed out that review by auditors at the firm level weeds out bad performance either because it results in inefficient work or termination of weak analysts. But in reality, “No one is being thrown out of the profession for bad work,” as one attendee said.

Nevertheless, most in attendance recognize that—while appraisal reports are nearly always scrutinized extraordinarily carefully by customers as well as opposing parties, thereby enforcing a very high standard of care—at the professional association level, NACVA, IBA, ASA, and AICPA rarely throw members out or punish them directly for business valuation projects. Another attendee said, “Who do you complain to if you think there are nonprofessional practices apparent from a business appraiser?”

“I don’t think there are a bunch of unethical people running around,” summarized Charles. “It’s not the ethical question we’re dealing with as much as the expectations by users of what sort of work standards they can assume to be done when there are grey areas or assumptions.” Discussions such as this session at TAF are the places where next steps begin to be considered, Aaron agreed.

Normalizing Adjustments—Time to Revisit

By Rod P. Burkert, CPA/ABV, CVA

For most valuations, adjusting entity-level earnings to develop control and minority interest values has become a generally accepted business valuation practice. This is a good thing. It frees us from extrapolating data from questionable control premium studies that, in the aggregate, measure a combination of strategic control, financial control, and hubris and from interpolating implied minority interest discounts from those studies. It’s also a bad thing. Not all appraisers agree about the extent of the adjustments that should be made to entity-level earnings.

In adjusting entity-level earnings, appraisers make normalization adjustments. These adjustments reveal the base-level earnings of the private company that is (a) the source of realizable value to a control interest buyer who will gain control over the benefit stream; and (b) the source of potential value to a minority interest holder.

1 A minority interest discount is derived from control premium information using the formula MID = 1 – [1/(1 + CP)].

2 I say “base-level” benefit stream because in the valuation of a control interest, the buyer can make further adjustments that reflect his ability to run the company “better” (financial control) or operate it “differently” (strategic control).
NORMALIZING ADJUSTMENTS—TIME TO REVISIT

buyer who must make decisions about how and when future value will be realized.

Understanding this is key, because it shows that normalization adjustments are required to develop an entity-level (not an interest-level) minority, marketable value, that is, an “as-if freely traded” value. This terminology in our various levels of value charts emphasizes that earnings are normalized to where they would be if our private company were public; it does not require that the private company have the potential to go public.

Most appraisers have little difficulty identifying and making the relatively “easy” normalization adjustments. Such adjustments remove the effects of unusual, nonrecurring items and the income and expense associated with non-operating assets and liabilities. Rarely is there any debate about the propriety of making these adjustments.

The real controversy involves normalization adjustments that reduce officer/owner salaries to market levels and remove other discretionary expenses that would not exist in a well-run public company. Many appraisers do not make these adjustments when valuing a minority interest because they assert that a minority interest lacks the power to make such changes. These appraisers argue that these adjustments are “control” adjustments and that not adjusting for these items serves as a proxy for a minority interest discount. This position is not defensible, as can be seen from these related arguments:

1. Minority shareholders in public companies also lack control over officer salaries and discretionary expenses. But they expect normalized operations, and generally, they get them.

2. Using inadequately adjusted earnings implies, vis-à-vis a terminal value calculation or market pricing multiples, that a minority shareholder will be disenfranchised into perpetuity and never receive his/her pro rata value—even if/when the company is sold.

3. Discount rates based on market data and multiples obtained from guideline public companies are derived from normalized earnings and, therefore, should be applied to private company earnings that are similarly adjusted to a public equivalent basis.

4. Items 1, 2, and 3 place our private company at the minority, marketable level of value. If we start with adjusted earnings that are less robust, we are at some make-believe level of value—call it the “being taken advantage of minority, marketable” level of value.

5. Discounts for lack of marketability based on restricted stock studies and pre-IPO stock studies are deducted from the minority, marketable level of value, not a “being taken advantage of” level of value.

6. And finally, couldn’t a rational hypothetical investor sue under a state’s shareholder rights statutes if it was being permanently deprived of its pro rata value because of egregious owner salaries and discretionary expenses?

Guide to Intellectual Property Valuation

Authored by Michael Pellegrino
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Let’s face it, excessive owner compensation comes up more often in businesses that are “family-owned” and less often in those that are “closely held.” In the family-owned cases, there seems to be a “nod-nod, wink-wink” atmosphere where control and minority owners know the compensation is excessive or that discretionary expenses exist, but no one questions the practice because it’s mom or dad. Thus, it can be easy to rationalize not making an adjustment if the purpose is to value a minority interest in that business.

But I have a problem with this. At the extreme, what if excessive compensation and discretionary expenses take the cash flows of the company down to zero. Would we submit a report to the IRS claiming a zero value for the minority interest? Few, if any, appraisers would. So where do we draw the line as to when an adjustment needs to be made? Because once we admit that a line needs to be drawn, we might as well adjust for excessive compensation and discretionary expense in all cases.

Suboptimal earnings are transitory in the real world—the one that is being mirrored by the minority, marketable level of value. And normalizing officer salaries and discretionary expenses correctly reflects the fact that these items do not affect the value of the enterprise at the minority, marketable level of value. If we need to consider the impairment of value that owner salaries and discretionary expenses have on the value of the minority interest, we should consider it in our determination of the appropriate discount for lack of marketability.

It is often said that valuation is as much an art as it is a science; however, no one said anything about make-believe. If we do not make adjustments to normalize officer salaries and remove discretionary expenses, our conclusion cannot be at a minority, nonmarketable level of value. The result will be at some other level of value that is neither supported by valuation theory nor recognized in the valuation community.

Rod Burkert, CPA/ABV, CVA, is the founder of Burkert Valuation Advisors LLC. His assignments focus on income/gift/estate situations, divorce proceedings, partner/shareholder disputes, and commercial damage/economic loss matters. He provides independent report review and project consulting services to assist fellow practitioners with engagements.

A Poor Example of Celebrity Valuation

By Mike Pellegrino, MBA

In November 2009, Tiger Woods was the focus of an international media storm relating to his marital infidelities. Fallout erupted from several of Woods’s sponsors. Two professors at the University of California-Davis (U.C.-Davis) published a paper claiming that the scandal had reduced shareholder value between $5 billion and $12 billion. An analysis of their methods yields several significant shortcomings. For brevity, we present only a few of them in this article.

Celebrities typically create value in one of three ways (or variants thereof):

- Greater revenues;
- Greater/faster market adoption; and
- Lower sales and marketing costs.

If celebrity value cannot achieve any of these outcomes, then the celebrity brings limited value for the product or service in question. Thus, if the Tiger Woods scandal had any true impact on the value of his sponsors, then any one of them would experience excess sales and marketing costs (e.g., costs to change advertising, which may be true), reduced revenues, or shrinking market share. Without answers to such questions,
valuation analysts or academics cannot opine on the true economic value impacts.

A simplified look at the reasonableness of the U.C.-Davis study’s claims proves the incredulity of the authors’ conclusions. A $5 billion-to-$12 billion loss in market value should represent the permanent loss of capitalized free cash flows to the sponsor’s shareholders. At generous price-to-free cash flow ratios of 10% and profit margins of 10% of revenues, this means that these companies collectively lost between $5 billion and $12 billion in incremental revenues because of their association with Tiger Woods. These losses are permanent, not transient. This conclusion is nonsensical.

For example, basic research of the fundamental economics of Tiger Woods’s sponsors proves it. Nike generated $19 billion in revenues as of May 31, 2009. Much of that revenue had nothing to do with Tiger Woods and occurred outside of the United States, in countries that may be indifferent to Woods’s marital status. Nike Golf comprised about 3.3% of the company’s total revenues. Nike would have to report permanent free cash flow losses of hundreds of millions of dollars, which would indicate billions of dollars of lost revenues.

These billions of dollars in lost revenues did not occur. Per Nike’s 2010 Annual Report, Nike Golf did experience a slight revenue drop (about 1.5%), yet no evidence suggests that the revenue drop related at all to the Tiger Woods incident. Nike attributes the decrease in revenues to general reductions in discretionary consumer spending (Cole Haan revenue dropped by a similar percentage). Further, revenues associated with the two quarters nearest to the Tiger Woods incident were actually greater than the prior two quarters.

A similar result comes from another sponsor of Tiger Woods, Electronic Arts (EA). A substantial portion of EA’s revenues comes from blockbuster titles such as Rock Band, Rock Band 2, Madden NFL, and the Need for Speed series. The Tiger Woods Golf product is but a fraction of the total revenue contribution to EA.

Based on these considerations, the conclusions of the U.C.-Davis study are meaningless in the context of true IP value, lack any theoretical or practical grounding, and are wholly impeachable.

A Credible Approach to Celebrity Valuation

Literature establishes that damage components can include a combination of lost unit sales, lower unit sales prices, higher costs (such as increased marketing or legal costs), and/or lost sales on ancillary products. Several analysis items include the following:

- **Cost to cure brand impairment:** If the publicity casts a negative view on the stability, security, and integrity of the Nike brand, the company must repair that damage. An industry-accepted way to estimate the value of the brand impairment is to value the cost to cure it. Nike might consult with a public relations agency to perform an independent assessment of its brand impairment and create a campaign to repair the reputation damage (it did this). The tangible result of these public relations activities would be to persuade the public and the target markets for Nike products that the brand is indeed strong by continued association with Woods. The full economic costs of this campaign (i.e., including capitalized opportunity costs on dollars spent performing these corrective actions) would represent one component of the value impairment.

- **Cost of permanent income losses or deferrals:** Suppose that the publicity caused Nike to lose sales to competitors either temporarily or permanently. In this situation, Nike incurs temporary or permanent cash flow losses because it loses the customers, as captured in Exhibit 1.

Exhibit 1 demonstrates a time delay that will defer cash flows Nike would have enjoyed sooner. The
Cost of Capital Should Align With the Broad Market Conditions as of the Valuation Date

By Marc Vianello, CPA, ABV, CFF

Editor’s note: Marc Vianello introduced his observations regarding the problems associated with conventional methods of calculating cost of capital under volatile market conditions in the January issue of BVU. This article presents one possible methodology for adjusting conventional cost of capital estimates so that they reflect prevailing market conditions.

Fair market value should reflect general economic conditions, be they normal, boom, or depression. Valuation practitioners cannot meet this Revenue Ruling 59-60 requirement using Ibbotson and Duff & Phelps cost of capital estimates without adjusting for current market conditions. These measures of cost of capital are based on cumulative arithmetic means that can yield equity costs contrary to current market conditions.

Comparing the arithmetic mean returns estimated using the Ibbotson and Duff & Phelps buildup methods over time discloses a lack of fluctuation in cost of capital despite the dramatically different market conditions that can and do exist. Sometimes, what little fluctuation occurs with these buildup methods is contrary to the movement of the market. For example, as of March 31, 2009, Sept. 30, 2009, and Sept. 30, 2011, the Ibbotson buildup method estimates arithmetic mean equity costs of capital for a

shaded area represents the value impairment that Nike might incur.

A valuation analyst would have to use the income valuation approach to quantify the permanent revenue losses that Nike would have suffered. The valuation analyst would have to build two discounted cash flow models to capture the magnitude of the damages. The first discounted cash flow model would capture the present value of the free cash flows that Nike may likely have generated if not for any impairment associated with Tiger Woods. The second discounted cash flow model would capture the present value of the free cash flows that Nike may likely have generated as well. However, it would have deferred a portion of those free cash flows to account for the time lag it would have taken for Nike to cure any impairment that it suffered because of Tiger’s actions. The value of the damage that Nike may have incurred is the difference between the value indications of the first valuation model.

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Decile 1 company of 9.34%, 9.75%, and 8.38%, respectively. Yet Graph 1, which provides a historical perspective of the P/E ratio of the S&P 500, suggests that the market would have valued a dollar of earnings much differently on each of these dates.

Based on the trailing 12 months (TTM) of operating earnings, the long-term average P/E ratio of the S&P 500 index from Dec. 31, 1988, to Sept. 30, 2011, was 19:1, which implies a marketable capitalization rate of 5.26% and an average expected growth rate of 3.12% for the overall market based on Ibbotson’s long horizon Decile 1 cost of capital of 8.38%.

But looking at Sept. 30, 2011, on a discrete TTM basis, the P/E ratio of the S&P 500 was 12:1. This implies

a marketable capitalization rate of 8.33%, and a negative 0.05% growth rate expectation for the overall market based cost of capital of 8.38%.

Graph 2 compares the change in cost of equity of a hypothetical Decile 1 company at three points in time, and compares the changes to the contemporaneous changes of the S&P 500 TTM P/E ratio. March 31, 2009 (point A on Graph 1), serves as the baseline of the graph and the related discussion.

On Sept. 30, 2009 (point B on Graph 1), using the Ibbotson buildup method, the arithmetic mean cost of equity estimated for a Decile 1 company was 9.75%, or 4.4% higher than the 9.34% cost as of March 31, 2009 (point A on Graph 1). Assuming all other things to be equal, the equity value of a hypothetical Decile 1 company on Sept. 30, 2009, should have been 4.4% lower relative to the earlier date. However, on March 31, 2009, the market was at about parity with the historical long-term average P/E (18.555 P/E versus 19.045 P/E) while at Sept. 30, 2009 (point B on Graph 1), the P/E ratio of the market was much higher than on the earlier date (26.687 P/E versus 18.555 P/E). Therefore, the market was placing a much higher value on each dollar of operating earnings on Sept. 30, 2009, than on March 31, 2009—about 43.8% more value.

Similarly, with an Ibbotson cost of equity capital of 8.38% on Sept. 30, 2011, the value of a dollar of operating earnings for the same hypothetical company should have been worth 10.3% more than on March 31, 2009, all other things assumed to be equal. However, on Sept. 30, 2011 (point C on Graph 1), the P/E of the market was well below the P/E as of March 31, 2009 (12.003 P/E versus 18.555 P/E). Therefore, the market considered a dollar of operating earnings to be much less valuable on Sept. 30, 2011, than it was on March 31, 2009—about 35.3% less valuable. These contradictions demonstrate the need for a market conditions adjustment of the cost of equity estimated using cumulative arithmetic mean methodologies.

Although no method to adjust for prevailing market conditions is likely to be perfect, one objective way to deal with disparate prevailing market conditions is creating an adjustment factor to apply, by multiplication, to the arithmetic means determined using the Ibbotson and Duff & Phelps buildup methods. Using the S&P 500, practitioners can construct such a factor by dividing the TTM historical average P/E ratio by the TTM P/E ratio as of the valuation date. For example, if the historical P/E ratio through a valuation date is 19x and the recent P/E ratio is 13x then the factor to multiply times the arithmetic mean cost of capital is 1.38. If the conventional Ibbotson or Duff & Phelps buildup of cost of capital is an arithmetic mean of 10% then adjusting for the described P/E shift in market conditions results in an adjusted mean of 13.8%. This, of course, would drive the market value of the valuation subject down, which is the result that one would expect if P/E ratios have contracted. Conversely, application of the method results in higher values during periods of time when the market is rewarding earnings more than it has historically.

The described approach for adjusting cost of capital is consistent with valuation theory because the inverse of a P/E ratio is a market capitalization rate.

The method also preserves the underlying usefulness of Ibbotson and Duff & Phelps cost of capital calculations as the baseline from which to adjust cost of capital for current market conditions. Using 12 trailing months provides some smoothing of dramatic single-quarter S&P index and earnings per share anomalies, while being consistent with the way in which...
Valuing Common Stock in Anticipation of a Biotech IPO

By Joel F. Johnson, ASA

The window for biotech IPOs is open. Each company that files a registration statement or even considers an IPO will need a professional appraisal prepared with the following points in mind:

- The SEC is likely to compare the appraised values leading up to the offering with the proposed IPO price. The appraiser should anticipate the IPO price and be prepared to reconcile the appraised values with the offering price.

- Biotech IPOs are being priced as financings, not as liquidity events. The difference between the pricing of the last preferred round and the IPO price may be relatively small.

- Appraisals should anticipate SEC disclosure requirements. It’s helpful to provide an estimate of the probability of an IPO at each appraisal date.

- Before the filing, the appraiser should discuss with the client whether the appraiser’s name may be cited in the prospectus.

In this article, we’ll take a close look at five recent biotech IPOs (see Exhibit 1). These transactions are representative of the current market and
illustrate how common stock is valued in the months and years before an offering.

**Anticipating the SEC’s Review.** Biotech companies filing to go public should be prepared to answer this request from the Securities & Exchange Commission (SEC):

> Once you have disclosed an estimated offering price, please provide an updated listing of all stock option grants and other equity transactions through the date of your filing and provide quantitative and qualitative disclosures explaining the difference between the estimated offering price and the fair value of each equity issuance.¹

The SEC’s request is straightforward, but let me rephrase: “We know that you plan to sell shares at $10 in your IPO, but how can you possibly believe the value was only $2 just 18 months ago?”

In the management’s discussion and analysis (MD&A) section of the prospectus, it provides its description of the how the common stock was valued in the months preceding the IPO. Close to the offering date, the company will disclose the “filing range”—the range of prices within which the underwriter expects to price the IPO. In the MD&A, it is necessary to reconcile the appraised values with the filing range.

Of course, the actual offering price is unknown when the prospectus is prepared. Prior to the IPO, the underwriter builds a book of potential orders from institutional investors. If the book is strong and the demand for shares greatly exceeds supply, the underwriters may be able to price the offering near the top of the filing range or above it. If demand is weak, a lower price may be necessary. On the IPO date, the final price is established, shares are issued, and trading begins.

Appraisers may take comfort in knowing we’re not the only ones who have difficulty valuing biotechs. One of the ironies of the SEC’s disclosure request is that companies respond on the assumption that the offering will be priced within the filing range. As shown in Exhibit 2, this is not always the case.

Verastem was priced in the middle of the filing range, Clovis was priced at the low end, and ChemoCentryx, Cempra, and NewLink were priced below the range. When the offering is priced below the range, there may be a disconnect between the price on the cover of the prospectus and the disclosures in the MD&A.

Ultimately, the price of any IPO is a function of the demand for shares relative to the fixed supply the company is willing to offer.

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¹ Correspondence between Clovis Oncology and the SEC filed Sept. 21, 2011.
The current market is conservative in its pricing of biotech IPOs. Most appraisers, with guidance from the AICPA cheap stock practice aid, regard the IPO as a liquidity event, but for the venture investors, it isn’t a liquidity event, it’s a financing. In all five IPOs, the existing investors were buyers in the IPO. (See Exhibit 3.)

The appraiser should keep in mind that the IPO investors are likely to include the venture investors. The venture capitalists’ pricing of the preferred stock may be an indicator of how the offering will be priced. For many appraisers, the option-pricing method (OPM) backsolve is a favored way for valuing common stock because the pricing of a recent preferred round provides an objective benchmark. Investors in public offerings look to the pricing of recent preferred rounds as well. They evaluate the “step up” from the last preferred round to the IPO price.

As shown in Exhibit 4, the step-up may be modest or even a step down.

A variation in the step-up analysis takes time into account by considering the investor’s annual rate of return. All other things being equal, the step up from an investment made three years prior to an IPO should be greater than the step up from an investment made six months prior.

In addition to the step-up analysis, investors will consider the company’s cash position and its stage of clinical trials. These trials burn cash. Ideally, the company will receive positive data from one of its trials before it runs out of cash. The positive news provides a basis for a higher valuation in the next offering. Companies filing to go public should already have some cash. They don’t want to appear desperate. The investor is trying to gauge how far the company can progress in its trials with the cash on its balance sheet and the amount it raises from the IPO.

The amount raised in the offering is a function of several factors, including the company’s need for capital, its premoney value, and market liquidity. (Without a minimum number of shares and investors, a liquid market won’t develop). Exhibit 5 provides a summary of the premoney values and offering sizes for our five IPOs. A “premoney” value does not include the proceeds of the IPO.

The values observed for our five companies are indicative of current IPO market conditions. For the eight biotech IPOs priced in 2011, the median premoney value was $106 million. The highest was $355 million, for a company that had an approved product, and the lowest was $60 million.

Valuations of common stock using PWERM and OPM backsolve. When valuing common stock in a venture-backed company, the appraiser

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<th>Exhibit 3. Summary of Insider Participation in the Offerings</th>
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<th>Exhibit 4. IPO Prices Compared to Recent Preferred Rounds</th>
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<td>Preferred round</td>
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Preferred prices have been adjusted for stock splits and conversion rates.
determines a value for the equity and allocates this value among the preferred and common shares. The steps can be mingled. Under the probability-weighted expected returns method (PWERM), the scenarios may both determine equity value and allocate it. Similarly, in the OPM backsolve, a single model both determines and allocates equity value.

All five of the biotech IPOs used a variation of the PWERM for the purpose of determining the value of the common stock. In some cases, a hybrid method is used in which an IPO scenario is combined with one or more scenarios that make use of the OPM. For a company going public, the advantage of a PWERM is that it allows the appraiser to consider the IPO value explicitly. When the SEC asks, “Why has the value increased?” a straightforward answer is that the probability of an IPO has increased. In the MD&A, management can show how the prospects for an IPO improved over time and the value increased accordingly.

Exhibit 6 provides the probability weights assigned to an IPO by each of the companies.

As the IPO date draws near and the prospects for a completed IPO improve, one would expect the discount for lack of marketability (DLOM) to decrease. DLOM assumptions are summarized in Exhibit 7.

Exhibit 6. Company-Assigned Probability Weights

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* “Months” is the number of months from the IPO date to the appraisal date.
* “Prob.” is the probability of an IPO.

Exhibit 7. DLOM Assumptions

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<td><strong>DLOM</strong></td>
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* “Months” is the number of months from the IPO date to the appraisal date.
* “DLOM” is discount for lack of marketability.
The DLOMs presented in Exhibit 7 have been simplified for the purposes of comparison. Some of the companies assumed different DLOMs for different scenarios. Some assumed no DLOM for the IPO scenario.

In retrospect, the progression to an IPO may seem more orderly than it does in real time. The market moves both ways, and contemporaneous appraisals don’t always show regularly increasing values. One reason companies decide to go public is that the prospect for a favorable offering suddenly improves. When this happens, there may be a wide gap between the expected IPO price and the values determined by contemporaneous appraisals. Some companies (at least two of our five) elect to “reassess” the value of the common stock. Retrospective appraisals are performed to assign higher values to the common stock for financial reporting. Cempra describes this decision as follows:

In connection with the preparation of our consolidated financial statements included in this prospectus, after giving consideration to the estimated values that could be obtained in an IPO in the first quarter of 2012 and based on market and other conditions, we determined in September 2011 that the grant date fair value of the options granted on December 8, 2010 required adjustment. Accordingly, we reassessed the fair value of our common shares at December 8, 2010 for financial reporting purposes.2

Four of the five companies did not name the appraiser in the prospectus. Instead, they used language such as “Our board of directors, with the assistance of management and independent consultants, performed fair value analyses for the valuation of our common stock.”3 One of the companies named the appraiser, who is listed as an expert in the registration statement. The issue of “expertizing” the appraiser is addressed in the working draft of the revised cheap stock practice aid. If a company discloses that its valuation techniques were developed by a valuation specialist and relied on by management, Securities Act Rule 436 requires the company to provide the name and written consent of the valuation specialist. According to the practice aid, “A registrant has no requirement to make reference to a valuation specialist simply because the registrant used or relied on the valuation specialist’s report or valuation or opinion in connection with the preparation of a Securities Act registration statement.”4

Conclusion

Valuing biotechs is difficult because many of the conventional building blocks of value—earnings, positive cash flows, even revenues—are

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3 ChemoCentryx final prospectus filed Feb. 8, 2012.
4 AICPA. Valuation of Privately Held Company Equity Securities Issued as Compensation (working draft). Paragraph 11.13a, footnote 3.
Dear Editor:

I read with interest the article in the April 2012 issue of *BVU* by C. Fred Hall III, titled “How Regression Analysis Makes the Market Approach More Valuable.” I congratulate Mr. Hall for using regression analysis in his own work and for encouraging others to do so through published articles and content available on his website. It is evident that Mr. Hall has put in much time and effort thinking through how appraisers can apply regression analysis to the market approach. However, I’d like to address some concerns that, if not dealt with, could lead to a *Daubert* challenge.

Nonexistent. Given this uncertainty, it should come as no surprise that there is no secret but universally recognized discount from the IPO price.

Exhibit 8 summarizes the appraised values of common stock relative to the IPO price. Each appraisal is unique, and the range of values is wide.

For the SEC examiner, the proposed offering price is one of the few objective benchmarks of value. Just as estate appraisals anticipate the potential concerns and requirements of the IRS, the appraisers serving biotech clients should consider the perspective of the SEC. Each appraisal should include an estimate of the IPO price and the probability of completing the offering.

Letter to the Editor

Mr. Hall suggests building a multiple regression model with the four key independent variables of gross revenue, cash flow (aka seller’s discretionary earnings), inventory, and fixtures (aka furniture and equipment). This model will suffer from the infirmity of multicollinearity caused by the fact that gross revenue and cash flow can be more highly correlated with each other than either is with the selling price. This will cause one or more coefficient signs to be negative and will either over- or understate the values of all the variable coefficients, preventing the analyst from determining the actual impact of each variable on selling price.

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**Exhibit 8 Appraised Values of Common Stock Relative to the IPO Price**

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<td>Months</td>
<td>Ratio</td>
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<td>34</td>
<td>71</td>
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<td>61</td>
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</table>

“Months” is the number of months from the IPO date to the appraisal date.

“Ratio” is the ratio of the appraised value for the common stock to the IPO price.

**Sources**


Joel F. Johnson, ASA, MBA, is the founder and president of Orchard Partners Inc., which provides business appraisals for rapidly growing companies. His articles have been published in *Valuation Strategies*, *M&A Today*, and *Mass High Tech*. He has been a panelist at national conferences on the subject of common stock appraisals for IRS regulation 409A.
The use of inventory as one of the independent variables in the multiple regression model is problematic. Inventory is typically valued separately by the buyer and seller and transacts on a dollar-for-dollar basis, often after the closing. The selling price of a business’s fixed and intangible assets won’t change depending upon the value of the inventory, even when there is either excess or deficient amounts of inventory. Therefore, even though inventory values are correlated and associated with selling prices (larger companies have bigger selling prices and inventories), inventory itself is not a value driver and therefore, should not be in the regression model.

I also take issue with using fixtures as an independent variable in the multiple regression model. The use of fixtures is problematic for two reasons. One, we don’t know whether the value given for fixtures is book value from the latest balance sheet or the allocated price in the P&S. If the latter, we all know that since fixed assets have shorter depreciable lives for tax purposes than do intangible assets, they are allocated an amount that is higher than their actual fair market value. So, in either case, the wrong values are assigned to fixtures—book value is too low, and allocated price is too high. But more importantly, fixtures should not be included in the regression model because they are in the selling price and the analyst would be creating a tautology, or a circular reference. How easy it would be to predict selling prices if we only knew the value of the fixed and intangible assets!

Which model to use will require the use of reasonableness, common sense, and informed judgment.

Kudos to Mr. Hall for insisting that a company’s degree of profitability (its return on sales) be taken into account when developing a multiple of sales, for certain, and even in some circumstances when developing a multiple of cash flow. However, I would caution the reader that these ratio models (price/revenue versus SDE/revenue, and price/SDE versus SDE/revenue) are not substitutes for each other and are applicable only in certain situations. Which model to use in any particular situation cannot be automated by some computer program, but will require the use of reasonableness, common sense, and informed judgment.

I also wish to address the weighting of the results of the three different models by using R-squared as the weighting factor. There is nothing in the regression literature to support this procedure, and better ways exist for combining forecasts, such as regressing—in a multiple regression model—the observed selling prices against the predicted selling prices of each model. Therefore, the use of the revenue multiplier model and the cash flow multiplier model together in a valuation assignment is often inappropriate because the analyst will need to choose the more suitable of the two models. This will leave the analyst with only one regression model for the market approach. And this is OK—we use only one model in the income approach, as the single-period capitalization model is mutually exclusive with the multiperiod DCF model.

I appreciate this opportunity to comment on Mr. Hall’s article and look forward to reviewing more of his website content on this topic.

Sincerely,

Mark G. Filler, CPA/ABV, CBA, AM, CVA
Court Favors Expert Over Owners in Dissenting S/H Dispute


Ten days before his death in 1998, the owner of an unincorporated trash removal business wrote and signed a document purporting to allocate his interests among his two grown sons and his fiancée (who also owned a separate sanitation business). In this writing, he indicated his desire for the three to equally split the profits from an existing contract with the city until its renewal in 2007, when the fiancée would inherit it and all remaining assets exclusively.

After his death, the sons and fiancée incorporated the business, with each owning a one-third interest. The fiancée became the president of the company, in charge of all daily operations, and the two sons remained passive shareholders. After the city renewed its contract, the shareholders met to dissolve the corporation, transferring all of its assets to the fiancée’s separate company. One son dissented and sued the company for the fair value of his interest under state law (North Dakota). The company counterclaimed for unjust enrichment, based on an implied oral agreement among the parties. The trial court dismissed this claim and, based solely on the son’s expert evidence, valued the company at just over $550,000, awarding him a third. The majority shareholders appealed, arguing that the trial court erred in its finding on the oral contract as well as its exclusion of their testimony regarding value.

No written agreement. The “linchpin” of the defendants’ claims on appeal was their reliance on the unwritten agreement to pay the plaintiff one-third of the annual profits from 1998 until the company’s dissolution in 2007. This partial performance was sufficient to remove the oral contract from the statute of frauds, the majority shareholders argued, and enforce it against the son.

However, under state law, any act of partial performance must be consistent only with the existence of the alleged contract, the appellate court ruled. “It is certainly not uncommon … for a passive shareholder in a closely held corporation to receive a share of the profits, and distribution of corporate profits to shareholders is expressly provided for in [the state statute].” The son’s acceptance of his share of the profits, even while doing no work for the company, was “entirely consistent with the benefits routinely afforded to a passive shareholder.” Moreover, if the parties had intended to limit the duration of the corporation or provide for a specific distribution of the assets, they could have included such provisions in the 1998 articles of incorporation, instead of claiming “some nine years later” that the former fiancée would inherit all the assets, the court said, in barring her claims based on an implied agreement.

In considering the valuation evidence, the court first noted the “contentious” discovery in this case. More than three months before trial, for instance, the plaintiff disclosed his expert valuation witness, but the defendants did not depose the expert or request the bases for her opinion (which are not subject to mandatory disclosure under state law). They also failed to appear at the deposition of the company’s CPA and refused to turn over the necessary financial information until the last minute, causing the plaintiff’s expert to finish her report the day before trial. When they subsequently objected to her testimony, claiming surprise and prejudice, the trial court found they had essentially sat on their discovery rights for more than three months. It denied their request to continue the case for a day to locate their own expert witness and permitted the plaintiff’s expert to testify.

Valuation was key. Under these facts, the defendants “had ample opportunity to secure
their own expert before trial," the appellate court observed. Further, the case had been pending for more than two years, and “it was clear at the outset that valuation of the corporation would be a key issue in the case.” The defendants also knew about the plaintiff’s valuation witness, yet “then claimed surprise and sought a continuance when [the expert], as promised, was called” to testify. Any prejudice was caused by the defendants’ own choices, the court held, in affirming the trial court’s evidentiary rulings.

In considering the expert’s evidence at trial, the appellate court noted that she testified “at length” about her methodology in reaching the $550,000 fair value for the corporation. Hers was also the only evidence of value as of the valuation date (the 2007 dissolution of the corporation). By contrast, one of the majority shareholders (the other son) “believed” that the company was worth between $250,000 and $275,000, based on its lower profits in 2008 and 2009. When the former fiancée tried to testify that the company was worth only $275,000, the trial court barred her testimony, because she had refused to give a specific value during her deposition.

On appeal, the defendants argued that the trial court must have “forgotten” about this evidence of value, pointing to language in its final orders concluding that the $550,000 value by the plaintiff’s expert was the “only” evidence of fair value for the company. The defendants also argued that the trial court should have considered the 2008 and 2009 profits in its valuation.

The appellate court overruled both points. The statutory fair value scheme “clearly indicates that post-event occurrences have no bearing on the valuation of stock to be awarded to a dissenting shareholder.” Rather, this value is to be measured immediately before the effective date of the controlling corporate action—in this case, the 2007 dissolution. The trial court clearly stressed that the expert’s testimony was the “only” valuation of the company as of this date. Any other reading “fundamentally misunderstood” the statutory remedy available to a dissenting shareholder, which entitled him to the fair value of his shares as of the effective date without considering the profits earned as being from “a different corporation, operating with different management practices and under different circumstances, in subsequent years,” the appellate court held, and affirmed the award.

Divorce Experts Dispute DLOM in Valuing Pharmacy

Taylor v. Taylor, 2012 N.C. App. LEXIS 304 (March 6, 2012)

For 20 years of their marriage, the parties owned and operated a hospital pharmacy. During their divorce, each retained experts to value the business. After considering the three traditional valuation approaches (income, market, and asset), both experts agreed that a capitalization of earnings method would best value the business, but they disagreed on certain data and assumptions.

For instance, the husband’s expert relied on only two years of earnings to value the pharmacy at $211,000. By contrast, the wife’s expert relied on a five years of earnings, which he said was “the typical number of years used for business valuation.” He also used a higher capitalization rate than the husband’s expert (the appellate court opinion does not specify the rates used by either expert). He believed the higher cap rate was appropriate based on the three specific risk factors: 1) the husband had become disabled, leaving the wife as the “key person” to run the business; 2) the pharmacy’s contract with the hospital had a termination clause; and 3) there was a relatively short term remaining on the contract.

As a final step, the wife’s expert applied a 20% discount for lack of marketability (DLOM) due to the costs and difficulty of finding a buyer for the business. Overall, his calculations resulted in a value of $107,350.

**Fair market value is the standard.** After considering the conflicting expert testimony, the trial court noted that the applicable marital dissolution statute (North Carolina) required determining
a fair market value for the business. Based on the traditional “willing buyer/ willing seller” definition, the court found that the $107,350 value, as calculated by the wife’s expert, was more appropriate, and the husband appealed.

Essentially, the husband argued that “his expert [was] correct in his valuation of the business and that [the wife’s expert was] wrong,” the appellate court explained. However, the credibility of expert testimony fell within the discretion of the trial court as the finder of fact, and in this case, the lower court clearly decided that the wife’s expert presented the more accurate valuation.

The husband also claimed that the trial court erred by applying a marketability discount to the value of the business and cited case law from other states’ jurisdictions in support. However, this argument “overlooked” a North Carolina case, Crowder v. Crowder, 556 S.E.2d 639 (2001)(available at BVLaw). This case specifically upheld the application of a DLOM in valuing a marital business, “if substantiated by the evidence.” In the present case, the wife’s expert “provided the necessary evidentiary support for use of the lack of marketability discount,” the appellate held, and affirmed the $107,350 value for the pharmacy.

Lost profits even more costly and contentious. The plaintiff also sued the defendant in federal district court (S.D. N.Y.) for consequential damages, including loss of use (lost profits). Since the defendant had already admitted fault, only two issues remained: 1) the reasonable certainty of the damages claims; and 2) the extent of the loss period. In support, the plaintiff presented its president/CFO as well as several project managers and marine survey engineer to testify as industry experts. The plaintiff also retained a credentialed financial analyst (CPA/ABV, CBA, CVA, and CFE) to present its lost profits damage.

To build his lost profits model, the damages expert met with many of the plaintiff’s personnel and reviewed the company’s books to make sure the financial information was fair, reasonable, and supported by audited results. In particular, he found:

• The super-powerful dredge had earned revenues in every year since its construction in 1999, posting a historic utilization rate of 51% through 2006.

• Demand rose substantially in 2007, after a major competitor lost a similar dredge at sea and the U.S. Army Corps of Engineers initiated its New York Harbor Deepening Project, for which it allocated $2 billion over eight years.

• A “bidding analysis” by the expert showed that the plaintiff obtained a large share of deep port projects—winning 95% of its bids in 2007 alone.

• In fact, the plaintiff’s dredge posted a 92% utilization rate for the 85 days leading up to the allision, and was able to maintain this rate after it came back online and until the date of trial, for a total of 577 days at the 92% rate.

• At the time of the allision, the plaintiff’s dredge was working on two contracts for the Army Corps, one for 310 days and the other for two years. After the dredge...
was dry-docked, the Corps awarded a 950-day contract to another dredger. Once repaired, the plaintiff’s dredge finished its two contracts and picked up work on the third, although all three were delayed by the damages period.

• Once the New York harbor project is done, several other East and West Coast ports will require dredging to keep them competitive with international ports. Recent developments in the liquid natural gas (LNG) markets have also created demand for capital dredging projects that only the plaintiff’s excavator can perform.

A dredge is not a cup of coffee. “Why wouldn’t it generate revenue during this eight-month period [of repairs], especially recognizing that there is increased demand and reduced supply?” the expert explained to the court. In addition, he testified:

[Since] this is not a Starbucks, the lost profits [are] even easier to calculate.... This is a very valuable piece of equipment. It has significant efficiency in the marketplace of dredging. It has been utilized almost consistently on an annual basis every year since it was commissioned. It’s the unique dredge of its size and ability in the United States [outperforming its remaining competition].... And so there are significant opportunities all over the world for a dredge of this capability.

Based on the “credible and compelling” testimony, the court found that there was a “robust” national and international market for the type of dredging that the plaintiff’s excavator could perform. It also found that except for the defendant’s allision, the plaintiff would have employed its dredge at the 92% utilization rate and would have completed its existing contracts sooner before moving on to additional, available contracts. “This would have kept the dredge operational and generating revenue during virtually all of the 194-day repair period and more productively employed during the 24-day startup period,” the court held, in concluding that the loss period lasted 218 days.

Finally, the court credited the expert’s calculation of lost profits based on the 92% utilization rate as well as other factors, including the variable costs that the plaintiff would have incurred during the loss period as well as the earnings that would have been attributable to other pieces of equipment. All told, the expert concluded that the lost profits associated with the 218-day repair and startup period equaled $11,736,645—which the court adopted in full, awarding the precise amount to the plaintiff, plus interest.

**Patent Damages for ‘Lost Opportunity Value’ Pass Daubert**


The plaintiff developed a patented technology for use in substance abuse screening devices (such as those used in the criminal justice system). In 2004, the plaintiff agreed to custom-build drug impairment systems for the defendant to distribute under the name “PassPoint.” Under the contract, the defendant paid a specific price for the screeners plus a 10% royalty for the service fees that it charged purchasers.

**Dueling Daubert motions.** Within a year of executing the contract, however, the defendant began to build and distribute its own substance abuse screener under the name “PassPoint.net.” The plaintiff terminated the contract, sued the defendant for patent infringement, and retained an expert to calculate damages under a “lost opportunity value” analysis. The defendant also retained an expert to rebut this analysis and present a competing estimate of damages. Prior to trial, each party challenged the other’s expert under Daubert.

In particular, the plaintiff asserted two reasons for disqualifying the independent calculations by the defendant’s expert. First, it claimed the expert’s application of the Georgia-Pacific factors “improperly usurped the role of the
court.” Second, since the witness had no expertise in negotiations, he was not qualified to opine on the “hypothetical negotiations” that Georgia-Pacific advocates for use in patent cases.

The district court agreed that Georgia-Pacific Corp. v. U.S. Plywood Corp., 318 F. Supp. 1116 (S.D.N.Y. 1970) is a “seminal case in patent law” that articulates 15 factors that courts may consider when determining reasonable royalty damages. Although the trier of fact makes the final determination of damages, their estimation is an issue for which courts “time and again” seek the assistance of experts. In this case, the defendant’s expert clearly discussed the Georgia-Pacific factors in relation to the facts and not as questions of law, and the court dismissed the plaintiff’s first argument.

The Georgia-Pacific factors also provide an analytical “framework” for envisioning a hypothetical negotiation between the parties; as such, the process falls within the “bailiwick of experts,” the court found. In its second argument, the plaintiff was attempting a “sleight of hand” by focusing on the tool employed by the expert rather than his area of expertise, it added, with emphasis. Since the plaintiff did not challenge the expert’s credentials as a damages expert, he could testify within the bounds of his expertise, the court said, which “includes using the tools of the trade” to “imagine a hypothetical negotiation to determine a reasonable royalty rate.”

Finally, the framework for a hypothetical negotiation in patent cases relies on fixed, artificial assumptions, which differ substantially from those in a “real world” negotiation. Because of this artificiality, the plaintiff’s arguments regarding the expert’s lack of negotiating experience were “misplaced,” the court ruled, and admitted his reasonable royalty estimate for damages purposes.

Alleged errors in rebuttal report. In challenging the expert’s rebuttal evidence, the plaintiff advanced three arguments. First, the expert’s background was not identical to the background of the plaintiff’s expert. Second, the expert’s rebuttal report improperly relied on an associate’s work. Third, the report contained factual sections that did not constitute rebuttal.

The court summarily dismissed each challenge. “There is no requirement that experts share identical backgrounds to be able to opine on the same subject,” it ruled. Likewise, “courts in this circuit and across the country have consistently held that an expert may rely on the work of others when preparing an expert report,” particularly when other experts in the field typically rely on such work and when, as in patent cases, the calculations can be complex.

In this case, the defendant’s expert testified repeatedly in deposition that he supervised his associate’s preparation of certain sections of the rebuttal report, including those that critiqued the discounted cash flow analysis used by the plaintiff’s expert. Although the expert relied on the associate’s work, he was the “ultimate author” of its findings, he said, and the court found no reason to bar his testimony. Similarly, it found the factual sections of his report provided a reasonable context for his opinions and dismissed all of the plaintiff’s Daubert claims.

Georgia-Pacific remedy is not exclusive. Turning to the defendant’s challenges to the plaintiff’s damages expert, the court found as a preliminary matter that he was qualified due to his education, credentials, and experience. On a more substantive level, it considered whether the expert’s “lost opportunity value” analysis was admissible because it “veered from the well-trod path of court-approved patent damages methods,” particularly the Georgia-Pacific framework and a lost profits analysis.

The Federal Circuit has “repeatedly endorsed” the use of the Georgia-Pacific factors as well as a lost profits analysis in patent infringement cases, the court acknowledged. However, these two methods are not the “only” permissible means to calculate patent damages. Indeed, the Federal Circuit has ruled that an appropriate measure of damages is “highly case-specific” and “fact-specific.”
In this case, the plaintiff’s expert did not expressly discuss or apply the Georgia-Pacific factors, but he used a “lost opportunity” value to estimate a 13.5% licensing fee. This appeared to be tantamount to a reasonable royalty rate, but differed by capturing income that the plaintiff could have made, had it made the same investments in marketing and sales that the defendant made in its infringing product. Given the facts of the case, the expert’s approach was, at very least, relevant and reliable, the court held. At best, it “might in the end be a better method for calculating damages than the traditional methods.” Any objections to the expert’s assumptions or bias went to the weight rather than the admissibility of his opinions, and the court admitted his lost opportunity value analysis for trial.

Reasonable Comp. Is Focus of Restaurant Value in S/H Litigation

Hubbard v. Phil’s BBQ of Point Loma, Inc., 2012 U.S. Dist. LEXIS 41884 (March 27, 2012)

A 10% shareholder in a new restaurant accused his two fellow owners of mismanaging the business; they counterclaimed for fraud and also brought an action in federal district court to dissolve the corporation under California law. To award the dissenting shareholder his share of the business, the applicable statutory scheme required the court to appoint appraisers and hold a hearing to determine the fair market value (FMV) of the corporation as a going concern.

Three appraisers reach consensus. Accordingly, the court sought nominations for appraisers from the plaintiff (the dissenting shareholder) as well as the defendants, who together owned 90% of the restaurant. After appointing these two appraisers as well as its own, the court instructed the three experts concerning the statutory standard for valuing the restaurant as well as the procedures for their report; in particular, it permitted the appraisers to submit a single report, with notations of any specific disagreements.

Each of three appraisers received financial data and other pertinent information from the parties. They visited the restaurant and interviewed the owners as well as the employees; all three attended the personnel interviews. Ultimately, the appraisers were able to agree on all key approaches, assumptions, and adjustments. For instance, they calculated the restaurant’s value using both the market approach (multiple of EBITDA) and a hybrid approach (income/market), using the value of excess earnings. They considered but rejected other approaches, including a discounted cash flow (DCF) analysis due to the startup nature of the business. They also assumed a long-term sustainable growth rate of 3% as of April 2009, which excluded certain expansion plans that they believed were too speculative at the time.

In terms of normalization adjustments, the appraisers agreed that one of the defendant owners was acting as the restaurant’s chief executive officer (CEO) while the other, in spite of his title as chief financial officer (CFO), was in fact acting as chief operations officer (COO). The appraisers treated current owners’ compensation (for the plaintiff, CEO, and COO) as profits, but at the same time, assumed that a hypothetical buyer would have to pay a reasonable amount to hire replacements. To determine this amount, the appraisers reviewed executive compensation surveys from the Economic Research Institute—specifically, data pertaining to San Diego corporations with comparable revenues to the subject restaurant—and concluded that a CEO and COO in this particular business would command a total of $460,000 in annual salaries. They also counted the compensation for a market consultant ($150,000), who was essentially hired to replace what the plaintiff had done, as an ongoing expense.

In the end, after performing all calculations and adjustments, the appraisers unanimously agreed that the fair market value of the restaurant as a going concern was $3.97 million, making the plaintiff’s 10% share worth $397,000.

Objections to adjustments. The plaintiff claimed the appraisers undervalued the
restaurant by overvaluing the salaries of the CEO and COO and by failing to account for future growth. Based on his review of job descriptions and their related salaries from the Bureau of Labor Statistics (BLS) for California, he agreed with the CEO designation but argued that the COO was in fact “nothing more than a head cook who also did payroll,” such that his replacement salary would have been much lower, leading to a total of only $195,000 to replace these two positions. He also believed that, similar to the way the appraisers “backed out” his salary, they should have done the same with the marketing consultant’s salary and adjusted profits accordingly.

The plaintiff also faulted the appraisers’ valuation approach, arguing that they “overlooked” the discounted cash flow analysis and should have increased long term the growth rate based on the restaurant’s expansion plans. In response to these objections, the defendants simply endorsed the appraisers' report, urging the court to treat it as analogous to a binding arbitration award. However, the applicable business code did not require the court to give the report the same deference as it would an arbitration award; in fact, if the court found any errors in the appraisal, it was obliged to “fix the correct value itself,” it said. On the other hand, the court could confirm the award if it found that the appraisers considered the “right facts” and used the “right” valuation methods to reach “valid conclusions.”

In this case, the consensus with which the three appraisers reached their ultimate value “carried some weight” in the court’s analysis. Overall, it found their reliance on ERI salary data to be better-founded than the plaintiff’s reliance on BLM data, largely because the BLM data were too general, merely listing median annual income for people with broad job titles, compared to ERI’s data, which accounted for the size of the business.

The court also credited their assessments of individual job descriptions and duties, in particular because all three appraisers conducted “face-to-face” interviews with the restaurants personnel and visited the site. Moreover, their report mentioned no concerns about overstaffing or excessive compensation; as a result, the court agreed with the appraisers’ treatment of the marketing consultant’s position, finding it likely that his services would be ongoing. Thus it was reasonable to expense the consultant’s compensation but to “back out” the plaintiff’s, particularly since he would no longer be working for the restaurant.

**A well-reasoned report.** Finally, the court found that the appraisers’ valuation “properly considered probably growth, not speculative growth,” and appropriately discounted a DCF analysis due to the restaurant’s lack of historic cash flows. Overall, their report was “impressively thorough” and “very well-reasoned and well-founded,” the court said, and adopted the appraisers’ $3.97 million value for the restaurant and the corresponding $397,000 value for a 10% share.

**Well-Planned FLP Survives IRS Challenge**

*Estate of Kelly v. Commissioner, T.C. Memo 2012-73 (March 19, 2012)*

It’s hard to imagine a better set of facts supporting the formation, funding, and operation of a family limited partnership (FLP). In 1990, a widow inherited her husband’s quarry business plus additional real property and stock. Shortly thereafter, she executed a will leaving many of the specific assets to her three grown children, dividing the residual equally among them.

Over time, the value of the specific bequests changed, and the assets became exposed to potential liability. By then, however, the decedent was suffering from Alzheimer’s. Without knowing the contents of the will, the three children (who all managed the family businesses in various capacities) agreed to divide their mother’s estate equally and petitioned the probate court to become her co-guardians. When they discovered the unequal bequests—which would have required the recipients to issue disclaimers to effectuate an equal division—the children approached an estate planning attorney.
Three FLPs plus a corporate GP. The estate attorney advised the creation of three FLPs, one for the benefit of each grown child, plus a corporation to serve as general partner (GP) for all three. Each FLP would receive equal assets, while the mother would retain over $1.1 million in a separate guardianship account for her living expenses. Under this plan, the property that would otherwise pass to the children as unequal bequests would convert to equal devises of partnership interests, passing to them pursuant to the residual clause of the mother’s will.

In petitioning the probate court for approval, the children described the plan’s “simple” solution to allocating the assets without the need for a complex series of disclaimers and the potential for disputes. The corporate GP would also receive a “reasonable management” fee for its services, thus ensuring that the mother (who would own all the stock in the corporation) would receive “adequate income to cover [her] probable expenses for support, care, and maintenance for the remainder of [her] lifetime.” Finally, they noted the plan should reduce estate taxes by nearly $3 million.

The probate court approved the plan in June 2003, and the mother (acting through her children as co-guardians) executed three FLPs, funded with equal values of property and stock. The mother retained a 99% limited partnership interest in each FLP, with the remaining 1% allocated to the GP. To determine a reasonable management fee for the GP, the children created a job description and consulted with banks as well as local businesses. Ultimately they decided on a fee that ranged from 0.7% to 1% of the FLPs’ net asset value, or slightly lower than the going rate of 1.2% to 2%.

In December 2003, the mother transferred equal values of stock and other property to the FLPs. Over the next three years, she gave partnership interests to the three children, with appropriate entries to her capital accounts. During the same time, the children collectively put in 60 to 80 hours per week to maintain the properties and the accounts. They also met regularly as officers and directors of the corporate GP and kept minutes of these meetings, at which they discussed operations, approved budgets, and reported the financial status of all entities. For their work, the corporate GP paid each of the children an annual salary of just over $21,000.

In 2005, the mother died. Her federal estate tax return reported her remaining ownership interests in the FLPs as well as her full (100%) ownership of the corporate GP. Three years later, the IRS assessed a deficiency of just over $2.2 million, based on its determination that the full fair market value of the FLP assets should be included in the decedent’s estate pursuant to IRC Sec. 2036(a). In response, her estate argued that the decedent’s transfer of assets met the “bona fide sale” exception to Sec. 2036(a) because she had “legitimate and significant nontax reasons” for creating the FLPs and because she received partnership interests proportionate to the value of the transferred property.

Estate (but not tax) planning is paramount. In analyzing the decedent’s transfers, the Tax Court found several facts that substantially supported her position:

- Long before the probate court petition, the decedent (acting through her children) made it clear that her primary concern was “to ensure the equal distribution of [her] estate, thereby avoiding litigation.”
- She was also “legitimately concerned” about the effective management of, and potential liability related to, her specific assets, the court said.
- By setting up the corporate GP, her children were able to manage the assets as individuals rather than co-guardians.
The decedent received partnership interests equal in value to the assets she contributed to the FLPs, and her contributions were properly credited to her capital account.

Moreover, the nature of the properties involved—including multiple rental homes, a post office, and a rural property—“would lead any prudent person to manage the assets in the form of an entity,” the court observed. Although the probate court petition references estate tax planning, “there is no evidence that tax savings motivated the defendant,” the court held, in finding that the value of the FLP transfers fell within the bona fide sale exception to Sec. 2036(a).

As a second argument, the IRS claimed the parties had an implied agreement that the decedent would continue to enjoy the income from the FLPs during her lifetime. In particular, the FLPs’ agreement to pay a management fee to the corporate general partner demonstrated “an express retention of income by the decedent,” the IRS said, citing the provisions of the probate court petition that explained how the decedent would use these fees to pay her living expenses.

The court rejected both arguments. “The decedent respected the partnerships and the corporation as separate and distinct legal entities, observed partnership formalities, and retained sufficient assets for her personal needs,” it held. The court also found no authority (and the IRS cited none) that the retention of an income interest in the general partner permitted the decedent to retain an economic interest in the FLP assets. Indeed, evidence showed the fees that the FLP paid to the GP were lower than the industry standard. Further, the language of the probate petition that provision of these fees would help ensure the decedent’s support was “merely an expression of financial benefits the decedent could receive” the court said; it was not a “legally binding directive to provide her support and maintenance.” To do so would have violated the partnership agreements as well as the general partner’s fiduciary duties.

Even more important, the creation of the corporate general partner “changed the decedent’s rights to, and relationships with, the contributed assets,” the court ruled. Not only did the decedent have a bona fide purpose for creating the FLPs, she also had a bona fide purpose for creating the corporation to manage them, and she appropriately reported the full value of the corporation on her estate tax return. Based on all these facts, the court excluded the value of the FLPs from the decedent’s gross estate.

Court ‘Surprised’ by Lack of Expert to Prove Losses to Employee Benefit Plan


The Hollister company, a wholly owned subsidiary of a privately held corporation, has manufactured medical devices since the 1970s. In 1974, the founder of both companies established an employee share ownership plan (HolliShare), whose operational mandate was to invest plan assets solely in shares of the parent company. The plan’s investment strategy proved successful; from 1977 through 2010, the mean average increase in the company’s share price was nearly 27% each year, well outpacing the 8% average annual increase of the S&P 500 Index.

1980s oral agreement. The company’s stock is highly restricted and subject to an extremely limited market. In particular, the articles of incorporation subjected any transfer of shares to the company’s right of first refusal at book value, calculated at the end of the calendar month in which the repurchase occurred. The articles also permitted the company to pay for the shares with a combination of cash plus a promissory note.

The plan maintained its liquidity by having the company periodically repurchase its stock. Since ERISA prohibits an employer to pay a qualified plan with a promissory note, all payments had to be in cash. During the mid-1980s, the plan agreed to provide the company with advance projections of its cash needs, such that the
company would only have to repurchase stock once a year. The company agreed to repurchase all the shares the plan needed to sell, at a value equal to the audited book value from December 31 of the prior year. Neither this agreement (the mid-1980s agreement) nor its terms was ever put into writing, including—importantly—the repurchase price, which differed from the price set out in the articles of incorporation. Annual plan reports also led participants to believe that the company was repurchasing stock at month-end book values rather than year-end book value.

As a result of this discrepancy, in 2004, several former employees and plan participants sued the company, its officers, and plan trustees for alleged ERISA violations. Essentially, the plaintiffs claimed the company should have repurchased plan shares at either 1) the month-end book value following the repurchase date; or 2) fair market value. By using the prior year-end book value, however, the defendants breached their ERISA fiduciary duties, the plaintiffs said, causing them “extraordinary” losses.

As a preliminary matter, the federal district court found that ERISA’s statute of limitations barred any claims prior to 1992, largely because the plan reports didn’t clearly mislead participants about the repurchase values. Beginning in 1993, however, revisions to the plan reports could have led participants to believe that the company would fulfill its repurchase obligations by using fair market value or at least month-end book values, such that a reasonable participant would not have made further inquiries. Accordingly, the court allowed the plaintiff’s post-1992 claims to proceed.

**Trustees never retained an independent appraisal.** ERISA generally prohibits a sale or transfer between a qualified plan and an employer, unless the transfer is for “adequate consideration.” When the transfer consists of private securities without access to a recognized market, adequate consideration means “the fair market value of the asset as determined in good faith by the [plan] trustee or named fiduciary pursuant to the terms of the plan.”

In addition to these requirements, ERISA also imposed the “highest duties known to law” on plan fiduciaries, the court stated. Case law has interpreted this standard to require trustees to, “at a minimum ... engage in an intensive and scrupulous independent investigation of their options to insure that they act in the best interests of plan beneficiaries.” Moreover, if the fiduciaries do not have all of the knowledge and expertise necessary to make a prudent decision, they have the duty to obtain independent advice, and such advice is evidence that the fiduciaries’ investigation was sufficiently thorough.

Under this standard, the plaintiffs claimed the Hollishare trustees breached their duties not only when they failed to determine whether the year-end book value of the plan’s shares would generate a repurchase price equal to “adequate consideration,” but also when they subsequently sold the shares at that value, for what amounted to less-than-adequate consideration.

At trial, the plan trustees testified consistently that, pursuant to the mid-1980s agreement—which came about due to “severe financial strains on the company”—they had always agreed to the company’s repurchase of stock at year-end book values, as determined by its finance department. They also admitted that they never attempted to determine whether the year-end book value was equal to the fair market value of the plan stock; nor did any trustee adequately explain to the court how the circumstances giving rise to the mid-1980s agreement justified their collective and “unquestioning adherence” to its terms, which they never tried to renegotiate.

Further, as the district court pointed out, trial testimony demonstrated that no trustee had a complete or consistent understanding of the “amorphous” agreement that set the price of the plan’s “most valuable asset.” Despite this lack of understanding, no trustee had ever attempted to determine the fair market value of company shares or requested, let alone obtained, an independent appraisal of the stock by an outside auditor. In fact, it appeared that the first-ever appraisal in Hollishare’s history was done at the request of the defendants’ attorneys in this case,
and yet even the current, acting trustee—who knew about the litigation and the appraisal—did not request to review it.

At least one former trustee testified that he knew an outside appraiser had conducted a valuation of the company as part of its termination of preferred stock in the 1970s. This appraisal suggested that the market value of company stock was at least worth 3.4 times book value. “Of course, a valuation of [company] stock without ownership restrictions was entirely hypothetical because the shares … could not be sold on the public market,” the court observed. “In receipt of such information, however, a prudent fiduciary would at least inquire whether an outside appraiser would value [the] stock above book value, even without the restrictions.”

Only one trustee, who had a finance and accounting background, used a sensitivity analysis to try to determine whether the use of year-end book values made a “significant difference to the overall operation of the plan.” He did not, however, use his analysis to question whether the repurchase prices that used year-end values constituted “fair market value.”

From this testimony, the court’s “overall impression” was that the plan trustees “never meaningfully questioned the disparity in price between Hollishare’s sales and individual shareholders’ sales that occurred in the same month.” Nothing precluded the trustees from obtaining an independent audit of a month-end book value and, because sales generally occurred only once a year, “the burden of obtaining a single, updated valuation based on the annual audited valuation would not have been unbearable.”

The court also found, given the plan’s requirement of cash payments for its stock and the company articles providing for payment by promissory note, “that the cash payment could detrimentally affect the value of Hollishare’s shares” Nevertheless, no trustee ever tried to quantify how the plan’s cash needs might have affected the fair market value of its stock holdings. Similarly, no trustee ever attempted to quantify the amount by which the substantial restrictions on the stock impacted its fair market value.

Based on these facts and findings, the court determined the trustees failed to carry their burden of proving that they fulfilled their ERISA fiduciary duties.

Plaintiffs fail to request a remedy or obtain an expert. Despite these findings, the plaintiffs were unable to articulate the specific remedy they were seeking at any point during the trial. When they finally did in post-trial pleadings, the plaintiffs requested damages equal to either: 1) the difference between the actual price paid for the plan stock and the subsequent month-end book value; or 2) fair market value of the shares at the time the sale occurred, as determined by an independent appraiser. This appraiser could be obtained by a new, court-appointed trustee for the plan, the plaintiffs suggested. They also put forth various calculations of damages requests ranging from roughly $30.7 million to $244.4 million.

The court did not detail the basis for their damages calculations; nor would it grant the plaintiffs’ request to appoint a new trustee. “This case has been pending since … 2004,” the court observed. “Plaintiffs have had more than ample time and opportunity to prove their case and could have retained experts to testify at trial about the exact calculations they are asking a court-appointed trustee to calculate.” Equally “surprising,” the court said, during four weeks of trial, neither party had presented “a single expert witness” to estimate the value of company stock at the time of each sale.

In fact, the only expert evidence that the plaintiffs presented was limited to the fair market value of the company stock on a single date (Dec. 31, 2003, or just prior to the filing of the lawsuit). For this appraisal, the plaintiffs’ expert relied on both the market and income approaches to value the company’s shares and then applied a 15% discount for lack of marketability. The appraiser also relied on two key assumptions: that the plan would not have to sell its shares at book value (even though it was still using book value for
direct purchases under the company’s right of first refusal), and that the company would buy back its shares at “fair market value.” The court rejected both of these assumptions as flawed, finding that a valuation of company stock would not vary so “drastically” between plan sales and sales by direct shareholders.

Defendants did retain a reputable expert. Importantly, the only credible testimony at trial concerning the company and plan value came from the defendants’ expert, a long-time appraiser, member of the ASA, and author of five books on business valuation. In his opinion, the fair market value of the company’s stock during the relevant time period equaled the “formula price,” or book value. Historical practice not only corroborated this value, but so did the substantially limited market. “No reasonable financial investor would pay more,” the expert told the court.

The expert’s appraisal did not distinguish between using year-end book values versus month-end book values; at the time defense counsel solicited his opinion, the plaintiffs had yet to articulate this theory of the case. The court still found the expert’s discussion helpful, however, particularly with regard to the factors that would impact the stock’s value. The court also put the blame for any deficiencies in his valuation (as well as the valuation performed by the plaintiff’s exert) squarely on the parties’ respective attorneys and their “failure to request opinions on the relevant issues and ensure that the experts did not rely on assumptions that rendered their [ultimate] opinions irrelevant.”

Despite the lack of expert testimony on value, the weight of all the evidence persuaded the court that fair market value of the plan stock did not exceed the year-end book value for any given transaction. By themselves, the severe restrictions on the stock suggested that no eligible, authorized purchaser “would have been willing to purchase stock from Hollishare at a price that exceeded [year-end] book value,” when the only other “market” for the shares (created by the articles of incorporation) was set at year-end value. “It is at least possible that the fair market value of those shares was the [year-end] book value,” the court said. That this select group of purchasers could also receive payment in the form of a promissory note further supported the court’s conclusion; at least one shareholder testified that when he sold the company’s promissory note to the bank, he received only 90% of principal value.

Moreover, even if the court assumed that the fair market value of the plan’s shares at the time of each sale exceeded year-end book value, it still found that these sales did not cause material harm to the plan or have a prolonged detrimental effect. In particular, and based on testimony from the defendants’ expert, the court found that the “principal driver” of the plan’s value was its incremental changes from year to year rather than its overall market value. Any variability that occurred in book value of the company stock was actually “a lot lower than” the volatility displayed by public company comparables, according to the defendants’ expert. As he explained:

So there’s a continuous change in how the value of the plan changes, but it’s really the incremental change. If book value goes up the same amount in percentage terms as market value goes up, [then] the relative wealth at the end will be the same, the relative benefit to the participants.

As a result, “the benefits the participants received would have ultimately been the same regardless of whether the book value was used,” the court said, “or a hypothetical fair market value of two or three times book value was used.”

Ultimately, based on all the evidence and because the court found no material harm to the employee profit-sharing plan caused by the trustees’ breaches, it denied the plaintiffs’ claims for damages as well as their remaining claims and entered judgment on behalf of the defendants.
Del. Chancery Says ‘Suspicious’ Valuations Tainted Merger

*In re El Paso Corp. Shareholders Litigation, 2012 Del. Ch. LEXIS (Feb. 29, 2012)*

Just four months after criticizing investment bankers at Goldman Sachs for using a “relative” valuation technique to “dress up” a suboptimal deal into a fair one in *In re Southern Peru Corp.*, 2011 WL 4907799 (Del. Ch.)(see the December 2011 issue of *BVUpdate*), Vice Chancellor Leo Strine of the Delaware Court of Chancery charged Goldman Sachs with using “questionable” and “suspicious” valuations to exert a “troubling” influence over Kinder Morgan’s billion-dollar bid for the El Paso Corp.

**El Paso announces spinoff.** El Paso is an energy company that operates a natural gas pipeline business as well as an exploration and production (E&P) division. In May 2011, El Paso publicly announced that it would spin off the E&P business. In an attempt to preempt other bidders for the spinoff, Kinder Morgan offered El Paso $25.50 per share for the entire company. After consulting with its longtime financial advisors, Goldman Sachs, as well as an independent bank (Morgan Stanley), the El Paso board countered with an offer of $28.00 per share and sent its CEO to negotiate the deal directly with the Kinder CEO. By late September 2001, the chief executives had agreed on a $27.55 merger price, subject to due diligence by Kinder Morgan.

Just one day after setting the deal terms, however—as V.C. Strine recounts it—“Kinder said, ‘Oops, we made a mistake. We relied on a bullish set of analyst projections in order to make our bid. Our bad.’” Instead of telling the Kinder CEO “where to put his drilling equipment,” the El Paso CEO backed down and then continued to take the deal on a “downward spiral,” according to Strine, compromised by “debatable negotiation tactics” on the part of El Paso advisors as well as its principals. Included among these:

- Goldman Sachs stood on both sides of the transaction, ostensibly advising the El Paso board on the financial soundness of the Kinder bid (for a $20 million fee) while also owning roughly 19% of Kinder Morgan stock (worth nearly $4 billion).

- Goldman also occupied two seats on the Kinder board and was part of the control group that collectively held over 78% of the voting power of Kinder stock.

- More troubling still, the lead Goldman advisor to the El Paso board failed to disclose that he personally owned $340,000 worth of Kinder holdings.

- After Morgan Stanley was brought on to “cleanse” any perceived conflicts, Goldman was able to accomplish the “remarkable feat,” Strine said, of giving the new bankers an incentive to favor the merger by tying their fees to the completion of the deal.

- On the executive side, the El Paso CEO failed to disclose his “secret motive” for closing the deal, which involved making a post-merger management buyout of the E&P division.

In less than a month after Kinder reneged on its original terms, El Paso ended up taking a package that was valued at $26.87 per share as of the signing date (Oct. 16, 2011). The merger price, comprised of $25.91 in cash and stock and a warrant with a strike price of $40 per share, was $13 above Kinder’s then-current stock price and failed to protect against ordinary dividends. The merger agreement also contained a “no-shop” provision, preventing El Paso from soliciting other bids, permitting it only to take a “superior offer” for over 50% of its assets, on payment of a $650 million termination fee. This effectively precluded El Paso from spinning off its E&P division to a third party, because it comprised less than 50% of the consolidated assets and the substantial termination fee made the prospect even of selling its weaker pipeline division prohibitively expensive.
Despite these conditions on the deal, the proposed merger price was at a substantial (37%) premium to El Paso’s market value ($19.59 per share on the signing date). In fact, after the agreement went public, the price of Kinder’s share rose, thus increasing the merger price to $30.37 per share, or a 47.8% premium over El Paso’s then-trading price. Nevertheless, a group of El Paso stockholders sued to enjoin the merger, asserting numerous breaches of fiduciary duty based on the alleged conflicts of interest.

**Questionable decisions based on questionable values.** The court agreed that the El Paso board made “numerous decisions” during the negotiations that “could be seen as questionable.” These included the board’s failure to:

- Shop the company’s two divisions separately to any other bidder after Kinder’s first overtures, despite knowing that Kinder wanted to deflect other buyers from the attractive E&P division;

- Force Kinder to go public and face market pressure to raise its bid in a hostile takeover;

- Object when Kinder reneged on its original deal, based on the “arguably ludicrous” assertion that it relied on forecasts by one of the “most bullish analysts” covering El Paso’s stock;

- Negotiate deal protections that would permit a post-signing market check for better bids for the separate divisions; and

- Negotiate a deal that at least equaled the value of Kinder’s original offer.

As a result of these failures, the board was basically down to two options: sell the entire company to Kinder or spin off its E&P assets. Importantly, although the board attempted to “wall off” its conflicted Goldman advisors by bringing in Morgan Stanley, it still permitted Goldman to remain as lead advisor on any spinoff. Thus, Goldman “was in a position to continue to exert influence over the merger,” Strine explained, by revising its valuations of the spinoff downward during the Kinder negotiations.

For instance, using a comparable company’s analysis and based on enterprise value to earnings multiples, Goldman first valued the E&P assets at $8 billion to $10 billion in May 2011, when El Paso first announced its spinoff plan. By September 2011, when Kinder negotiations were well under way, Goldman said that declining EV/EBITDA multiples caused the E&P assets to lose another $1 billion in value; by October and the closing of the deal terms, their range of value had bottomed out at $6 billion to $8 billion.

By comparison, Kinder Morgan’s advisors valued the same assets as of late September 2011 at $7.86 billion. Moreover, aspects of Goldman’s valuations were “questionable,” Strine noted, because short-term volatility in commodity prices had depressed the market multiples, making them inadequate indicators of long-term value. Further, “solely looking to market multiples to generate a hypothetical trading value fails to take into account the control premium that could be achieved on the sale of the E&P business,” he said.

“Heightening these suspicions” was the failure by Goldman’s lead banker to disclose his ownership of Kinder stock, “a very troubling” lapse that tended to undercut his testimony regarding the soundness of the deal and the strategic advice that he gave the El Paso board, Strine said. “Even worse, Goldman tainted the cleansing effect of Morgan Stanley” by refusing to permit it to collect a fee if only the spinoff is consummated. In other words, if Morgan approved a deal (in which Goldman owned 19% of the acquiring entity), it received a $25 million fee. If it counseled the board to go with the spinoff or another option, Morgan got “zilch, nada, zero,” Strine said.

This fee incentive led to “odd” valuations by Morgan Stanley. For example, evidence suggested that Morgan used an unreasonably low terminal value for a portion of its discounted cash flow analysis of the El Paso pipeline business. That is, rather than use a perpetual growth model to calculate this terminal value, the Morgan analysts used a midpoint exit EV/EBITDA multiple of
10x, which resulted in a long-term growth rate of only 0.7%, “a rate less than half of the estimated rate of inflation (2%),” Strine emphasized. This assumption conflicted directly with testimony from the El Paso CEO, who insisted the pipeline business had strong growth potential. It also conflicted with the management forecasts used by Morgan Stanley, which included capital expenditures for both maintenance and growth.

The record also revealed that Morgan may have used internally inconsistent values for Kinder’s cost of equity, using a higher rate (11.8%) when benchmarking El Paso’s COE but using a substantially lower rate (7.5%) when valuing Kinder directly. This arguably skewed Morgan’s analysis in favor of the merger by overvaluing the stock portion of the Kinder price and undervaluing El Paso’s stock.

To enjoin or not to enjoin? Based on all the “distortions” of the deal and concealed self-interests of the key players, the plaintiffs were reasonably likely to prove that El Paso breached its fiduciary duty and that “more faithful, unconflicted parties” could have secured a better merger price from Kinder Morgan, Strine said.

“The question is what to do about it.”

Post-merger, monetary damages might not provide an adequate remedy, particularly since the board of largely independent directors (the El Paso CEO was the only insider) were shielded by an exculpatory provision in their charter and appeared to rely on their financial advisors in good faith. The CEO is a “wealthy man,” Strine observed, but “it is unlikely that he would be good for a verdict of more than half a billion dollars.” And though Goldman Sachs could be seen as an aider and abettor, “it has substantial, some might say government-insured, financial resources.” Kinder Morgan also bargained hard, as it was entitled to do. For these reasons, the plaintiffs were likely to incur irreparable harm without an injunction, the court held.

At the same time, the El Paso shareholders were due to vote on the deal within a couple of weeks of the court’s decision, or on March 6, 2012.

Thus the real question was whether the court should intervene in the balloting process, given that its opinion would fully disclose the tainted terms of the deal and no other bidder had come forward. In truth, the plaintiffs were also asking for an odd mixture of remedies, requesting the court to enjoin the merger while the company shopped itself in whole or parts but then lift the injunction should a better deal fail to materialize. That would not be fair to Kinder Morgan, Strine said, and “it is not real life.”

As a result, the court “reluctantly denied” the plaintiffs’ request for a preliminary injunction, concluding that the El Paso shareholders should have the chance to decide for themselves about the proposed merger, “despite the disturbing nature of some of the behavior leading to its terms.”

Editor’s note: As a result of Strine’s decision, the El Paso board delayed the shareholder vote by several days, to allow full dissemination of its findings and conclusions. Nevertheless, on March 9, 2011, the vast majority of El Paso shareholders (in excess of 95%) voted in favor of the Kinder Morgan merger. See, e.g., dealbook.nytimes.com/2012/03/09/el-paso-shareholders-approve-kinder-morgan-takeover/. Only one major stockholder, the California State Teachers’ Retirement System, voted against; see dealbook.nytimes.com/2012/03/07/pension-fund-to-vote-against-kinder-morgan-el-paso-deal/.
testimony of a 706 expert would assist the jury by providing a neutral explanation and viewpoint,” particularly when—as in this case—“both sides have taken such extreme and unreasonable positions regarding damages.”

**Google goes after court-appointed expert.** In fact, since that time, the defendant, Google Inc., has already challenged the plaintiff’s damages expert twice under *Daubert*. Each time, Google has succeeded in convincing the court to strike substantial portions of the expert’s opinion for failing to comply with the entire market value rule and for failing to apportion the damages between the patented and unpatented features of the technology at issue. (For the digests of those two court opinions, see the October 2011 and April 2012 issues of *BVU*.)

In particular, in its first opinion, the court “strongly” advised that the calculation of any patent damages in this case should start with the “real world” negotiations between Sun Microsystems (Oracle’s predecessor to the Java mobile technology), which took place in 2006 but failed to come to fruition. Adjustments could then account for several factors, including the validity of the asserted claims (as opposed to the asserted patents) and their proportionate value within the two very broad Java and Android systems. An expert’s adjustments could also account for the traditional 15 factors set forth in the *Georgia-Pacific* “hypothetical negotiations” framework.

In these most recent proceedings, Google challenged the court-appointed expert for assuming that, during the parties’ hypothetical negotiations, they would have equated the value of the intellectual property in suit (in-suit IP) with the entire Java portfolio of patents. Although the expert began with the parties’ 2006 negotiations, he did not move onto an apportionment analysis. Instead, he noted in his report:

Setting aside what the law may require, my best economic advice is that there are good economic reasons why the value of the in-suit IP … is the 2006 value of a hypothetical negotiation for the entire Java … portfolio and the reasonable royalty rate is 12%.

The expert offered three “economic reasons” for this opinion. First, if the parties knew in 2006 that the in-suit IP would be the most relevant to developing the Android system, then these patents that have “driven the negotiations and the aggregate value of the license in the 2006 negotiations is attributable to this subset.”

Second, even if the parties did not know which IP subset in the portfolio would be the most useful, then Google would have licensed an option to use any subset, to be decided at a later date. “In this case, the 2006 value of the in-suit IP is also the 2006 value of the Java portfolio,” the expert explained. In other words, for Google to acquire the rights to use “one, two, or as many of the patents and copyrights in the Java portfolio,” it would have had to pay for the entire portfolio.

Third, even if Google had been interested in writing its own Android-type operating system but had decided that it had to be written in Java (or based on Java technology), then it would have acquired a license to the plaintiff’s entire portfolio of mobile technology as “insurance against litigation” should Google unintentionally infringe one of the patents later.

**Court repeats itself.** Setting aside these economic explanations, the court reiterated its prior orders in the case. That is, the hypothetical license “must be tailored to the amount and type of infringement that actually occurred” and that “the reasonable royalty must compensate for the infringing features, but not for the infringing ones.” In so holding, the court relied on recent Federal Circuit precedent, including *ResQNet. com v. Lansa, Inc.*, 594 F.3d 860 (2010) (available at *BVLaw*), which held that “at all times, the damages inquiry must concentrate on compensation for the economic harm caused by the infringement of the claimed invention.” (emphasis added by the court)

In this case, the court-appointed expert’s second and third reasons for equating the value of the in-suit IP to the entire Java portfolio of mobile technology “are inappropriate for the hypothetical negotiation scenario,” the court held. “Significantly, [the expert] fails to take into
account that at the end of the hypothetical negotiation, Google gets a license to the IP in suit, *nothing more.* Google would not have ended up with a license to the entire portfolio, an option to choose any subset of Java technology, or insurance against future litigation, the court explained. “Nor can we presume that Google would have made good use of the licensed IP.” If Google were liable for the entire value of the IP portfolio every time an infringement was asserted, then Oracle would have been overcompensated.

In contrast, the expert’s first explanation did not run into these same problems, the court said, because it appropriately presumed that Google would only receive a license to the patents in suit. However, because the expert framed the opinion as and “if … then” conditional, the court was unclear whether he was actually asserting that the 2006 value of the aggregate portfolio was driving the parties’ negotiations. Accordingly, the court struck those portions of the expert’s report pertaining to his second and third explanations and denied the *Daubert* motion pertaining to his first without prejudice, thereby leaving the parties to argue the issue further.

**Oracle contests copyright damages.** Oracle also disputed the court-appointed expert’s calculation of copyright damages under *Daubert.* In his analysis, the expert relied on the same figures for Android-related expenses that Google’s expert used in his damages report. Google’s expert derived these expenses from an Android profit and loss statement that calculated traffic acquisition costs and operational costs, including those for sales, marketing, product management, and engineering.

Oracle challenged the experts’ reliance on the P&L statements and sought to preclude both the Google and the court-appointed expert from offering any testimony about Google’s Android-related expenses in calculating copyright damages, which would result in lowering such estimates by approximately $700 million. To support its claims, Oracle offered three reasons. First, the Google expert did not independently verify the P&L figures. Second, he relied on the hearsay of the Google analyst for their verification. Third, Google had not disclosed this analyst as a witness for trial.

In response, Google said that it had disclosed other witnesses who could lay the proper foundation for verifying the P&L expenses. It also cited case law from the Ninth Circuit, which permits deductions from overhead when the expenses were “of actual assistance in the production, distribution, or sale of the infringing product.”

Based on this precedent, the court denied Oracle’s first challenge to the experts’ use of the P&L statement without prejudice. “If the proper foundation is laid at trial that the P&L statements were routinely updated every quarter by Google in the ordinary course of business and the figures therein accurately encompass Android financial data,” then the Google expert could reasonably rely on those figures, the court said, without conducting an independent audit. If Google fails to lay this foundation at trial, then Oracle may reraise the objection.

As for Oracle’s second and third challenges, its proposed remedy—preventing any testimony based on the P&L statements—was too drastic and prejudicial. “Here, it is clear that Android’s gross revenue through 2011 was not entirely profit attributable to the allegedly infringed material,” the court said. Undoubtedly, expenses went into the development and marketing of Android (allegedly $700 million), and it would be “unjust to hide these from the jury.”

To temper any possible prejudice to the plaintiff, the court also denied these challenges without prejudice, conditioned on the Google expert submitting a supplemental report that revised the “foundational interviewees” to fit witnesses who had already been disclosed and subject to Oracle’s depositions of the witnesses within a reasonable time. “No other materials need be produced,” the court instructed, in an effort to keep this protracted litigation on track. Up next: Google’s third attempt to disqualify Oracle’s damaged expert under *Daubert.* The parties fully briefed the motion as of March 9, 2012; stay tuned …
Consensus Economics, Inc., publisher of Consensus Forecasts—USA, reports that the consensus of U.S. forecasters believes real GDP will increase at a seasonally adjusted annual rate of 2.3% in the second quarter of 2012 and 2.4% in the third quarter. The forecasters expect GDP to grow 2.3% in 2012, 2.5% in 2013, and 3.1% in 2014. In the long term, they report that real GDP will grow by an average annual rate of 2.4% between 2017 and 2021.

They forecast personal consumption will increase at a rate of 2.2% in the second quarter of 2012 and 2.3% in the third quarter. They expect personal consumption to increase 2.1% in 2012 and 2.3% in 2013.

The forecasters believe unemployment will average 8.2% in the second quarter of 2012 and 8.1% in the third quarter. They believe unemployment will average 8.2% in 2012 and 7.8% in 2013.

The forecasters believe the 3-Month Treasury Bill rate will be 0.1% at the end of the second quarter of 2012 and will remain at 0.1% through the end of 2012. They believe the 3-Month Treasury Bill rate will climb to 0.3% at the end of 2013. They forecast the 10-Year Treasury Bond yield will rise to 2.2% at the end of the second quarter of 2012 and 2.4% at the end of the third quarter of 2012.

They believe the 10-Year Treasury Bond yield will rise to 2.5% at the end of 2012 and 3.1% at the end of 2013. They also believe consumer prices will rise at a rate of 2.3% in the second quarter of 2012 and 2.1% in the third quarter. They expect consumer prices to increase 2.3% in 2012 and 2.1% in 2013. They expect producer prices to increase at a rate of 2.0% in the second quarter of 2012 and 1.1% in the third quarter. The forecasters anticipate producer prices will rise 2.3% in 2012 and 1.6% in 2013.

Nominal pre-tax corporate profits will increase at a rate of 4.5% and 4.3% in 2012 and 2013, respectively, according to the forecasters. The forecasters project housing starts will be 740,000 in 2012 and 900,000 in 2013.

1 The Economic Outlook Update is published monthly and quarterly by Business Valuation Resources, LLC (BVR). For more information or to purchase, please visit www.BVResources.com or call (503) 291-7963, ext 0.

2 Every month, Consensus Economics surveys a panel of 28 prominent U.S. economic and financial forecasters (the "forecasters") for their predictions on a range of variables including future growth, inflation, current account and budget balances, and interest rates.

Source of forecasts: Consensus Forecasts.
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### CALENDAR

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## Cost of Capital

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<td>Sales</td>
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<td>Total Assets</td>
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Prime lending rate: 3.25%

Dow Jones 20-bond yield: 3.21%

Barron's intermediate-grade bonds: 6.18%

### Economic Growth and Inflation

- **Long-term inflation estimate:** 2.5%
- **Long-term rate of growth GDP:** 2.6%

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1. Source: The Federal Reserve Board as reported by the BVR Risk-Free Rate Tool, located in the Free Downloads section at BVResources.com, May 1, 2012.

2. Source: 2012 Duff & Phelps Risk Premium Report ©Duff & Phelps LLC. All rights reserved. Risk Premium Report includes premiums where size is measured by market value of equity, market value of invested capital, book value of equity, and number of employees. We highly recommend that analysts using Duff & Phelps data for cost of capital have the current year’s Risk Premium Report and thoroughly understand the derivation of the numbers used. Complete current and historical Duff & Phelps cost of capital data is available at BVRResources.com/dp.

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