

McReath v. McReath— Lessons for the Valuation Professional

By Dennis Kleinheinz

On July 12, 2011, the Supreme Court of Wisconsin released its decision in the case of *McReath v. McReath*, Case No. 2009AP639. This decision has an important impact on two issues valuation analysts and family law experts often face: personal goodwill in professional practices and the “double counting” issue related to business income streams used both for property division purposes and maintenance calculations.

Here's a quick review of the two key issues:

Professional goodwill. The court in *McReath* noted that personal goodwill could sometimes be sold (Dr. McReath himself had previously purchased his practice for an amount of approximately \$930,000). As a result, the court chose not to require circuit courts to draw a distinction between personal goodwill and enterprise goodwill when dividing a marital estate that includes professional goodwill. Rather, the court concluded that when valuing a business interest that is part of the marital estate for purposes of divorce, a circuit court shall include the value of the “saleable professional goodwill” attendant to the business interest.

Double Counting. In *McReath*, the court recognized that double counting can occur in awards of maintenance. In addressing the double counting issue with respect to business interests, the court noted that a spouse who is awarded an income property could sell the property the next day and immediately realize the value of the property. The spouse could also elect to keep the property and earn income from it. As the spouse earns income, he or she does not lose the value of the property,

continued on page 6...

The Marketing Period of Private Sale Transactions: Updated for Sales through 2010

By Marc Vianello, CPA, ABV, CFF

The time needed to market and sell a privately held business continues to trend downward. Industry, price, and month of listing appear to be key contributing factors that need to be explored to arrive at an appropriate opinion regarding marketing period. Broader economic and demographic factors do not generally appear to be determinative of the marketing time period. But recessions, such as the mild one in 2001 and the current major economic dislocation that started in

continued on next page...

INSIDE THIS ISSUE

Control Premiums Get More Attention	7
Don't Use Gordon Growth Model for Patents —and 14 Other Warnings for IP Valuations	10
Valuing a Majority Fractional Interest and the Minority Premium Model	12
Government Contractors With Set-Aside Status Require Risk Adjusted Timelines.	17
Oil and Gas Field Services Industry: Sources of Information	20
Letter to the Editor: Clarification of Requirements for ASA, AM, and FASA Credentials	21
Legal & Court Case Updates	23
– Estate of Turner v. Commissioner	23
– Howard v. United States	25
– AmBase Corp. v. United States.	26
– Farmer v. Farmer, 2011 WL 3929114 (Wash.)(Sept. 8, 2011)	28
– In re Marriage of Hashemian	30
– Douglas Dynamics v. Buyers Products Co.	32
– Rughani-Shah v. Noaz	33
– Showell v. Pusey	35
– DFG Wine Co., LLC v. Eight Estates Wine Holdings, LLC	36
– Oracle USA, Inc. v. SAP AG	38
Burkert on Advanced Business Valuation Report Issues	40
BVR's Economic Outlook for the Month	42
CALENDAR	43
COST OF CAPITAL	44

BUSINESS VALUATION UPDATE

Executive Editor: Jan Davis
 Legal Editor: Sherrye Henry Jr.
 CEO, Publisher: David Foster
 Managing Editor: Janice Prescott
 Graphic & Technical Designer: Monique Nijhout
 Customer Service: Stephanie Crader
 VP of Sales: Lexie Gross
 President: Lucretia Lyons

EDITORIAL ADVISORY BOARD

CHRISTINE BAKER
 CPA/ABV/CFF
 PARENTEBEARD
 NEW YORK, NY

NEIL J. BEATON
 CPA/ABV, CFA, ASA
 GRANT THORNTON
 SEATTLE, WA

JOHN A. BOGDANSKI, ESQ.
 LEWIS & CLARK
 LAW SCHOOL
 PORTLAND, OR

NANCY J. FANNON
 ASA, CPA/ABV, MCBA
 FANNON VALUATION GROUP
 PORTLAND, ME

JAY E. FISHMAN
 FASA, CBA
 FINANCIAL RESEARCH
 ASSOCIATES
 BALA CYNWYD, PA

LYNNE Z. GOLD-BIKIN, ESQ.
 WOLF, BLOCK, SCHORR
 & SOLIS-COHEN
 NORRISTOWN, PA

LANCE S. HALL, ASA
 FMV OPINIONS
 IRVINE, CA

JAMES R. HITCHNER
 CPA/ABV, ASA
 THE FINANCIAL
 VALUATION GROUP
 ATLANTA, GA

THEODORE D. ISRAEL
 CPA/ABV/CFF, CVA
 ECKHOFF ACCOUNTANCY CORP.
 SAN RAFAEL, CA

JARED KAPLAN, ESQ.
 MCDERMOTT, WILL & EMERY
 CHICAGO, IL

GILBERT E. MATTHEWS CFA
 SUTTER SECURITIES
 INCORPORATED
 SAN FRANCISCO, CA

Z. CHRISTOPHER MERCER
 ASA, CFA
 MERCER CAPITAL
 MEMPHIS, TN

JOHN W. PORTER, ESQ.
 BAKER & BOTTS
 HOUSTON, TX

RONALD L. SEIGNEUR
 MBA CPA/ABV CVA
 SEIGNEUR GUSTAFSON
 LAKEWOOD, CO

BRUCE SILVERSTEIN, ESQ.
 YOUNG, CONAWAY, STARGATT
 & TAYLOR
 WILMINGTON, DE

JEFFREY S. TARBELL
 ASA, CFA
 HOULIHAN LOKEY
 SAN FRANCISCO, CA

GARY R. TRUGMAN
 ASA, CPA/ABV, MCBA, MVS
 TRUGMAN VALUATION
 ASSOCIATES
 PLANTATION, FL

KEVIN R. YEANOPLOS
 CPA/ABV/CFF, ASA
 BRUEGGEMAN & JOHNSON
 YEANOPLOS, P.C.
 TUCSON, AZ

Business Valuation Update™ (ISSN 1088-4882) is published monthly by Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035. Periodicals Postage Paid at Portland, OR, and at additional mailing offices. Postmaster: Send address changes to *Business Valuation Update*™, Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035.

The annual subscription price for the *Business Valuation Update*™ is \$359. Low cost site licenses are available for those wishing to distribute the *BVU* to their colleagues at the same address. Contact our sales department for details. Please feel free to contact us via email at customerservice@BVRResources.com, via phone at 503-291-7963, via fax at 503-291-7955 or visit our web site at BVRResources.com. Editorial and subscription requests may be made via email, mail, fax or phone.

Please note that by submitting material to *BVU*, you are granting permission for the newsletter to republish your material in electronic form.

Although the information in this newsletter has been obtained from sources that BVR believes to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal, or consulting advice.

Copyright 2011, Business Valuation Resources, LLC (BVR). All rights reserved. No part of this newsletter may be reproduced without express written consent from BVR.

late 2007, increase the marketing period of sales initiated but not completed prior to the economic downturn. These are among the results of the annual update of our study *Marketing Period of Private Sales Transactions*.

An excerpt from the complete study follows. For more information, contact the author or the Business Valuation Resources web site at BVRResources.com.

Recessions increase the marketing period of sales initiated but not completed prior to the economic downturn.

Background of the study. The business valuation concept of marketability deals with the liquidity of the ownership interest. How quickly and with what certainty an owner can convert an investment to cash are two very different variables, but they work together when determining the value of an investment. For immediately marketable investments, the value of illiquid investments (regardless of the level of value) must be discounted to reflect the uncertainty of the time and price of sale. This uncertainty is reflected in business valuations by the discount for lack of marketability (DL0M).

This is the second year we have studied the period of time it might reasonably take to sell an interest in a privately held business. We assume that the marketable value of the ownership interest has been reasonably estimated. We then hypothesize that any consistency of the marketing time period of illiquid investments may be influenced by the industry, price, and marketing dates of the investment. If market prices for similar investments fall dramatically while the marketplace is being explored, the seller will have lost the opportunity to lock in the higher price that existed when the sell decision was made. Conversely, if the sale price is fixed for some reason (such as a listing agreement) and market prices for similar investments rise dramatically

during the marketing period, the seller will have lost the opportunity to realize the increased value.

To test our hypothesis, Business Valuation Resources provided us data on 8,184 private company sale transactions from its *Pratt's Stats* database. The population of transactions occurred from February 1992 through the end of 2010 and reported an associated Standard Industrial Classification (SIC) code; sale initiation date; sale closing date; market value of invested capital (MVIC); and asking price. The average time that elapsed from the initial offering date to the closing date of these transactions is 200 days. The standard deviation of the reported time periods is 97.7%, or 195 days.

Graph 1 shows the distribution of the amount of time it took to consummate the sale transactions in the database. Since the marketing time period cannot be less than zero days, the distribution of the database obviously skews to the

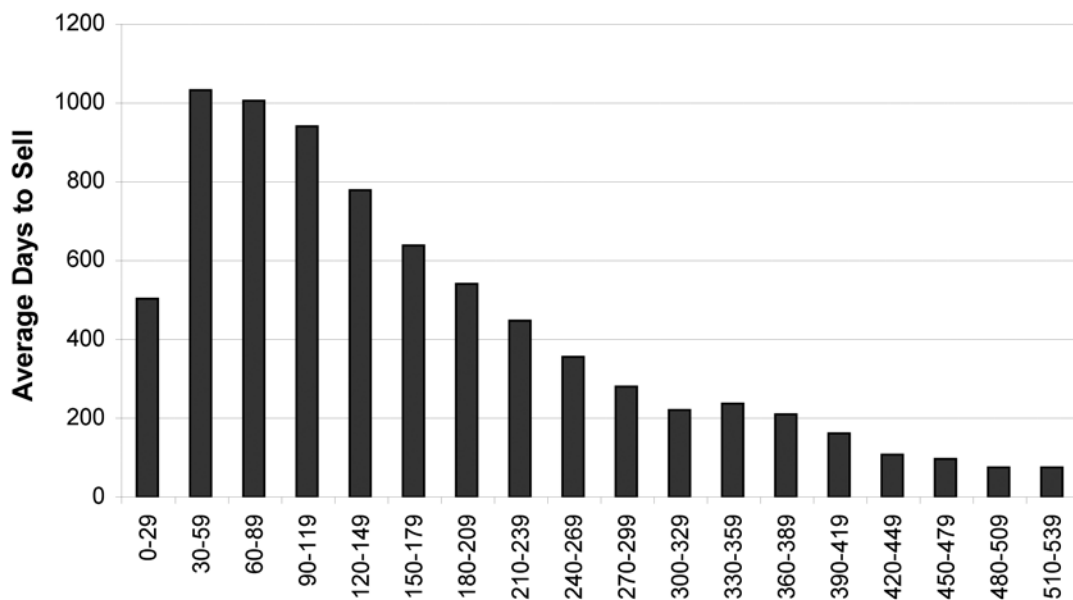
right. The data is split into 30-day increments for presentation and analytical purposes.

Marketing Periods Based on Industry. Three industry groups—construction, wholesale trade, and manufacturing—had the longest marketing periods, with averages of 239, 219, and 216, respectively. Businesses reported in the agriculture, forestry, and fishing industries sold quickly, in an average of 182 days. On average, businesses in the transportation, communications, electric, gas, and sanitary services industry groups sold within 199 days; businesses in the retail industry group sold within 197 days; those in the financial, insurance, and real estate industry group sold within 193 days; businesses in the services industry group sold within 191 days; and those in the mining industry group sold within 187 days.

Marketing Periods Based on Sale Year. The next factor explored is the effect on the marketing

The average time that elapsed from the initial offering date to the closing date of these transactions is 200 days.

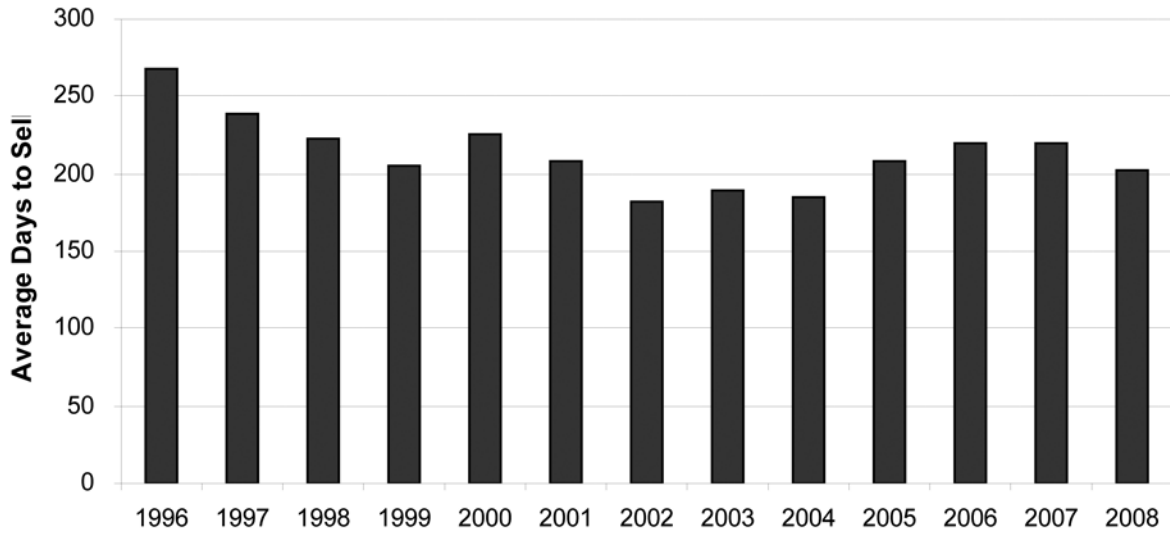
Graph 1. Average Marketing Period by Year of Sale Initiation
8,184 Private Sales Transactions



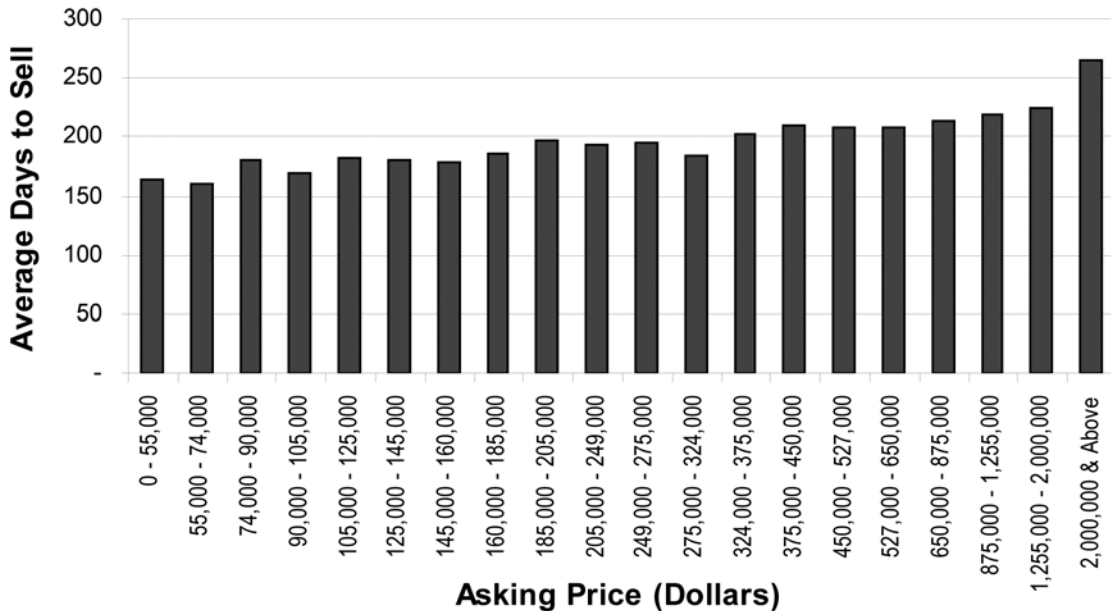
period of the calendar year in which the businesses were listed for sale. The *Pratt's Stats* database reports sale transactions commencing in 1991 and extending through 2010. The years 1991 to 1995 were not used in the calendar year analysis since there were very few listings from these years. Excluding 1991 through

1995 reduced the database population from 8,184 to 8,103. Calendar years 2009 and 2010 were also not used in the calendar year analysis because the closing dates of these listings are not yet known. Excluding 2009 and 2010 reduced the database population from 8,103 to 6,940.

Graph 2. Average Marketing Period by Year of Sale Initiation
6,940 Private Sales Transactions



Graph 3. Average Marketing Period by Asking Price
7,607 Private Sales Transactions



Graph 2 shows the declining trend of average selling periods over time. The average number of days it took to sell the privately held businesses in the study decreased from 267 days in 1996 to 182 days in 2002, before increasing to 220 days in 2007 and falling to 202 days in 2008.

Marketing Periods Based on Price.

The *Pratt's Stats* database of transactions also provided the asking price of each transaction. The range of asking prices was \$3,456 to \$70,000,000. Graph 3 shows the average days to sell for each asking price group.

Generally, the average days to sell increases with the rise in asking price. When the asking price is under \$55,000, the average days to sell is 164 days. The length of marketing periods gradually increases until the asking price is greater than \$2,000,000, when the average days to sell is 265 days.

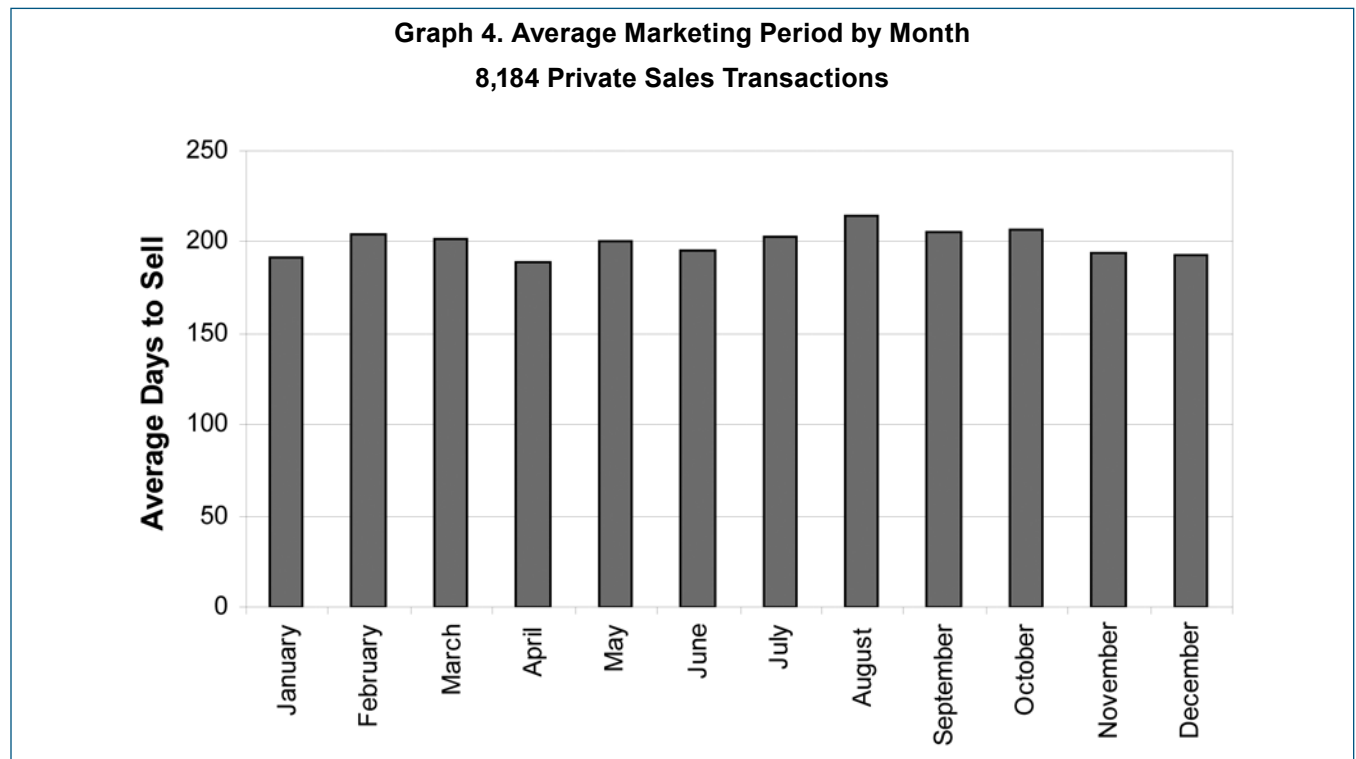
Marketing Periods Based on Seasonality. To consider whether the time of year a sale transaction is initiated makes a difference in the length of

marketing periods, we grouped the sale transactions based on the month the company was listed to sell. Graph 4 shows, on average, that sale transactions originally listed in August took the longest time to sell, with a mean of 214 days. Sale transactions originally listed in October also were lengthy, averaging 207 days to sell. The months with the shortest marketing periods were April, January, December, and November,

averaging 190, 192, 193, and 194 days, respectively. Possible explanations for these phenomena are proximity to year end numbers for November, December, and January listings, and proximity to completion of tax filings for April listings. Such proximity tends to offer buyers enhanced transparency through more timely financial reporting.

Marc Vianello, CPA, ABV, CFF, is managing member of *Vianello Forensic Consulting LLC*. He thanks *Paul Murray, CPA,* a consultant with *Vianello Forensic Consulting LLC,* for his assistance in writing this article. He can be reached at vianello@vianello.biz.

Generally, the average days to sell increases with the rise in asking price.



Lessons for the Valuation Professional

...continued from front page

because he or she always has the option to sell the property for fair market value.

Lessons for business valuation practitioners.

There are several other valuation issues in the McReath case that are pertinent to the valuation community. Most of these issues are described in the trial court's decision and deal with reports issued by Dr. McReath's expert (a CPA and an ABV). Listed below are the trial court's specific concerns and my opinions (in italics) of their implications for the valuation community.

1. The expert did not perform a full valuation report. Instead, he reviewed the work of Mrs. McReath's expert and made adjustments he thought appropriate. As a result, the trial court found that this was not a comprehensive approach to valuation.

It is not uncommon for experts in valuation and economic damage analysis to prepare rebuttal reports which expound upon the calculations of another expert. The decision by the trial court would indicate that this might be looked upon as not doing enough work.

2. The expert relied extensively on information provided by Dr. McReath with seemingly little independent or critical analysis of that information. The court noted that in his testimony, Dr. McReath was vague about his financial affairs and frequently stated he could not remember details.

This would be a reminder that we are proponents of our own opinions. Information provided by clients needs to be considered, but should not be the sole basis for our opinions.

3. The expert limited his use of financial information to the most recent year, ignoring the

immediately preceding more profitable years. The court noted that business earnings often decline in the year of divorce.

Sometimes it is appropriate to use the most current year as a foundation for a valuation calculation. If that is the case, the expert most certainly will want to describe why the

As the spouse earns income, he or she does not lose the value of the property, because he or she always has the option to sell the property for fair market value.

current year is more appropriate than either historical earnings over a longer period of time or projected future earnings. And in the case where the most current year reflects declining profitability, extra care and documentation are a necessity.

4. The expert looked little to external sources to determine industry norms to support his conclusions. He was critical of Mrs. McReath's expert who relied upon industry publications and surveys and chose instead to rely primarily on information from Dr. McReath and his own personal experiences.

In this case, as in most cases, published information derived from thorough research trumps personal experiences.

5. The expert arrived at a value that was much lower than Mrs. McReath's expert (\$415,000 versus \$1,058,000). This in spite of the fact that Dr. McReath had previously purchased the practice for approximately \$900,000, the practice consistently grossed \$1.6 million per year, and the practice held a virtual monopoly in the two communities it served.

At the end of every valuation engagement valuers are encouraged to perform "sanity checks." In this case Dr. McReath's expert had the valuation report prepared by Mrs. McReath's expert and he should have been aware of the prior purchase price. Sanity checks should not be limited to the usual mathematical calculations. At the end of an engagement a valuator should ask himself or herself: "Does this value make sense?"

6. While stating that it was not a significant factor, the court noted that Dr. McReath's expert works for the accounting firm that for years has provided accounting services to Dr. McReath's business.

There are conflicting views of this issue. Some valuers believe that the court's observation reflects a conflict of interest. Other valuers believe that no one knows a business as well as the CPA firm that has worked with that business in the past.

7. The expert testified that he attributed 95% of the goodwill of the business to personal goodwill and the 5% balance to corporate

goodwill. This, he stated, represented his professional judgment. He provided no other basis for arriving at this conclusion. He also testified that he has never valued an orthodontic practice in the past.

Obviously, this is something a valuator never wants to read about a valuation report they have written.

Dennis Kleinheinz is a partner with the CPA firm Meicher & Associates LLP in Middleton, Wis. He is a CPA, ABV, and CVA. Kleinheinz was engaged by Mrs. McReath as an expert with respect to income and support issues. He can be reached at dennisk@meichercpa.com.

Control Premiums Get More Attention

"Regulators are aware of the substantial impact on value that control premiums can have," said Dayton Nordin of Ernst & Young, speaking at the ASA Advanced BV Conference in Chicago last week. "The downturn in 2008 highlighted that we don't have a lot of consistency and there are many different approaches. Further, the support for the selection of a control premium has not been consistent with its importance to the analysis."

Nordin has been a member of The Appraisal Foundation's Working Group on Control Premiums (and he makes the point that the opinions he presented in Chicago are his alone, and not those of TAF or E&Y). To support his belief that regulators are aware of control premiums, he provided examples of SEC comments that demand disclosure of the basis for premiums be included. One letter specifically asks, "please tell us how you determined that control premium and why you believe the assumed premium is appropriate in your circumstances." Nordin postulates that this might suggest the SEC is questioning the use of control premiums in this circumstance, and therefore people should be thinking about whether a premium is appropriate as well as what size it might be.

"We were seeing a lot of value added by these premiums," Nordin says. "In fact there were control premiums in the 50% to 100% range" during the economic downturn.

Where does Nordin see the variation in the use and application of control premiums? He highlights the following hot spots:

- Applying premiums for impairment;
- Applying premiums in step transactions;
- Equity compensation;
- Applying premiums when considering investment company holdings;
- And, "general disagreement because some analysts argue that the application of a control premium should be rarely used, if ever."

The last argument relies on the belief that current public prices already reflect highest and best use value. If that's the case, "the control premium should be small, if it exists at all," said Nordin.

This isn't a new idea: Nordin refers to Eric Nath's 1990 article in *Business Valuation Review* that discussed how market prices are and should be very close to control values already. Damodaran (in 2005) argued that control premiums should only develop based on the value that a new set of owners would add.

These thoughts are working their way into various efforts under way in the industry. For financial reporting, there are three major ones in process now:

1. The Appraisal Foundation's Working Group (with Nordin as a member) looking at control or acquisition premiums in the context of impairment, step transactions, and investment company issues;
2. AICPA Impairment Task Force focusing on premiums as they relate to testing for impairment of reporting units; and
3. AICPA Valuation of Privately Held Company Equity Securities Issued as Compensation (The "Cheap Stock") Task Force—exposure draft has Chapter 9, which covers discounts and premiums. "It's very well-written and footnoted," says Nordin. "I think this cheap stock guide will be used widely and perhaps off-label, just like the original IPR&D aid was from 10 years ago."

Nordin's Appraisal Foundation Third Working Group focuses on premiums in the fair value for financial reporting purposes only. Obviously the goal of this working group, as with all TAF best practices efforts, is that the final white paper will be accepted by accounting firms as best practice.

The working group is developing a new term for what has been known as the control premium: the Market Participant Acquisition Premium (MPAP). What does this term mean, and how does it differ from the previous sense of the value of control? MPAP is defined as:

'The type of market participant (strategic or financial) is often aligned with the obvious way to derive value,' Nordin believes.

- The premium paid by a set of market participants in order to acquire a controlling interest (One argument is that there has to be at least two market participants who will pay this premium to minimize the influence of the "stupidity premium" of overpaying for an asset, Nordin says.)
- It is also the difference between: 1. the price that would be paid by those market participants for subject controlling interest (fair value) and 2. the value of the marketable non-controlling interest in the subject business or entity prior to the hypothetical transactions
 - Representing the enhancement to value that market participants would expect to realize as a result of enhanced cash flows and/or reduced risk if they gain control

To achieve these premiums, the economic benefits to the buyers should be quantified, particularly in term of cash flow impacts (enhanced growth, increased margins, and working capital or capital expenditure efficiencies) or reduced risk. So, for instance, Nordin provided a case study of a \$100,000,000 company that has a 25% control premium—and the need for analysts to quantify the elements of the resulting \$25,000,000 in economic benefits from new control.

"The risk factors are more complicated," but include greater size and diversification, better access to less costly capital, or optimizing the financing mix of a company. "The type of market participant (strategic or financial) is often aligned with the obvious way to derive value," Nordin believes.

In any case, "in no case is a market participant willing to pay an amount that exceeds the value of the maximum cash flows that could be generated through the business combination," Nordin says, challenging some of the huge control premiums that were generated during the 2008-2009

downturn, for instance. “But robust bidder activity might indicate something on the higher range of MPAP allocation.”

The working group also recognizes the need for a benchmark control premium analysis (such as the BVR/Mergerstat Control Premium Study) but believes it should be used as a secondary or corroborating analysis.

In considering the size of the potential premium regardless of the method, Nordin also outlined some of the factors to consider in analysis such as:

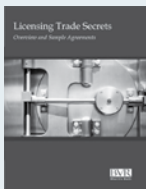
- market participants;
- size of market participants;
- stage in the life cycle of the subject entity;
- state of industry acquisition activity (“Has this industry heated up, leading to the conclusion that buyers think there’s value to be unlocked,” asks Nordin);

- growth rate of peer companies, their margins, capital structures;
- perceived quality of management (“Look at what’s happened to the value of Netflix in the last two months as an example of the changed premium for good management,” Nordin commented);
- balance of information;
- contingent consideration; and
- regulatory factors.

“MPAP conclusions will need to be tested for reasonableness,” says Nordin. Ratio analysis and internal rate of return analyses of “hockey stick” projections of synergistic values will be increasingly necessary to justify these premiums, he believes.

“As a starting point, you need to understand all aspects of control between classes of owners” and how that impacts value, Nordin concludes.

Get These Library Essentials for Valuing Intellectual Property...



Licensing Trade Secrets: Overview and Sample Agreements

\$299.00 (+\$9.95 S&H)



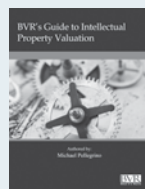
Royalty Rates in Copyright Agreements: A Guide to Full-Text Licensing Agreements

\$595.00 (+\$9.95 S&H)



Royalty Rates in Biotech: BVR's Guide to Full-Text Licensing Agreements

\$595.00 (+\$9.95 S&H)



BVR's Guide to Intellectual Property Valuation

\$199.00 (+\$9.95 S&H)

View Table of Contents & Order Today at:

www.BVResources.com/IP

Or contact BVR at: (503) 291-7963 or (888) 287-8258

Don't Use Gordon Growth Model for Patents —and 14 Other Warnings for IP Valuations

Speaking at the NYSSCPA BV Committee meeting last month, Mike Pellegrino (Pellegrino & Associates) warned business appraisers that a lot of their most common methods and approaches work poorly when applied to intellectual property valuations. For instance: there is no such thing as perpetual value for patents. “You can't use the Gordon Growth Model because patents last 20 years. If you have seven days left and you make \$1 a day, the patent has a value of \$7.”

Pellegrino is the author of the *Guide to Valuing Intellectual Property*. A major revision of this standard work is releasing this month, and is available at www.bvresources.com and elsewhere.

Here are some other trouble spots for financial analysts when valuing IP:

- Trademarks cause consumers to do irrational things that influence value. “The simplest example is Morton Salt. It's sodium chloride, just like the products sold by everyone else. But the brand allows them to price 18% to 40% above competitors,” said Pellegrino. Or Tostitos. “It's the same salt, oil, corn and water. And yet it prices 28% higher than competitors.”
- Patents get more attention, but using trade secret protections has other advantages that can't be ignored in a valuation. Trade secrets don't require disclosure, so, at a minimum, “your competitors will need to

reverse-engineer what you have,” Mike said. Of course, there are risks—such as impact of key person discounts if the secrets are controlled by a few people. Pellegrino warns appraisers that, with the start of “first to file” rules the previous week, there's the possibility that someone will patent your idea underneath your trade secrets. “There's a huge amount of exposure and diligence required now in this area,” he warned, and appraisers need to account for this in their value conclusions.

- Direct use of the technology is not the only way to create IP value. “You have to value other options such as not using the technology but preventing a competitor to enter the space, licensing the technology for royalties, and more,” said Mike. Each of these generates value.
- IP comparables are rarely comparable. “What's the comparable for Lipitor, the most valuable patent of all time?” Mike asked (citing the fact that the patent expired in late June 2011). Another factor that makes the market approach risky when valuing intangibles: “IP discount rates are not directly observable, so that method is challenged when patents are under analysis,” he stressed. Pellegrino admits there are market indicators that can be used as proxies. But “economic lives are almost never the same, even in the same art.” He warns that free cash flow and timing in the market have to

Which valuation method works best for which IP asset class?

Asset Type	Recommended Valuation Method
Patent Valuation	Integrated DCF and real option model
Copyright Valuation	Integrated DCF and real option model or cost approach for weak copyrights
Trademark Valuation	Integrated DCF and real option model
Trade Secret Valuation	Lower of integrated DCF and real option model or cost approach
Software Valuation	Lower of integrated DCF and real option model or cost approach

be the same, too. “The mathematical impact of these differences on value is unequivocal,” he concludes.

- Subsequent events can't always be ignored. Unfavorable post-launch clinical studies need to be considered because they happen so frequently—“just recall Vioxx.” The risk of these kinds of events should be included in your discount rate calculations. In IP, these events might not be “known,” but they're “knowable.”
 - Depreciation—IP doesn't behave like other assets. “In some cases it's binary, by which I mean either it has value or it doesn't,” Pellegrino said. So, appraisers will need to justify their depreciation forecasts.
 - Using trended costs in your forecast will rarely yield the right value. Appraisers often trend operation costs when preparing future year financial statements. But, Pellegrino argues, since software, for instance, can be appraised at replacement cost, trending of IP-related cost items is likely to skew your results.
 - Discount rates for IP are often disturbingly high. Pellegrino said “most of our analyses have discount rates of 35% or more.” For analysts used to more “normal” business activity, these numbers can be worrisome. “At this kind of discount, the most damaging part of a valuation is the time it takes to get a product to market,” he explained. “Cell phone software has a shelf life of 18 months. If it takes you 15 months to get to market, you should get out of the cell phone business. You've wasted most of your value.”
 - The cost approach is irrelevant for most—but not all—IP valuations (see table). Pellegrino believes that the cost approach can help in trade secret and software valuations only, “where you're looking at a make vs. buy valuation,” he says. Otherwise, “usually you can only use income-based approaches.”
 - Auction transactions appear to be good market proxies, but rarely are. Much of the most valuable IP is transacted before it even gets to the auction broker, Mike stressed, and there are many transactions that never get to public markets. So the “comparable” data from the increasing numbers of auction transactions is “very dangerous.”
 - Survivorship bias is worse in IP comparables than elsewhere. “So many transactions never come to market, and among those, half fail to meet their financial targets,” said Pellegrino. He believes that, therefore, appraisers have an even higher risk of survivorship bias in IP than in valuation of “traditional” asset proxies.
 - Revenue models can't be built on market share. Except in some consumer products, this won't work, Mike's experience shows. “You need to build income models from the bottom up, starting with how many salespeople, what their quotas are, and so on.” Guessing that a new biotech product will earn “15% market share” won't produce dependable results.
 - Weighting multiple valuation methods will give the wrong answer with IP assets. “Particularly in software valuations, your value is the lower of the cost or integrated income approaches, so there's no weighting,” said Pellegrino. “Why would someone pay more than what it costs to create?”
 - It's risky to do IP valuations alone. Pellegrino sees a more collaborative valuation approach for IP assets than for traditional businesses. “First, you've got *Daubert* and the technology, so you're going to need to backfill your expertise by partnering with a university or a chemist friend,” he said. “Second, the math is complicated enough that we have three levels of review before anything goes to the client.”
- But here is one usual method you should not throw out: Free cash flow should be the basis for analysis. “This is the one method you can take to the bank,” says Mike.

Valuing a Majority Fractional Interest and the Minority Premium Model

By Neil B. Mills-Mazer, JD, AVA

The views and opinions expressed are those of the author and do not necessarily reflect the views and opinions of the IRS.

On April 18, 2011, I made a presentation at the 3rd annual National IRS Symposium sponsored by the ASA's Los Angeles Chapter. My topic was discounts for fractional interests in real property, and during this presentation I introduced my model that I called the minority premium. I received a lot of interest in this as well as criticism during this presentation and in the months that followed. I hope this article will clarify what I was talking about as well as open up some valid communications about this topic.

This article will limit the discussion to the minority premium model and only touch on other aspects of fractional interests as they might relate to this. It also, for the most part, only applies where there is one holder that owns more than a 50% interest, although at the end I will talk about the ramifications of this model to other scenarios. Also keep in mind that we are only talking about the discount as it relates to the majority holder, not the minority holder.

I will start out with some very simple examples and then move forward to more complex situations. I will also mention various methodologies I have seen and how they relate to this model.

But before we start, let me tell you a story . . .

Several years ago, we got a new puppy and we were in the process of paper training it. One night, our daughter spent the night with us. At this time, she was dating a professional hockey player. Both my wife and I left for work early that next morning and I did the usual routine of laying down newspaper for the puppy in his room. When I came home later that evening, I was told that my joke wasn't appreciated. Of course I didn't understand

what I had done. It seemed that the newspaper I put down was the front page of the sports section which was entirely dedicated to a story about the hockey player she was seeing. By the time our daughter woke up, the puppy had done its business all over the paper. If I had stepped back and been more observant, perhaps I would have used the business section instead of the sports section. The reason I like telling this story is it reminds me that you have to make sure that what you have done makes sense and cannot be misunderstood or misinterpreted. In applying this to valuations, you have to step back and make sure that the implications of what you put together even makes sense. If not, perhaps the data that you used was incorrect or misapplied to the facts that exist.

Let's first start out with this simple example:

Father A owns a 100% interest in a personal residence which is valued at \$4,000,000 and gifts a 5% interest to his daughter, B. So in effect, Father's 95% interest before any considered discount is worth \$3,800,000, and the daughter's 5% interest is worth \$200,000.

Now, let me tell you about the various methodologies I've seen to value the fractional interest of the 95% holder . . .

	Property Value	Interest Holders	
		95.00%	5.00%
	\$4,000,000	\$3,800,000	\$200,000

Use of actual transactions to indicate what an appropriate discount should be. None of these actually have the interest holders as in this example; usually they are 50% owners or less and not involving a majority holder. They usually come up with an implied discount of 30% to 45%. After making some adjustments to that data, I usually come out with an implied discount of around 24%. They also only deal with someone selling a fractional interest to someone else (what I like to call fractional to fractional). However, we know that there are lots more circumstances

where someone sells a whole interest to two or more parties to hold title as TIC (whole to fractional). As we expect, the seller wouldn't give any discount to those sellers simply because of the way they are going to hold title. I even had a case where a minority interest was taking a discount of over 40% but yet at the same time bought a minority interest on another property from the same majority owner of the first property for an equivalent discount of only 3% (my newspaper story comes to my mind again).

Use of Limited Real Estate Partnership Database. These usually come up with an implied discount of 35% to 50%. This comparison to the case at hand really doesn't apply since we are dealing with a majority holder while these partnerships are all held by numerous minority owners. Furthermore, recent court decisions have also suggested that these partnerships are not comparable to tenant in common cases, especially when the threat of partitioning exists. When a waiver of partition is in play, this might change the facts somewhat, and I will explain this later.

Use of the Cost to Partition Method. These usually come up with an implied discount of 28% to 45%. Again, if a waiver of partition is in play, this method would not apply.

Just using an average of what I've seen taken as discounts in situations like this, let's assume the discount taken based on the above methods resulted in a calculation of a 35% discount. Using the above facts, the assumption is then made that the 95% owner would be willing to take \$1,330,000 less than his pro-rata share. My position is that the 95% owner would not be willing to take such a drastic reduction when a more attractive alternative is available. He could offer to buy out the 5% holder equal to her pro-rata share or at a slight premium, thus gaining a full 100% interest and then being able to sell with no discount at all. So the question then becomes, what is that acceptable premium and the correlation of the discount on the majority holder? As the chart below shows, if we allowed a 35% discount to the 95% majority holder, that would be the same as if we paid the 5% minority holder the \$1,330,000, or a resulting premium of 665%.

		Interest Holders	
		95.00%	5.00%
Property Value	\$4,000,000	\$3,800,000	\$200,000
Discount Allowed	35.00%	\$1,330,000	\$1,330,000
		\$2,470,000	\$1,530,000

Indicated Premium for Minority Interest Holder 665.00%

NOTE: The \$1,330,000 majority discount amount becomes the potential minority premium.

This of course would be an unreasonable premium to pay the minority holder, especially when the right to partition exists and a forced sale could take place.

So let's start playing with some numbers first and then I'll talk about the reality of the transactions:

If we allowed a 20% discount, this would still equate to a 380% premium to the minority holder. Still a hefty premium in my world.

		Interest Holders	
		95.00%	5.00%
Property Value	\$4,000,000	\$3,800,000	\$200,000
Discount Allowed	20.00%	\$760,000	\$760,000
		\$3,040,000	\$960,000

Indicated Premium for Minority Interest Holder 380.00%

NOTE: The \$760,000 majority discount amount becomes the potential minority premium.

So what would be an acceptable discount/premium? The chart below gives an indication about what kind of discount would result in an acceptable premium to the minority interest.

Using the chart at the top of page 14, if we allowed a 5% discount (staying in the blue range) to the 95% majority holder, this would result in a premium to the 5% minority holder of 95%.

		Interest Holders	
		95.00%	5.00%
Property Value	\$4,000,000	\$3,800,000	\$200,000
Discount Allowed	5.00%	\$190,000	\$190,000
		\$3,610,000	\$390,000

Indicated Premium for Minority Interest Holder 95.00%

NOTE: The \$190,000 majority discount amount becomes the potential minority premium

Depending on other facts, I still might consider the 95% to be a high premium for the minority holder, so perhaps playing around more with the

Discount Allowed	Minority Interest									
	1.00%	5.00%	10.00%	15.00%	20.00%	25.00%	30.00%	35.00%	40.00%	45.00%
1.00%	99.00%	19.00%	9.00%	5.67%	4.00%	3.00%	2.33%	1.86%	1.50%	1.22%
5.00%	495.00%	95.00%	45.00%	28.33%	20.00%	15.00%	11.67%	9.29%	7.50%	6.11%
10.00%	990.00%	190.00%	90.00%	56.67%	40.00%	30.00%	23.33%	18.57%	15.00%	12.22%
15.00%	1485.00%	285.00%	135.00%	85.00%	60.00%	45.00%	35.00%	27.86%	22.50%	18.33%
20.00%	1980.00%	380.00%	180.00%	113.33%	80.00%	60.00%	46.67%	37.14%	30.00%	24.44%
25.00%	2475.00%	475.00%	225.00%	141.67%	100.00%	75.00%	58.33%	46.43%	37.50%	30.56%
30.00%	2970.00%	570.00%	270.00%	170.00%	120.00%	90.00%	70.00%	55.71%	45.00%	36.67%

LEGEND

- Range of Premium considered reasonable (between 20% to 35%)
- Range of Premium considered too large (over 35%)
- Range of Premium considered too low (under 20%)

discount allowed would bring it down to a more reasonable premium.

		Interest Holders	
		95.00%	5.00%
Property Value	\$4,000,000	\$3,800,000	\$200,000
Discount Allowed	3.00%	\$114,000	\$114,000
		\$3,686,000	\$314,000

Indicated Premium for Minority Interest Holder 57.00%

NOTE: The \$114,000 majority discount amount becomes the potential minority premium.

This of course does not necessarily mean that the 3% is the maximum discount to allow. It would be weighted, although probably very heavily for this factual situation, along with all the other methodologies in play. The following table illustrates the computation. Without going into the other methodologies, I assigned a heavy weight to the minority premium since we are dealing with a 95% interest. As the majority interests drops, so might the weighting of it, depending on the facts of the case.

Method	Indicated Discount	Indicated Value	Weight	Weighted Value	
Actual Transactions					
Fractional to Fractional	28.00%	\$2,736,000	4	\$109,440	
Whole to Fractional	0.00%	\$3,800,000	5	\$190,000	
Cost-To-Partition					
Present Holder	28.00%	\$2,736,000	4	\$109,440	
Hypothetical Buyer	31.00%	\$2,622,000	2	\$52,440	
Minority Premium	3.00%	\$3,686,000	85	\$3,133,100	
Total				100	\$3,594,420
Indicated Discount					5.41%
Rounded Value					\$3,594,000

Again without going into discussion on the other methodologies for this article, you can see that in this situation I would propose a 5.41% discount for the 95% fractional interest holder.

If the majority interest was 75% instead of 95%, the result might look as follows:

Method	Indicated Discount	Indicated Value	Weight	Weighted Value	
Actual Transactions					
Fractional to Fractional	28.00%	\$2,160,000	9	\$194,400	
Whole to Fractional	0.00%	\$3,000,000	10	\$300,000	
Cost-To-Partition					
Present Holder	28.00%	\$2,160,000	10	\$216,000	
Hypothetical Buyer	31.00%	\$2,070,000	6	\$124,200	
Minority Premium	3.00%	\$2,910,000	65	\$1,891,500	
Total				100	\$2,726,100
Indicated Discount					9.13%
Rounded Value					\$2,726,000

At this point, let's talk about the logistics of this minority premium . . .

Willing Seller: If you owned a pro-rata value of \$3,800,000, why would you be willing to sacrifice more than what you could buy out the other minority fractional interest holder for and then own 100% with the ability to sell with no discount? It would be common sense for the minority holder to take a small premium on her pro-rata value rather than have to go through a partitioning process, which could actually result in her receiving less than her pro-rata share due to the time and costs involved.

In fact, one could structure a deal where both parties agree to sell both their interests together and upon closing, the majority holder will agree to pay the minority holder a premium over her pro-rata share. This would eliminate the two-step process of first buying out the minority holder and then selling the entire 100% interest.

Let me interject something at this point. I've been accused of ignoring the proper standard of value and instead applying this model to a specific buyer or a strategic transaction. This is not what I am saying. One of the fundamentals of a proper standard of value is the all-important equation, willing buyer/willing seller—you can't have one without the other. So my question is, "Where are the willing sellers in this fact pattern?" If you know of one, let me know. I'm a willing buyer!

I would also add a couple of other observations about the model.

It would seem to indicate that any discount over 30%-35%, regardless of the size of the ownership, would tend to be negated and, if claimed, should be based on strong data and evidence to support such a discount.

Also, this model generally only applies to the owner of a larger than 50% interest. However, in weighing my methods for a minority interest, I will at times consider this minority premium as a potential scenario for the minority holder interest. The weight of course would be small in comparison to the other methods in play, perhaps no more than 10%.

Waiver of Partition. What happens if we introduce into this fact pattern that the father and daughter both entered into an agreement, waiving their respective rights to partition?

First, we need to verify that the waiver was proper, effective, and enforceable. I've seen fact patterns where the waiver was agreed to prior to the title transfer of the minority interest. How can one waive something that they don't have any right to? Another issue is just using common contract law, was there adequate consideration for that waiver? These legal issues could make the waiver questionable, and should then be considered when calculating any discount.

Secondly, that waiver by the 95% holder carries with it a large value. If it was not paid, either we go back to the first premise that it isn't proper, effective, or enforceable, or perhaps we have a taxable gift.

So what is the value of that waiver? I usually take a look at the transaction as if there was no waiver, make my calculations as usual, for all the interests, then I compute the calculations with the waiver in effect, eliminating the cost to partition method and perhaps including the limited real estate partnership data, changing the weights applied to the various methods to correspond with the effects of the waiver. The netted difference between those two calculations then becomes the value of that waiver. This is demonstrated in the chart below:

	With Waiver				Without Waiver (Per IRS)			
	Daughter		Father		Daughter		Father	
Underlying Value	\$4,000,000							
Interest Gifted	5.00000%	\$200,000	95.00000%	\$3,800,000		\$200,000		\$3,800,000
Discounted Value	35.00%	\$130,000	35.00%	\$2,470,000	18.00%	\$164,000	5.41%	\$3,594,420
Amount of Discount		\$70,000		\$1,330,000		\$36,000		\$205,580
Net Value giving up by each				<u>\$1,260,000</u>				<u>\$169,580</u>
Total Net Value giving up								<u>\$1,090,420</u>

Any taxable gift would get lower as the allowable discount is reduced, as demonstrated by the chart and graph below.

So entering into a waiver of the partitioning might not necessarily solve the problem of overcoming a low discount, and in fact could raise new issues. Only when the parties' interests are the same, 50/50, would a waiver help to change the overall calculations.

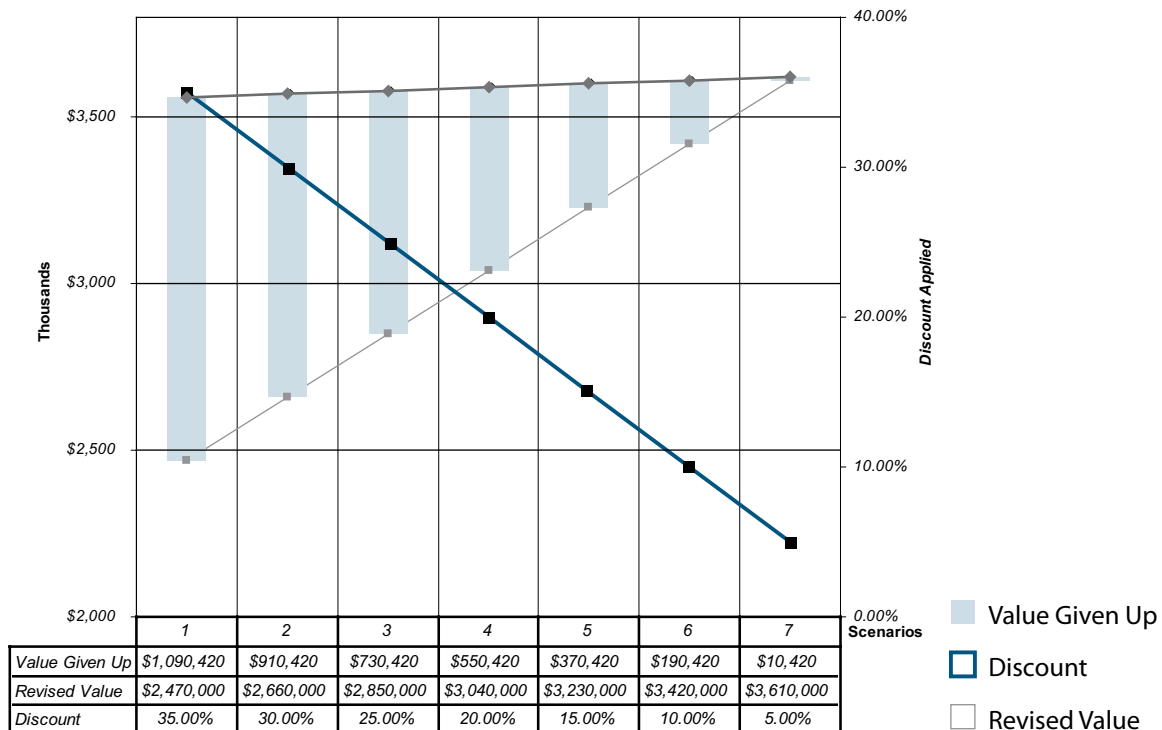
Conclusion. When calculating the fractional

interest discount in real estate, the usual data methods work fine with the common 50/50 split. But when you have a majority interest, those methods begin to lose logic based on common sense and the willing seller criterion. Care needs to be taken when you have these majority situations to make the proper determination of a reasonable discount.

Neil B. Mills-Mazer, JD, AVA, is an engineer team manager for the IRS. He can be reached at neil.mazer@irs.gov.

Underlying Value	With Waiver				Without Waiver (Per IRS)			
	Daughter		Father		Daughter		Father	
Underlying Value	\$4,000,000							
Interest Gifted	5.00000%	\$200,000	95.00000%	\$3,800,000				
					18.00%	\$200,000	5.41%	\$3,800,000
Discounted Value	30.00%	\$140,000	30.00%	\$2,660,000	18.00%	\$164,000	5.41%	\$3,594,420
Amount of Discount		\$60,000		\$1,140,000		\$36,000		\$205,580
Net Value giving up by each				<u>\$1,080,000</u>				<u>\$169,580</u>
Total Net Value giving up								<u>\$910,420</u>

Relationship of Value Given up to Discount Percentage



Government Contractors With Set-Aside Status Require Risk Adjusted Timelines

By Donald W. Nalley, Jr.

Thousands of businesses contract with the federal government. Although the top 20 government contractors account for approximately 34% of the government market, the remaining 66% is held by mostly small, closely held businesses. Dan Golish recently wrote in the *Business Valuation Update* (May 2011) that businesses contracting with the federal government are unique, and appraisers must take into account various factors that affect subject company risk. I agree, and our experience shows that those companies that have a “set-aside” status have additional distinct characteristics that valuation professionals must pay attention to.

The government allocates a percentage of its expenditures for products and services to those businesses with some type of disadvantage, including but not limited to small businesses, women owned, minority owned, and veteran disabled owned. The status most sought after is 8(a) certification from the Small Business Administration (SBA). The federal government builds in requirements that a certain percentage of the contract work go to set-aside businesses and thus provides the ability for small companies to obtain portions of contracts. For example, if Jacobs Engineering is bidding on a large job, it may be required to have a certain percentage of that work done by a set-aside business.

Businesses with set-aside status face many risks. For the business appraiser, assessing these risks is nothing new. However, it is important to understand the unique circumstances facing the small government contractor in order to adequately grasp the level of adjustment needed to the standard risk assessment model.

Government oversight is intense. The government has always been a keen watchdog of government contractors, but lately even more so. In fact, we typically see accounting and compliance

costs for a government contractor of at least three to four times the cost to a typical commercial business. This double-edged sword, increased compliance costs in the face of a need to keep administrative costs low to remain competitive, is a constant strain and a unique component in the drive for revenue growth and ultimately a sale.

In addition, the government is a very demanding buyer. It can approve a seller's profit margin and then audit that margin at the back end of a job or contract to make sure the deal was fair. It can also demand money back if the seller made a higher profit than originally budgeted.

The set-aside status is fragile and temporary. There are specific requirements to maintain a given status, and the status either terminates at a specific date or the company grows out of that particular classification. For example, we are working with a client now who as an 8(a) company had the ability to bid on sole source 8(a) work. However, the client entered into a joint venture with a larger business, retaining a 51% interest in the joint venture and the work. With a control interest, the financial statements had to be combined, which pushed the 8(a) revenue over the amount allowed for the given status. The SBA has notified the client that its ability to propose on sole source 8(a) work has been removed and it is in a workout period requiring quarterly financial statement submissions until certain revenue targets are met. Obviously, impacting potential future revenue affects value, and at a minimum the risk for this particular business just went up.

Set-aside businesses are generally small, almost by definition, and are managed by the SBA. Depending on the status, businesses either grow out or mature out. Excluded in this discussion are Alaskan Native companies and Tribal businesses, both of which enjoy continuous favored status. In addition, once a contractor leaves the protection of a particular set-aside status, competition can be stiff.

The need to keep costs low is important. Most government contracts go out in a bidding process via a request for proposal. Obviously, the government wants the best work at the best price. The request could be for a fixed-price contract or in many cases for a cost-plus contract. In a cost-plus contract, rates are critical. Rates therefore are dependent upon the base, or total, work. A contractor with general and administrative (G&A) costs of \$200,000 has a very different rate if the company's total costs in the base are \$2,000,000 than if the base is \$1,000,000. In the former, the G&A rate is 10%, generally very competitive, and in the latter it is 20% and obviously not as competitive in a bidding environment. The risk and impact on valuation, therefore, is a balancing act of obtaining quality management in the face of this pricing issue.

The government wants the best of all worlds--product and price. These businesses, being small, have the disadvantage of very little history and work experience. They have to focus and build slowly--reasons why many are forced to partner and turn to larger businesses as mentors.

When valuing a company with set-aside status for the purpose of an acquisition, there are other unique factors to consider as well. We have found that businesses that want to contract with the federal government do better when one hundred percent of their business is government contracts, because accounting is different, organizational structure is different, obtaining business is different, and professional contacts are different. Commercial businesses that don't understand this insider knowledge decide for the most part to avoid it, resulting in limited buyers, limited advisers, limited bankers, etc.

Deal flow is still significant but potential future buyers are therefore limited. Many government contractors with some type of set-aside classification are purchased each year by larger businesses--usually larger government contractors. But set-aside businesses are generally not capable of entering into a purchase transaction with another set-aside business due to various requirements. First, a set-aside business most likely does not have the ability to obtain the

capital required to purchase another business. Second, buying another business could upset the balance required in maintaining the favored set-aside status. (A discussion of the requirements facing the various categories of a set-aside business are beyond the scope of this article, but suffice it to say that there are multiple requirements to maintaining a given status, including officer salary, net worth of the owners, ownership interest of the disadvantaged owner, level of work of the majority owner, etc.) Finally, if a larger business buys a set-aside business, the favored status is lost and all contracts obtained related to that status would be re-bid at the next anniversary. So if the contracts with set-aside status are a significant part of the business, the possibility of a sale to even a large business diminishes substantially.

For these and other reasons, the odds of selling a set-aside business are low, but they improve: (1) as the business grows and a smaller portion of the revenue base is in set-aside contracts, and (2) as the business nears the end of its favored status. The result is a significant risk factor adjustment in the early years of a government contractor's life, the set-aside period. As the company matures and grows, the risk adjustment applied for this and the other issues discussed in this article would be expected to decline, thereby increasing the multiples. I've had small government contractors come to me and say, "The multiple for contractors is 1 times revenue based on the XYZ Investment Firm index," To that I reply, "That may be, but your company is not comparable to those companies," and then explain.

The approach to valuing a set-aside business is best understood with an example. To set the stage, let's summarize the need for a business valuation by a government contractor, especially one with a set-aside status. Typically these businesses are formed by someone at another government contractor that has been a part of or seen others grow and sell. The market is aware that this model can grow and be sold. We have seen government contractors that are family businesses, but that is the exception, not the rule. Most start with a goal of growth and a

liquidity event. As soon as the business gets its footing, the need to begin solidifying the structure and management base takes hold, and from that arises the need to value. Why? Because that next manager wants a piece of the action.

So, let's assume you have been asked to derive the value of a government contractor with \$3,000,000 in revenue. This is a good place to begin understanding the nuances of this business model, because the odds of being asked to value a government contractor smaller than this are practically zero and the odds of being asked to value a government contractor at this size are fairly high. Why? Because the business has obtained the size at which the founder finds the need to begin forming the management team that will assist in driving growth, and the person being considered has asked about a stock option plan. The odds are that the sought-after manager has also been with a larger contractor that had a plan, or at a minimum has heard that all government contractors have them. The market is aware of the model, and the model is growth and sale.

As the valuation professional, you might not think much of the landscape at this point in the business's life. The business is obviously small, it has almost no depth of management, two maybe three contracts, and one or two of those are probably as a sub to a prime contractor. Also, it is an 8(a), woman owned, veteran owned, or some other type of favored status, and some of the contracts depend on that status. At first blush you might ask, what value, the business can't be sold, so how can it have value? Don't be too hasty. You would be half right. The odds of a market transaction are basically zero. However, there are those who want in and won't join without stock or some type of equity sharing because they believe that it will engage in an M&A transaction sometime in the future. Therefore, the equity has value. From a big-picture point of view, the value is the discounted present value of the future sales price of the company. That is not my suggested valuation method, but it is how I look at it from a common sense point of view. It's not that it's that marketable today, but it has the chance of being marketable in the future. And that future value has value

today. It must be adjusted to reflect the risks of achievement.

So what will change between now and the future M&A event, assuming there is one? Obviously the answer is lots, but from a big picture point of view, three primary factors:

1. Management depth, systems and processes will develop and mature.
2. Revenue will grow and, in general, so will the size of the business.
3. Contracts will move to more full and open as opposed to set-aside.

In summary, the valuator must create a risk adjusted time line of the small business growing to a point in time that it becomes attractive to a larger business. At \$3,000,000 in revenue, the business has at least obtained viable status, desirable to attract quality management. Does management have what it takes to jump the hurdles necessary to achieve continued growth, and will they create a financially strong and viable \$40,000,000 business? If you as the valuator believe the answer is yes, then the business should be assessed as on a business time line. Each step along the way, the possibilities for success become greater, or for the valuator, risk declines. Again, nothing could be farther from the truth than to believe the government just throws money at small or disadvantaged businesses. Compliance with government accounting standards and billing practices is difficult and challenging, and finding the right people to staff and manage the work is critical. And that's assuming the business has managed to negotiate the difficult proposal stage. That stage in itself is challenging and requires skill and accuracy in understanding the "future" costs, both direct and indirect, that will be incurred after the contract is won. However, it has been done by more than a few businesses. Just because the landscape is tough, the risks high, and the buyer demanding doesn't mean the business has no value.

Donald W. Nalley, Jr., CPA/CVA, ABV, ASA, is director of Beason & Nalley. He can be reached at dnalley@beasonnalley.com.

Oil and Gas Field Services Industry: Sources of Information

Valuation practitioners can expect to find many opportunities for valuing oil and gas field services companies. At the recent 2011 ASA Advanced Business Valuation Conference, keynote speaker Marvin Zonis (professor emeritus, University of Chicago) told the audience it will take three to five years to emerge from this difficult economic period. When that time comes, the renewal will be “booming” and energy will play a major role. The world will reach peak oil output and the price of oil will continue to increase due to demand. However, the current shale gas boom in the U.S. is driving a switch from coal to natural gas, and manufacturing firms that have left the U.S. to find cheap power will return. “Shale gas generates a boom and an era of cheaper electricity for U.S. manufacturing—this is the big boom—it will change everything,” says Zonis.

In order to assist with your valuations the editors at BVU have compiled a select list of free and fee-based industry resources.

Prepackaged industry overviews

Bizminer
www.bvmarketdata.com

- Support activities for oil and gas operations

First Research
www.firstresearch.com

- Oil & gas field services industry

Trade Associations

American Petroleum Industry
www.ipaa.org

- Reports include “Petroleum Facts at a Glance” and “Monthly Import Statistics.”

Independent Petroleum Association of America
www.ipaa.org

- Data on American oil and natural gas production statistics by state, and statistics on exploration, drilling, reserves, supply, demand, prices, costs, industry employment, financial indicators.

Marcellus Shale Coalition
<http://marcelluscoalition.org>

- Studies, reports and presentations.

Natural Gas
www.naturalgas.org

- Overview of the business side of the natural gas industry. Sections include “Industry and Market Structure,” “Natural Gas Demand” and “Natural Gas Supply.”

International Energy Agency
www.iea.org

- The “Statistics & Balances” section contains data by product, region, and country.

Government Agencies

US Energy Information Administration (EIA)
www.eia.gov

- The *Annual Energy Review*, *Short-Term Energy and Winter Fuels Outlook*, *Weekly Retail Gasoline Prices*, *U.S. Natural Gas Imports and Exports*, and the *Natural Gas Year-in-Review*.

U.S. Bureau of Safety and Environmental Enforcement (BSEE)
www.bsee.gov

- “Offshore Stats and Facts” for three regions: Alaska, Gulf of Mexico, and Pacific.

U.S. Geological Survey Energy Resources Program (ERP)
energy.usgs.gov/oilgas.aspx

- Assessments and data for the U.S. and worldwide and regional studies.

Trade Publications

WellServicingMagazine.com

- The official publication of the Association of Energy Services Companies contains useful articles.

Oil & Gas Journal
www.ogj.com

- Subscription-based journal but articles in the “Economics & Oil Market News” section

are free. Web site is divided by industry segment: “Exploration & Development,” “Drilling & Production,” “Processing,” and “Transportation.”

Miscellaneous

Baker Hughes
www.bakerhughes.com

- Current and historical, U.S. and international rig count statistics.

Federal Reserve Bank of Dallas
www.dallasfed.org/research/energy/index.cfm

- The *Quarterly Energy Update* contains articles on current issues such as prices and forecasts.

Letter to the Editor: Clarification of Requirements for ASA, AM, and FASA Credentials

Dear Editor,

There has been a lot written recently presenting individual opinions about the differences in credentialing requirements among the various business valuation organizations. I am an ASA and the current vice-chair of the ASA’s Business Valuation Committee (BVC). The BVC and the ASA would like to clarify the ASA’s requirements for the Accredited Member (AM), Accredited Senior Appraiser (ASA), and Fellow Accredited Senior Appraiser (FASA) credentials in business valuation.

The requirements for obtaining and maintaining the AM and ASA credentials for business valuation are the same as those for the other disciplines of the ASA and are described below.

- The path to a credential from the ASA is a rigorous one that takes a minimum of two years of full-time commitment to complete. Once a prospect’s application has been approved, the applicant has 10 months to complete an ethics exam and a USPAP course and exam (see below).

Upon completion of both of these requirements, the applicant becomes a candidate for advancement. A candidate is not permitted to refer to him or herself as a “member” of the ASA as that term is reserved to those achieving the AM, ASA, or FASA status.

- The ethics exam is a 36-question open book exam that can be taken online or in person administered by an approved proctor. The USPAP course is a 15-hour course on the appraisal standards. Completion of the USPAP course includes a one-hour exam. USPAP resulted from the Financial Institution Reform, Recovery, and Enforcement Act of 1989 and is the only codification of appraisal standards specifically recognized by the United States Congress. In addition to USPAP, AMs, ASAs, and FASAs in business valuation are also required to comply with the American Society of Appraisers’ Business Valuation Standards. A candidate may apply for advancement to Accredited Member (AM) or Accredited Senior Appraiser (ASA) at any time as long as he or she

is a candidate in good standing (is current on dues and not the subject of an ethics violation).

- Advancement in the ASA requires: (1) successful completion of four 27-hour Principles of Valuation courses (108 hours total), each of which includes a three-hour exam¹; (2) a peer review of a valuation report from a valuation assignment in which the candidate is recognized in the Appraiser's Certification as making a significant contribution to the valuation assignment; and (3) documented proof to the ASA of the candidate's experience conducting business valuations in terms of "full-time equivalents." Advancement to AM requires proof of two years' full-time equivalent experience (roughly 4,000 hours), while advancement to ASA requires proof of five years' full-time equivalent experience (roughly 10,000 hours). The FASA is granted to members that have made considerable contribution to the ASA and the profession by nomination and election by the ASA's College of Fellows.
- Once accredited, AMs and ASAs are required to recertify every five years by successfully completing 100 hours of business valuation-related activities (reaccreditation credits). At least 40 of these hours must be directly related to continuing education (CE), which includes teaching and speaking. The remaining 60 hours may be completed as either CE or organizational participation (OP) credits.

1 The ASA does not presently offer an "opt-out" comprehensive exam in lieu of completing all individual course exams, although it is under consideration by the BVC.

In addition to the AM, ASA, and FASA designations, the ASA recently began offering an additional designation in the valuation of intangible assets. Receipt of the intangible asset designation requires: (1) Accredited Senior Appraiser status in business valuation; (2) successful completion of two advanced 27-hour intangible asset valuation courses (54 hours), each of which includes a three-hour exam; (3) a peer review of an intangible asset valuation report from a valuation assignment in which the candidate is recognized in the Appraiser's Certification as making a significant contribution to the valuation assignment; and (4) submission and acceptance of a log or other evidence documenting the level of experience valuating intangible assets.

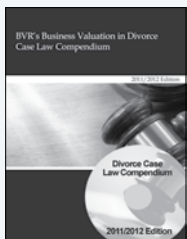
As a final note, the members of the BVC believe that certifications do not make a valuator; honesty, integrity, diligence, and informed judgment trump any alphabet soup on a business card. We challenge all in our profession to look beyond the nuances of the different organizations and focus on what we believe to be a common goal: to promote the quality and integrity of our chosen profession and demonstrate the value of our services.

Thank you on behalf of the BVC for this opportunity to clarify the ASA's credentialing requirements. If you have any questions or would like further clarification, please do not hesitate to contact me.

Sincerely,

Robert B. Morrison, ASA

Vice-Chair, Business Valuation Committee, American Society of Appraisers



\$299.00
(+ \$9.95 S&H)

520-page book
& searchable CD!

BVR's Business Valuation in Divorce Case Law Compendium - 2011/2012 edition

BVR's bestselling Divorce Case Law Compendium has just been updated! This one-of-a-kind legal resource will save you hours of research time. The Compendium puts 16 years of divorce case law that involve a business valuation issue in one place. Cases cover disputes over personal vs. professional goodwill, discounts for lack of marketability calculations, standards of value discrepancies, and much more!

Learn More & Order Online Today at:
www.bvresources.com/publications

LEGAL & COURT CASE UPDATES

‘Standard Form’ FLP Fails to Establish Non-Tax Purpose

Estate of Turner v. Commissioner, 2011 WL 3835663 (U.S. Tax Court)(Aug. 30, 2011)

Bad facts along with a standard legal form contributed to the taxpayer’s loss in this family limited partnership (FLP) case, as did the type of assets at issue.

Assets in a ‘scramble.’ By the time they were in their late seventies, the Turners were in good health and had accumulated substantial wealth, primarily stock in a family-held bank. The couple also established a life insurance trust for the benefit of their 12 children and grandchildren, for which they paid the premiums from personal funds in the amount of the then-allowed annual gift tax exclusion.

By 2002, however, the Turners’ assets were “scrambled,” according to one of their adult grandsons. He contacted an estate planning attorney, who helped establish an FLP for the couple in April 2002 but did not finalize its funding until 10 months later. The couple’s bank holdings comprised 60% of the contributed assets, along with several fixed income investment accounts, cash, and CDs, for a total value of nearly \$8.7 million. (Notably, the couple retained over \$2 million in assets for their personal living expenses.) In return for their contribution, the Turners each received a 0.5% general partnership interest and a 49.5% limited partnership (LP) interest.

The FLP was modeled on a standard form used by the attorney’s law firm. As a result, some of the purposes listed in the partnership agreement did not apply to the Turner family (e.g., the goal of consolidating fractional interests in real property). The agreement listed three purposes specific to the family: 1) to make a profit; 2) to increase their wealth; and 3) to provide a mechanism for family

members to become more knowledgeable about finances. One provision required the general partners to pay the FLP’s operating expenses from personal funds, but the Turners paid these by receiving monthly “management fees” from the partnership, which also paid two grandchildren for management services and booked all fees as distributions rather than expenses.

After funding the FLP, the Turners transferred LP interests to their beneficiaries, including a trust for one of their grandchildren due to his acknowledged drug abuse. In a letter, their attorney advised them that “a key element to a gifting plan is the need of a sound appraisal of the partnership for tax purposes.” Accordingly, the attorney obtained an appraisal firm, which found that the aggregate fair market value of the LP gifts was just over \$2 million. (*Note:* The Tax Court opinion does not provide any detail regarding the valuation methodology or the applied discounts.)

Two years later Mr. Turner died, and the attorney filed a gift tax return on behalf of the estate, deriving the values of the LP interests from the original appraisal. The estate also obtained an appraisal to file its return, reporting that Mr. Turner’s general and LP interests at the time of his death were worth \$31,000 and \$1.6 million, respectively. (Once again, the Tax Court did not detail the underlying valuations.)

In 2008, the IRS assessed a deficiency, claiming that IRC Sec. 2036 pulled the entire fair market value of the FLP assets into Mr. Turner’s gross estate. Prior to trial, the parties stipulated to the net asset value of the FLP assets at \$9.58 million. However, the estate claimed that the 2036(a)(1) exception for a “bona fide sale for an adequate and full consideration” applied to the FLP transfers, because the Turners created the FLP for at least three “legitimate and significant nontax reasons.”

Importantly, none of these asserted reasons tracked the stated purposes in the partnership agreement (which the court once noted was

drawn from the attorney's draft template, and did not reflect the family's "actual" motives.) Instead, the estate appeared drawn on the reasoning of Tax Court cases that preserve FLP form and transfer values. However, the court distinguished the precedent and facts in this case, as follows:

1. *Asset consolidation and centralized management.* "Consolidated asset management may be a legitimate and significant nontax purpose," the court said, citing *Estate of Schutt v. Comm'r*, T.C. Memo 2005-126 (2005) and *Estate of Black v. Comm'r*, 133 T.C. 340 (2009). However, those cases involved FLP assets that required active management or special protection against dissipation by family members. *Estate of Black*, for instance, involved a "swing" bloc of voting stock in a family-held company. The court also cited *Estate of Mirowski v. Comm'r*, T.C. Memo 2008-74 (patent royalties and related investments), and *Estate of Kimball v. Comm'r*, 371 F.3d 257 (5th Cir. 2004)(working oil and gas interests).

Moreover, in *Estate of Schutt*, even though the assets did not require active management, the FLP was formed to perpetuate the founder's specific "buy and hold" investment philosophy. In this case, however, the Turners did not own a significant bloc of voting stock in an operating business. In fact, the assets they contributed to the FLP required no active management or special protection, and did not change form in any substantial way during FLP operation. Further, Mr. Turner did not hope to perpetuate a "unique or distinct investment philosophy," the court observed. On the contrary, the lack of a cohesive investment plan was one of the family's primary reasons for forming the FLP, and the grandchildren's management responsibilities merely formalized the role they'd played previously in helping the Turners with their finances.

2. *Resolution of family discord.* There was some indication that the Turner's four grown children did not get along. "Although resolution of family disputes or promotion of family harmony" may be a legitimate business purpose, the court said, citing *Mirowski*, in this case, the "ill will among the Turner children was not about money, per se." None of the children had expressed any particular

interest in managing the family's assets, either. Under these facts, the court was not persuaded that the senior Turners transferred most of their wealth to an FLP to resolve family discord, and any claim that they did appeared to be "little more than an after-the fact hypothetical justification."

3. *Protection from dissipation by family members.* Asset protection can also furnish a legitimate business purpose, the court said, citing *Schurtz v. Comm'r*, T.C. Memo 2010-21 (formation of an FLP to protect family business from the litigious atmosphere in the state). But the estate's argument that the Turners formed the FLP to protect their one troubled grandson did not rise to the same level, in part because the Turners retained sufficient assets to provide for the grandson directly and did, in fact, give him money on occasion. They did not have to "go through the trouble" of forming and funding an FLP, the court said, when the grandson's trust provided sufficient protection against his potential dissipation of the assets.

Three additional factors indicated that the FLP transfers were not bona fide sales, the court found. First, Mr. Turner stood on both sides of the transaction, creating the FLP without any "meaningful bargaining" with his wife or any of the anticipated LPs. Second, Mr. Turner commingled personal and partnership funds to pay himself (and his wife) management fees, and to pay for their estate planning as well as the premiums on the children's trust life insurance policy. Third, the Turners did not complete funding for the FLP until eight months after its formation.

For all of these reasons, the court concluded that the formation of the FLP "falls short of meeting the bona fide sale exception" of Sec. 2036(a). Likewise, these facts supported the court's finding that Mr. Turner implicitly retained the FLP assets for his use and enjoyment during his lifetime.

A phrase not to use in an engagement letter? "Most importantly," the court held, the purpose of the Turner FLP was "primarily testamentary." Mr. Turner retained an estate planning attorney to accomplish his specific goals of providing for his wife and children after his death and preserving his assets. In particular, the court was struck

by the estate's "implausible" argument that tax savings never entered into the FLP discussions. After all, the attorney's letter had expressly counseled that an appraisal was a "key element" in tax planning purposes. "Indeed, such appraisal was the key to [Mr. Turner's] estate plan," the court said; "both the gift tax and estate tax returns used substantial discounts despite the fact that the partnership assets at each relevant date consisted of, inter alia, cash, cash equivalents, and marketable securities."

In sum, the court concluded that the entire fair market value of the FLP assets were included in the gross estate, pursuant to Sec. 2036.

As a final matter, the court considered the IRS's arguments that Mr. Turner's payment of life insurance premiums failed to fall within the annual gift tax exclusion (IRC Sec. 2503), because they were not gifts of present interests. In other words, "no part of the value of the gift of a future interest qualifies for the annual exclusion," the IRS argued, citing regulations related to Sec. 2503.

In distinguishing present from future interests, however, the test is not whether the beneficiary is likely to enjoy the gift in the present, the court explained, but "whether he or she had the legal right to demand it." Under the trust instrument, the Turner beneficiaries had the "absolute right and power" to demand withdrawals of funds to pay the life insurance premiums, the court said. Those rights were not "illusory" simply because Mr. Turner chose to pay the premiums directly instead of depositing the amounts with the trust.

Neither did the gift of LP interests to the children "use up" their annual exclusions, as the IRS argued. In fact, in its notice of deficiency, the IRS increased Mr. Turner's estate by the net asset value of the FLP transfers but made a corresponding reduction to the adjusted taxable gifts. To do anything else would have resulted in "the double inclusion of a significant part of the property transferred" to the FLP, the court held, in concluding that the premium payments qualified for the annual gift exclusion.

Note: all cited cases are available at *BVL*aw.

Non-Compete Transfers Professional Goodwill to Practice for Tax Purposes

Howard v. United States, 2011 WL 3796723
(C.A.9 (Wash.))(Aug. 29, 2011)

After incorporating his dental practice in 1980, Larry Howard, DDS, became the sole shareholder and officer of the Howard Corporation. Dr. Howard also entered an agreement not to compete with the Howard Corp. (in effect, protecting the company from himself). The agreement did not address whether the doctor or the business owned the related professional goodwill.

Subsequent sale allocates goodwill. When Dr. Howard retired in 2002, he sold the practice to another dentist pursuant to an asset purchase agreement, which expressly allocated nearly \$550,000 for Dr. Howard's personal goodwill and \$16,000 for his covenant not to compete with the new buyer. On his federal income tax returns that year, Dr. Howard reported just over \$320,000 as long-term capital gain income resulting from the sale of goodwill, but the IRS re-characterized the goodwill as a corporate asset, treating the \$320,000 as a dividend. After paying the deficiency, the dentist and his wife claimed a refund in federal district court, but the court granted summary judgment for the government. (For the digest of *Howard v. United States*, 2010 WL 3061626 (E.D.Wash.), see the October 2010 *BVU*.)

In their appeal to the U.S. Court of Appeals for the Ninth Circuit, the taxpayers reasserted their claims that the proceeds from the sale of Dr. Howard's goodwill were personal assets, subject to long-term capital gains taxation. Similarly, the government once again contended that the goodwill proceeds belonged to the Howard Corporation.

"For purposes of federal income taxation, the goodwill of a professional practice may attach to both the professional as well as the practice," the Ninth Circuit began. When the success of

the firm depends entirely on the practitioner's personal relationships, "the practice does not generally accumulate goodwill," the court added, citing *Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 (1998)(available at *BVLaw*). The practitioner may, however, transfer his or her goodwill to the practice by entering into a non-competition agreement; the issue in any case will turn on its particular facts.

In this case, Dr. Howard worked for the Howard Corporation for over 20 years pursuant to the employment contract, including the covenant not to compete. The agreement provided that the corporation retained "complete control and authority" regarding patient referrals, accounts, and records. Accordingly, although the relationships that Dr. Howard developed with his patients were certainly "personal," the court held, his agreements had conveyed their economic value to the corporation.

Moreover, pursuant to his asset purchase agreement with the new buyer, Dr. Howard entered into a restrictive covenant not to compete for three years from the date of sale. The Howard Corporation also agreed to compensate Dr. Howard for any services that he provided the buyer and his patients. The taxpayer argued that by its express language, the purchase agreement conveyed Dr. Howard's individual goodwill as a "personal, non-corporate asset," and by doing so, it effectively terminated his prior employment contract and non-competition agreement with the Howard Corporation.

But, "self-serving language in a purchase agreement is not a substitute for a careful analysis of the realities of a transaction," the court held, in rejecting any argument that the purchase agreement implicitly transferred the accumulated professional goodwill from the corporation back to the dentist. Further, even if the corporation released the goodwill via the purchase agreement, "such a release would constitute a dividend payment, the value of which would be equivalent to the price paid for the goodwill of the dental practice," the court said.

Finally, the taxpayer conceded that the dentist conducted his business as a C corporation to take advantage of certain tax benefits over the years. As a member of the Ninth Circuit panel asked during oral arguments, "why should we allow him . . . out of what he got himself into?" Since the taxpayer offered "no compelling reason" why he should be released from his chosen corporate structure, the court confirmed summary judgment on behalf of the government in this case, finding that the professional goodwill was an asset of the corporation and its sale proceeds a dividend to the taxpayer.

Market Value Approach Better Than Gordon Growth for Failed Bank

AmBase Corp. v. United States, 2011 WL 3891942 (Fed. Cl.)(Aug. 31, 2011)

As the U.S. Court of Federal Claims notes at the beginning of its opinion, this is one of the last of the *Winstar*-related cases to come out of the savings and loan crisis of the late 1980s and the government's enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). As with the prior *Winstar* cases that we've reported in the *BVU*, the lessons gleaned from this one—particularly in the calculation of economic damages related to failed financial institutions—may very well carry over into current economic and litigation climate.

Acquisitions during the troubled 80s. By 1986, and at the behest of federal regulators, the Carteret Savings Bank had acquired four failing, FSLIC-backed thrifts. Prior to the "supervisory mergers," the bank posted net profits of \$37 million. As a result of its acquisitions, however, its net worth fell to a *negative* \$212 million and the bank would have failed if not for the government's express agreement permitting it to book approximately \$238 million of "supervisory" goodwill as regulatory capital.

In 1987, the AmBase corporation acquired Carteret's holding company for \$266 million, and

within a year, the bank became the 19th largest savings and loan association in the country, with assets of almost \$6 billion. The bank also held \$322 million in regulatory capital, more than half of which (\$182 million) was supervisory goodwill.

Just a year later, however, Congress passed FIRREA and eliminated supervisory goodwill as counting toward regulatory capital requirements. To comply with the new law, Carteret took immediate action, shedding \$2.3 billion worth of assets and beefing up loan loss reserves from \$8.4 million to \$27.5 million. In 1991, the bank also successfully enjoined federal regulators from disregarding its supervisory goodwill and briefly returned to profitability. Despite capital infusions from its parent, however, the bank couldn't maintain sufficient capital and was placed in receivership. The bank and its parent company subsequently sued the federal government, claiming its enactment of FIRREA breached the supervisory merger agreements.

In a first opinion, the Federal Court of Claims found the government liable for breach of contract. In this opinion, the court determined the expectancy damages due; i.e., the benefits that the plaintiffs would have received, but for the defendant's breach.

As a preliminary matter, the court found that the plaintiffs satisfied the first two requirements of federal law on contract damages: foreseeability and causation. In particular, "the government understood at the time of the transactions that [the bank] could not survive without the use of supervisory goodwill," the court said. Further, "the breach significantly impacted Carteret's regulatory capital profile and set off a resulting chain of negative events that eventually led to the bank's seizure." Thus, there was sufficient evidence that the breach was a "substantial factor" in the bank's failure.

The government argued that the more stringent "but for" test applied. ("But for" the breach, the bank would have remained profitable.) The real reasons behind the bank's demise were the losses due to its corporate and commercial

real estate practices, along with its severe asset quality problems and lack of loan loss reserves. The court disagreed, however, and rejected the "but for" test in this case. Moreover, even if the higher standard applied, the court found sufficient evidence that the bank would have survived, "but for" the government's breach.

Evidence of market value trumps earnings models. As a third and final issue, the court determined damages. The plaintiffs' expert, a university finance professor, presented three alternative calculations:

- \$251.4 million, based on the market value of the bank at the time of its 1989 acquisition by AmBase;
- \$782.2 million, based on the bank's 1989 cash flows and its 2008 terminal value; or,
- \$920.7 million, representing the bank's market value in a "non-breach" world.

The court rejected the latter two approaches, based primarily on the expert's use of the Gordon Growth Model. As one of the defendants' rebuttal witnesses testified, the Gordon Growth Model "can only be used with firms with . . . very stable growth over time," and the evidence in this case showed the bank's earnings varied considerably over the years. The model also cannot (and did not) show the investment opportunities, sources of funding, and other options the "but for" bank might have enjoyed, the court held, concluding that the Gordon Growth Model did not apply in this case.

On the whole, the court accepted the expert's market value approach, which began with the price that AmBase paid for the bank (\$266 million) in 1989. At the time, two investment banks had evaluated the deal and concluded that it was fair. In addition, the stock market independently valued the bank at \$198 million just before the transaction. In light of the additional obligations that AmBase undertook as part of the deal, even one of the defense experts admitted that the final purchase price reflected a control premium that was "within the realm of reason."

Accordingly, the court agreed that the \$266 million sale price was a “reasonable measure of the fair market value of the bank prior to the breach.” After the acquisition, however, the bank was no longer publicly traded; as a result, the plaintiffs’ expert could no longer use the bank’s market-to-book ratios to determine value. Instead, he applied the average rate of increase in the market-to-book ratios from 46 publicly traded comparable thrifts (7.4%) to the bank’s pre-acquisition ratio (0.869) to calculate a post-acquisition ratio (0.934). Applying the latter to the bank’s post-acquisition book value (\$269.3 million) resulted in a market value of \$251.4 million at the time of the breach.

The court accepted the expert’s use of an industry “index,” derived from his selection of comparables. It also found that tracking the thrift industry’s growth in 1989 was conservative because—even though FIRREA didn’t pass until the end of the year, the market was already absorbing the impact of the legislation, which helped to suppress thrift values. Finally, the plaintiffs’ expert effectively captured the increase in the bank’s “classified assets,” which took place just before the 1989 breach.

At the same time, one of the defendant’s experts reduced the bank’s pre-breach value (\$269.3 million) by the \$77.2 million in loan loss reserves that federal regulators were requiring from the bank several months before FIRREA. Applying the mean market-to-book ratio of the industry (0.934) to this adjusted book value yielded an adjusted market value of \$179.4 million for the bank.

In response, the plaintiffs argued that regulators actually reduced the required loan loss reserves to \$49.8 million, and the court accepted this lesser amount. After applying the industry ratios, it concluded that the adjusted market value of the bank at the time of the breach was \$205 million, and ordered the defendant to pay damages in this amount. Based on its award of lost value, the court also rejected the plaintiffs’ arguments for additional “wounded bank” and reliance/restitution damages.

Court Rejects ‘One Size Fits All’ Rule for Valuing Stock Options

Farmer v. Farmer, 2011 WL 3929114
(Wash.)(Sept. 8, 2011)

In a 6-4 split decision, the Washington Supreme Court considered a wife’s measure of “damages” after her husband fraudulently exercised her share of stock options awarded in divorce. A strong dissent believed the majority’s ruling was punitive in nature, effectively giving the wife a windfall by maximizing the options’ value without appropriately accounting for their holding period and risks.

Divorce, lies, and stock options. During the marriage, the husband received upwards of 15,000 stock options from his company, PACCAR, a global manufacturer of commercial trucks. Each option grant came with a set price and a ten-year expiration period. During the parties’ 2006 divorce, they agreed to divide the non-transferable stock options equally, with the husband retaining possession but the wife having the right to choose when to exercise her share.

Approximately one month after filing the agreement with the court (but before entry of a decree), the husband unilaterally cashed in all the options, netting nearly \$450,000 after taxes. Shortly after, the husband tried to convince the wife several times to exercise her options, which, unbeknownst to her, no longer existed. The wife refused and, in the meantime, discovered a \$490,000 deposit in the husband’s bank account. At the final orders hearing, the husband told the court that the money came from exercising only *his* options, and the court granted the divorce decree but ordered the husband to turn over all records of the exercise to the wife. After weeks of continued defiance, the husband finally admitted that he had sold all the options.

The wife immediately moved the court to re-open the decree and award her an amount sufficient to compensate her for her loss. In support, she submitted an affidavit from a CPA, whose analysis of

PACCAR stock over the prior 10 years revealed an annual rate of return of just over 20%. By assuming this constant rate of return and that the wife would hold each of her options until the very last day before expiration, the expert calculated her losses at just over \$617,000.

The husband contested the valuation, but did not offer any competing analysis. The court awarded the wife \$617,000 in damages and the husband moved for reconsideration, citing two Washington decisions, a divorce case and a tort case, which he argued required measuring damages for fraudulent conversion of stock options (and other fluctuating assets) based on the highest value of the asset at the time of conversion or a reasonable time thereafter. Under this measure, the wife would have received \$173,000. The husband also argued that the court erred by failing to discount the wife's award to present value.

After thinking "long and hard" about the cited precedent, the trial court nevertheless upheld its award, citing its equitable role and also its reluctance to reward the husband for his wrongdoing. It did agree that any damages should be discounted to present value, and set a hearing to resolve this issue. At the hearing, the wife's expert proposed a rate of 6% and the husband's countered with a range of 15% to 20%. For the first time, the husband also offered his expert to criticize the original valuation of the stock options by the wife's expert, but the court rejected this evidence as untimely and adopted the 6% discount rate, awarding the wife just over \$487,000.

Court of appeals confirms. In an unpublished decision, the court of appeals rejected the husband's challenge to the award, deferring instead to the trial court's broad authority in marital dissolutions to equitably divide the assets. The appellate court also noted that the award, including its calculation of the discount rate, put the wife "in as good a position as she would have been" but for the husband's fraud.

The husband appealed to the state Supreme Court, reasserting his arguments based on the precedent. The majority opinion discussed only the divorce case, in which the husband cashed his

wife's share of options and the stock plummeted immediately after the conversion. In that case, the Supreme Court affirmed the trial court's reference to the tort measure of damages, which values the options on the day they were converted. Notably, the court did not address what damages framework would apply in a divorce should the value of the stock *increase* after conversion.

Nevertheless, the husband argued that this prior decision required *any* damages to be measured on the date of conversion or a reasonable time afterward, but under no circumstances beyond the date of judgment. The wife countered that the trial court's valuation was supported by the evidence and within its broad equitable discretion—and the Supreme Court agreed.

"We reject [the husband's] proposal for a single, categorical rule for measuring the value of stock options when the stock price increases after conversion," the six-member majority wrote. The divorce precedent did not mandate such a "one size fits all" rule. Further, "the valuation of stock options does not lend itself to one universal approach," the majority said, noting the "formidable task" involved given the numerous contingencies and restrictions related to options.

In general, divorce courts throughout the country have taken three approaches to stock options: present value, deferred distribution, and retained jurisdiction. The first involves complex option pricing methods such as the Black-Scholes formula, but the latter two don't involve valuation so much as a the courts' allocating the rights to the options at the time of divorce, with orders to award their value later, at the time of exercise. Measures of damages are equally varied in tort cases, the court said, noting at least seven approaches among different jurisdictions. The "New York Rule," for instance, uses the highest value of the stock between the time the victim learns of the conversion and a reasonable time thereafter, but excludes the time during which the victim had no notice, because presumably any exercise would have informed the victim of the fraud.

Employment options are irreplaceable. The rationale underlying the New York Rule as well

as other measures of conversion damages “makes sense only when dealing with assets that are readily replaceable on the market,” the court explained. But employment stock options “have no market and are irreplaceable.” Once the husband converted the wife’s options, “they were gone forever.” Adoption of the New York Rule, as argued by the husband, did not serve the remedial purposes of the law, the court held, when “the rule’s policy underpinnings are simply not present.”

The court also confirmed the trial courts’ broad equitable power to distribute assets, particularly those that pose “difficult valuation problems,” such as pensions and professional practice goodwill. “Our reluctance to second-guess the trial court’s equitable authority is even more pronounced when we are asked to dictate not only a method of valuation, but also the calculation of damages under that method,” the court said, in confirming the trial court’s adoption of the wife’s expert valuation. “Unlike the dissent, we decline to critique [the expert’s] calculations on review,” the court held, and confirmed the award of \$487,000 to the wife.

In the dissent, four members of the panel noted that the majority’s measure of damages went beyond making the wife whole—it granted her a windfall and effectively punished the husband. Moreover, the trial court’s valuation of the options came “without a scintilla of evidence” related to when the wife would have exercised her options or whether the assumption of a straight-line, 20% annual growth rate for the stock was reasonable. The trial court also accepted the 6% discount rate, which “unrealistically eliminated most of the risk of holding stock options until the day before expiration,” the dissent said.

Based on its review of state and federal tort cases, the dissent would have reversed the award as speculative and remanded the case for the wife to present evidence on when she would have exercised the options. Barring credible facts to support this determination, the dissent would require the trial court to calculate damages based on the New York Rule.

Atypical Life Insurance Firm Proves a ‘Sticky Wicket’ for Experts, Court

In re Marriage of Hashemian, 2011 WL 3873861 (Cal. App. 4 Dist.)(Sept. 2, 2011)(unpub.)

The husband was the sole owner of a company that dealt primarily with the purchase and sale of life insurance and also “life settlements,” secondary market transactions involving the insured and lenders or other third-party investors, for which the company had received substantial commissions in the past. Although the sale of life settlements represented the majority (79%) of the company’s revenues in 2005, this percentage had declined due to industry factors to just two-thirds (66%) of revenue by 2007, the time of the parties’ divorce.

To combat the declines in the life settlement industry, the husband’s company increased its insurance consulting and design practice. Its adjusted gross income for the two tax years prior to divorce was over \$1.5 million, and the husband controlled monthly cash flows of \$125,000 for the year before trial. During this time, the husband qualified for the “Million Dollar Round Table,” an organization for leading U.S. insurance agents; at one point, he was among the country’s top 250 insurance agents.

Three experts testify. The parties initially retained a joint expert to value the business. The expert used two approaches: the excess earnings method and a “formula approach.” Under the first, the expert valued the company’s goodwill (excess earnings) by reference to a 2003 survey by the Million Dollar Round Table, comparing the average income and expenses for insurance firms in the husband’s region (Southern California) to the husband’s averages over a five-year period, 2003 through 2007. The expert also applied a 100% capitalization rate for his December 2007 valuation to arrive at an ultimate value of \$867,000 under this approach. As a reality check, the expert noted that the husband’s 2007 commissions on all business but life settlements totaled \$882,000, or slightly more than his excess earnings value.

Under the formula approach, the parties' joint expert looked at an average of the firm's gross revenues over the five years prior to the valuation, which equaled \$2 million. He backed out nearly \$35,000 in life insurance premium renewals, to isolate a value for the non-renewal business. He then applied a 90% industry revenue multiplier, based on a review of two sources: 1) a "handbook [of] small business formulas," which indicated that the multiplier could be even higher; and 2) a "valuation guide" that the husband had given him, which indicated that a multiplier of 1.0 or even 1.1 would be an appropriate multiplier for firms with commissioned financial practices.

Using the .90 multiplier, the expert concluded the business was worth \$1.7 million; he applied a 50% discount, however, to account for the decline in the life settlement sector and the anticipated loss of these commissions. After speaking with the husband, the expert believed that the firm could redesign its sales strategy, especially given the husband's long history (more than 25 years) in the life insurance business and his record of making "a substantial amount of money prior to life settlement." The husband had just bought a list of 200 client referrals, for instance, and had commission arrangements with over 50 agents nationwide.

These facts supported the value of the firm's non-renewal business at \$850,000 (which was also less than the firm's 2007 commissions on traditional insurance policies). He then added its renewal business by multiplying this value (\$35,000) by a 1.5 multiplier, reasoning that it was "easier to generate renewal income" than a flat commission for a new policy, and concluded the firm was worth \$954,000 under this formula approach. Averaging the two approaches together yielded an ultimate value of \$911,000 for the business.

Both the husband and wife presented independent experts. The husband's expert said the firm was worth only \$100,000 and, further, "did not meet the criteria of a 'business.'" The wife's expert criticized the 50% discount that the joint expert applied to the non-renewal revenues as "too high." The court disagreed with both, rejecting

the opinion of the husband's expert as "tenuous and lacking in credibility" and that of the wife's expert as "speculative."

In contrast, the court found the joint expert's conclusions to be thorough and credible. Both his excess earnings and formula approach were "proper methods of valuation," the court said, and adopted his ultimate value of \$911,000.

Husband excludes the report, then complains the record is incomplete. On appeal, the husband raised three valuation issues. In the first, he noted that after conclusion of the joint expert's testimony, his attorney objected to the admission of the joint expert's report as cumulative evidence and also hearsay. The court sustained the objection on the basis of hearsay and excluded the expert's report, relying solely on his trial testimony to support its final findings and orders.

"This being the case, [the husband] now claims that there is no substantial evidence to support [the joint expert's] valuation of the business," the appellate court observed. "We disagree." Even without the reports as part of the record, the joint expert provided "lengthy and detailed" testimony, clearly explaining his methods and conclusions, thereby creating a substantial and complete record on which to review the trial court's findings.

As a second matter, the husband challenged both methods used by the joint expert. In particular, the husband cited *In re Marriage of Rosen*, 105 Cal. App. 4th 808 (2002)(available at *BVLaw*), in which the court faulted the expert for valuing the husband's solo law practice under the excess earnings approach by relying on two surveys—one a national survey of lawyer compensation and the second a survey of officers and directors compensation. The latter did not apply at all, the court found, and the former was far too broad.

In this case, however, "the geographical concern does not apply," the court held. The joint expert used the appropriate regional data from the 2003 Million Dollar Round Table survey in his calculations, and there was no more recent

data available. At the same time, “the more ticklish issue” was that the survey pertained only to life insurance agents rather than the life settlement business, the court conceded. In this respect, the survey was “less than ideal,” but it still had value because there was evidence the husband intended to realign his business back to the traditional life insurance sales and consulting.

Moreover, the expert’s conclusion under the excess earnings approach (\$867,000) was supported by the husband’s total 2007 sales commission from “regular” life insurance sales (\$882,000). Based on these facts and in the context of a changing business, the court found that the expert’s reliance on the survey in his excess earnings approach was not improper.

Formula approach was not ‘fair market value.’ Finally, the husband argued that the joint expert’s application of a “formula approach” contravened the applicable fair market value standard. Once again, the appellate court disagreed, finding that state precedent did not specifically require a fair market value standard when valuing closely held business interests, but, for example, also provides for investment value.

“Most of the cases illustrate there is no one applicable formula that may be properly applied to the myriad factual situations calling for a valuation of closely held stock,” the court said. Instead, the trial court must review “each factor” that might bear on value, using IRS Rev. Ruling 59-60 as a general guide.

In this case, although the joint expert did not specifically cite Rev. Ruling 59-60, the record reflected his consideration of “most” of these factors, the court found. Admittedly, the expert did not consider sale of similar businesses—but that factor did not necessarily apply to the husband’s company, for which there might not be ready or simple comparative data. “Without question, the valuation of the business was a little bit of a sticky wicket,” the court noted, in confirming that the record contained substantial evidence to support the \$911,000 valuation “affixed” by the joint expert and adopted by the trial court.

Federal Court Resurrects 25% Rule of Thumb to Calculate Ongoing Royalty

Douglas Dynamics v. Buyers Products Co., 3-09-cv-00261 (W.D. Wis.)(Sept. 22, 2011)

A jury found the defendant liable for infringing two of the plaintiff’s patented snowplow assemblies and awarded approximately \$1.1 million in damages for past infringement. After the verdict, the federal district court denied the plaintiff’s request for a permanent injunction and instead invited the parties to negotiate a reasonable royalty for any prospective infringement.

Parties were ‘miles apart.’ The parties agreed that an ongoing royalty rate should exceed the effective 3.3% awarded by the jury for past infringement, but they were “miles apart” as to what that rate should be, the court observed. The defendant suggested a 5% ongoing royalty based on applying wholesale prices to the snowplow assemblers.

In contrast, the plaintiffs wanted a 44% royalty rate to apply to the assemblies that the defendant sold between the jury’s entry of an award and the court’s denial of an injunction, and a 16% royalty rate for any sales thereafter. The court found no legal basis for “parceling” the prospective damages by time periods. The denial or issuance of an injunction is not relevant to the hypothetical license negotiation between the parties, which assumes infringement but does not allow “jockeying for position in litigation or leveraging the most draconian of outcomes,” the court found. Moreover, such a short-term “lever” would not apply in this case, in which the infringement concerned relatively minor patents that the defendant ultimately designed around, factors that supported the denial of a permanent injunction.

These factors also affected the parties’ suggested royalty rates, as when, during trial, the plaintiff could not offer any instances of actual lost sales due to the defendant’s infringing plows. Instead, the evidence suggested that the defendant’s sales were driven not by the patented technology, but

by its lower price point. Its customers were largely those that, absent the infringing products, would have purchased an inferior plow from another of the plaintiff's competitors rather than from the plaintiff. This was supported by additional trial evidence that showed the plaintiff's market share held constant or even increased slightly after the defendant's introduction of the infringing plows.

"On the other hand," the court noted, during a hypothetical negotiation, the plaintiff would not have known the impact of defendant's entry into the market with a plow that offered even minor advances compared to its own. Further, a reasonable royalty should "leave some room for profit," the court explained. "Otherwise it makes little sense to enter into an ongoing royalty at all." In light of all these considerations, the plaintiff's suggest range of 16% to 44% was "simply too high," the court held. These rates would not only cut all of the defendant's profits, but would mean selling infringing plows at a loss.

Begin with the 25% benchmark. Instead, the court was persuaded to start with the approach used by the district court in *Paice LLC v. Toyota Motor Corp.*, 609 F. Supp. 2d 609 F. Supp. 2d 620 (E.D. Tex. 2009), on remand from *Paice LLC v. Toyota Motor Corp.*, 504 F.3d 1293 (Fed. Cir. 2007). In that case, the federal district court applied the "25% rule of thumb" as a starting point for setting the plaintiff's post-verdict royalties, ultimately taking 25% of the defendant's profit margin to reach an ongoing royalty of 2.25%.

In this case, 25% of the defendant's 12.9% profit margin was 3.225%. The court found an additional 2% was reasonable, particularly since the defendant "offered" a reasonable royalty rate of 5% and its continued use of infringing plows would only provide a slight increase in sales. Even so, the court considered the plaintiff's relatively strong bargaining position, as the holder of an undisputed infringement claim with a "credible desire to give no leg up, however minor, to a potentially strong, long-term competitor."

Based on this assessment, the court believed that the plaintiff would have leveraged its position to nearly double the pre-verdict rate of 3.3%, and

awarded an ongoing rate of 6.225% for "every infringing snowplow assembly" that the defendant has sold or will sell from the time of the jury verdict to the patents' expiration.

Editor's note: In its reliance on the *Paice LLC v. Toyota Motor Corp.* decision as a general framework for calculating prospective royalty rates, the federal court does not cite or discuss *Uniloc USA, Inc. v. Microsoft Corp.*, in which the Federal Circuit abolished the 25% "rule of thumb" in patent infringement cases, finding the benchmark unreliable under *Daubert*. (For the case digest, see the March 2011 *BVU*.)

In fact, the Federal Circuit expressly cited its decision in *Paice* as one that, in the past, "passively tolerated" the 25% rule. This begs the question whether the district court's reliance on *Paice* to apply the rule, even as a benchmark in setting prospective royalties, contravenes *Uniloc* and leaves this case vulnerable on any appeal.

Medical Practice Value Deals with 'Murky' and 'Suspect' Accounts

Rughani-Shah v. Noaz, 2011 WL 4104507 (N.J. Super. A.D.)(Sept. 16, 2011)

As a young doctor, the plaintiff purchased a 25% interest in an ongoing pediatric practice for just over \$160,000 in 1998. The bulk of the purchase price (nearly \$150,000) was allocated to goodwill, determined by taking 35% of the average gross receipts from the practice's three most recent years. At the time, the senior shareholders required a payment for goodwill in exchange for giving the plaintiff a new patient base.

The plaintiff paid off the purchase price over several years through a series of salary adjustments and a promissory note; after adding interest and tax differentials, her buy-in price amounted to just over \$275,000 (although the plaintiff claimed it was closer to \$330,000). Upon completing all the payments in 2004, the plaintiff received a

stock certificate evidencing her 25% interest and also a buyout price of \$150,000.

In the meantime, another doctor resigned from the practice. The senior shareholders offered him \$200,000 for his 25% interest, which he declined due to a restrictive non-compete. After spending more than a year in negotiations, this doctor finally agreed to take \$75,000 “because he was tired of the hassling.” When he left, the plaintiff became a 33% shareholder; she also took over bookkeeping duties and began to discover certain discrepancies, particularly those involving alleged overpayments to the senior shareholders and underpayments on certain expenses.

Following these discoveries, “things went downhill tremendously,” the plaintiff said. She hired an attorney, who notified the shareholders that the plaintiff intended to initiate a suit for dissolution and requested a buyout at fair value. Not long after she filed the suit in 2008, however, the senior doctors terminated the plaintiff, claiming the shareholders’ agreement limited their repurchase obligation to book value.

Mismanaged accounts. In particular, the buy-sell provisions of the agreement permitted the practice to repurchase the shares of any terminated shareholder at “book value,” as determined by the accrual method and excluding goodwill (unless already carried on the books). In addition, the value of client receivables would be discounted by 10% for bad accounts, based on the practice’s historic collection rates.

At trial, the shareholders retained the director of their billing services to testify as their valuation expert. Although the accounts receivable had grown steadily, from \$200,000 in 2002 to over \$716,000 by 2007 (the valuation date), this growth was due to mismanagement rather than practice expansion, the expert said. For example, she discovered claims for services that had languished for up to five years and capitation payments that still appeared as open accounts when in fact they had been received.

All told, the expert discovered “several thousand claims outstanding” and credit balances that

inflated the 2007 accounts by up to \$130,000. After adjusting for all discrepancies, the expert determined the accounts were worth \$131,000, without applying the 10% discount provided in the shareholders’ agreement. She then added current and accrued assets, cash, inventory, and fixed assets; subtracted liabilities and added back retained earnings to arrive at a total practice value of just over \$125,000. Plaintiff’s 33% share of this amount equaled approximately \$41,000.

Based on the same financial documentation of accounts receivable, the plaintiff’s expert started with their \$716,000 value as of 2007, but simply reduced this by the contractual 10% discount. He then added current and fixed assets, based on the practice’s most recent tax return, and subtracted liabilities, for a total net book value of just over \$656,000, of which the plaintiff’s share amounted to about \$218,000. After adding her share of goodwill value, based on average annual gross revenues over the preceding three years (\$1.77 million), the expert produced a final “fair” value of just over \$425,000 for her 33% interest.

Irretrievable breakdown. As a preliminary matter, the trial court found an “irretrievable breakdown” among the shareholders, but it did not find any evidence of shareholder oppression. As a result, the plaintiff was entitled to have the practice repurchase her shares pursuant to the buy-sell agreement rather than any statutory “fair value” remedies, the court held.

Further, the court found that the accounts receivable were indeed inflated due to “suspect” and “murky” bookkeeping practices. However, the calculations by the shareholders’ expert reduced the accounts by 82%, “which is contrary to the [10% required by the] shareholders’ agreement,” the court said, and adopted the 10% discount, even though the actual percentage for uncollectability could have been higher. The court also noted that the growth had been flat, but it couldn’t “conceive” that the plaintiff’s 33% share of a practice that grossed over \$1 million per year amounted to “only” \$41,000. Similarly, the court was not persuaded that her interest could be bought out for only \$25,000, per the stock certificate.

Rather, based on all the evidence presented, the trial court concluded that the fair market value of the medical practice equaled \$656,000—the book value as determined by the plaintiff's expert, without any goodwill. Accordingly, the court awarded the plaintiff a 33% proportionate share, or \$218,000, and the shareholders appealed.

After carefully reviewing the record, however, the appellate court confirmed, deferring to the trial court's valuation as well within its discretion and the expert evidence presented.

Do CPA Firm Agreements Trump Statutory FV Value of Retiring Partner's Shares?

Showell v. Pusey, 2011 WL 3860419 (Del. Ch.)(Sept. 1, 2011)

A three-member accounting firm, organized as a limited liability company (LLC) under Delaware law, had been successfully operating for years when one of the partners wanted to “retire” to help take care of a family business. Interestingly, the CPA firm's operating agreement permitted the dissociation of a member under certain circumstances, including death or disability, but it expressly provided that “no member shall be entitled to withdraw or resign from the company.” A supplemental agreement permitted the repurchase of a member's share at liquidation value upon a “retiring event”—defined only as death, disability, or bankruptcy.

CPAs neglected to provide retirement value.

As a result of these contractual ambiguities, when the parties couldn't agree on a buyout price, the departing member petitioned the Delaware Court of Chancery to determine the value of his interest. He argued that his “retirement” entitled him to 29% of the firm's value as a going concern, based on the applicable Delaware statute.

Specifically, §18-604 of the Delaware Code provides that, if an LLC agreement allows a member to resign without specifying a buyout price, then

the member is entitled to a proportionate share of the “fair value” of the LLC. According to the departing member, the evidence clearly showed that, despite some rancor and resistance from the other members of the firm, everyone agreed that he should resign from the firm. Since they also agreed to pay him some value, they should pay him the statutory fair value for his interest, the departing member argued. In support, he offered an expert who calculated the going concern, fair value of the CPA firm at nearly \$980,000, based primarily on assigning the client list a goodwill value of just over \$665,000. As a result, the 29% member claimed he was due approximately \$281,500.

In response, the remaining members argued that “liquidation value,” as provided in the LLC operating agreement, controlled any value of the “retiring” member's interest. Under this standard, their expert calculated that a 29% interest was worth no more than \$65,000. The expert also maintained that the firm's client list had little or no value, in particular because the operating agreements did not impose a covenant not to compete. In fact, just the opposite: the operating agreement expressly provided that the members “*may compete with [the firm], even while they are still members*” (emphasis in the court's opinion).

As a preliminary matter, the court construed the applicable agreements. First, if confirmed that the LLC's members “manifestly neglected” to provide for a distribution value should one of them want to retire. Indeed, the operating agreements “do not *allow* for . . . retirement in the first place,” the court said, with emphasis.

At the same time, the parties' supplemental agreement provides that upon a defined event (such as disability), the “retiring” member would receive the “net equity” of his interest, or “the amount that would be distributed to a member in liquidation of the company,” determined as if all of the company's assets were sold at gross values after certain adjustments and payment of all accrued liabilities. Finally, the agreement provided that the company could pay any repurchase obligation over five years.

“Read together,” the court said, “the provisions of the operating agreement become clear.” The obligations to repurchase a retiring member’s interest at liquidation value over a period of years were “obviously meant” to protect the firm’s ongoing operations, the court observed. Although the reason for the departing partner’s “retirement” did not fall within a defined event, the remaining partners agreed that he *could* retire and that the firm should repurchase his interest at some amount, it added. Read in their entirety and in an attempt to harmonize the parties’ intent, the court rejected any argument that the “default” statutory fair value applied.

Rather, the departing member was entitled to receive his share (29%) of the company’s liquidation value on the date of his “retirement.” The parties’ expert generally agreed that this value equaled \$65,000; they differed primarily in their treatment of goodwill value. The court found, based on the operating agreements’ “covenant to compete,” that the customer list had little value. Thus, even if “fair value” instead of liquidation value applied, the net difference between the two would be “minimal,” the court held, and ordered the parties to determine the value of the departing member’s interest using the liquidation value, as defined in their agreements.

Must LLC Produce a Subsidiary’s Valuation Records to a Member?

DFG Wine Co., LLC v. Eight Estates Wine Holdings, LLC, C.A. No. 6110-VCN (Del. Ch.) (August 31, 2011)

The plaintiff is a family-owned limited liability company (LLC), formed under Delaware law, that acquired the defendant LLC in 2008. Also formed in Delaware, the defendant’s sole purpose is to hold a subsidiary, Ascentia Wine Estates, which owns and operates eight wine brands and associated assets. At one time, the plaintiff acted as Ascentia’s distributor, and one of its major shareholders sat on the Ascentia board.

After Ascentia’s financial condition began to deteriorate, the relationship between the plaintiff and defendant soured, and a legal dispute arose in California (which is currently ongoing). To determine the value of its holdings in the defendant, the plaintiff brought a books and records action in Delaware Chancery Court. Among other documents, the plaintiff sought access to the defendant’s income tax returns; operating agreements; financial statements; books and records, including the general ledger; business plans and budgets; loan agreements and debt facilities; management compensation records; and “grape contracts.”

Documents related to subsidiary’s value. In addition, the plaintiff sought any financial projections related to the defendant’s subsidiary (Ascentia), plus any other materials reflecting the subsidiary’s assets, debts, or liabilities. The defendant agreed to the document requests related to its own operations, but claimed that neither its operating agreements nor the applicable provisions of the Delaware Limited Liability Company Act (6 Del. C. §18-305) entitled the plaintiff to the subsidiary’s records.

The court began by reviewing Del. C. §18-305. In particular, the statute grants members the right to demand the LLC’s books and records for “any purpose.” If valuation is that purpose, then Delaware case law has consistently limited the inspection to “essential” records, sufficient to accomplish the valuation, the court explained. Those seeking to value a closely held company may, “because they do not have access to the same quantity of information available from” public filings and disclosures, “be given slightly broader rights.”

The Delaware statute does not explicitly permit a member to access the records of an LLC’s subsidiary. Nonetheless, the courts have recognized such rights when the facts suggest “the absence, in reality, of separate entities,” the court found. Such a lack of separate corporate identity might exist, for example, when a subsidiary is under the parent’s complete control and all of its value accrues to the parent. Objections available to the LLC include establishing its “good faith belief” that disclosure of the subsidiary’s information would

not be in its best interest. The LLC's operating agreements may also grant its members inspection rights in addition to their statutory rights, the court said, adding that such provisions are subject to typical rules of contract enforcement.

In its objections to the plaintiff's requests for the subsidiary's records, the defendant cited Delaware precedent for the proposition that when valuation is a "matter of simple arithmetic," its validity as a stated purpose becomes "meaningless." In this case, valuation was similarly meaningless, the defendant argued, because in the California proceedings the plaintiff claimed the defendant was insolvent, with zero value.

In response, the plaintiff said that its prior belief was "irrelevant," particularly because several months had passed and circumstances had changed. Public information suggested that the defendant had reorganized its management and debt and that "there may well be *some* value there," the plaintiff said, with emphasis.

Valuation of parent depends on subsidiary.

The court agreed with the plaintiff, finding that the value of the defendant depended on the subsidiary's value. The plaintiff's request was therefore proper under Delaware law as well as the LLC's operative agreements, which gave preferred members the same broad rights as they had under statute.

As to this last point, the defendant tried to argue that the LLC agreement created a contractual right only for members to receive data required to be provided under Delaware statute; and further, that the agreement only required the LLC to maintain books and records "of the company." Read together, the LLC had no separate contractual duty to maintain (or provide) the subsidiary's documents to members.

However, the subsidiary was clearly the defendant's sole asset, the court found; the defendant had no separate value. The defendant also managed the subsidiary, and both were located at the same address. Finally, the defendant had no budget, business plan, or projections apart from the subsidiary. These facts suggested the

"absence, in reality, of separate entities," the court held, and under these circumstances, it would be "unfair" to require the plaintiff to attempt to value its holdings without providing access to the records of the LLCs only asset; in particular, those records which pertained to value. Accordingly, to the extent the plaintiff's stated purpose was proper under the Delaware statute—and because the LLC agreement entitled members to receive records that are proper under the statute—the plaintiff was also entitled to receive copies of the subsidiary's books and records, the court held.

Some limitations. As a final attempt, the defendant argued that it was not in its best interests to divulge certain information, particularly because it believed that the plaintiff sought to take advantage of the subsidiary's financial condition to dissolve the entire company. The court agreed that the plaintiff was "trying to undermine [the subsidiary's very existence," and permitted the defendant to withhold any materials directly related to the subsidiary's future ability to pay its creditors. At the same time, the defendant had to turn over materials that were only "tenuously" related to the subsidiary's creditor relations, such as its financial statements.

Similarly, the defendant insisted that the plaintiff wanted to "cherry pick" its wine brands, to sell them to others. But the court found this amounted to no more than a "general impression." At the same time, the court observed that the defendant did not ask protection for its trade secrets, and on its own motion, the court permitted the defendant to redact information "reasonably believed to be in the nature of trade secrets" from any disclosed documents.

Further, in reviewing the plaintiff's document requests, the court found that its request for the internal records of the LLCs board was not reasonably related to its stated purpose; i.e., to value its holdings. Likewise, past payments or benefits to the LLC's managers, to the extent they reflected value, would already be reflected by the company's financial statements, and the court denied this request. However, documents related to the subsidiary's employment of its key personnel fell within the plaintiff's stated purpose,

as did the subsidiary’s “grape contracts,” which could be redacted for trade secrets. In the alternative, the defendant could provide a summary of the contracts that showed how many it has had since the valuation date; which of the contracts are tied to the market price of grapes; which have locked-in costs (and what those costs are); and the LLC’s good faith estimate the growers will fulfill the contracts.

Finally, the court assessed costs of the action (but not attorneys’ fees) against the LLC and directed both parties to comply with its order.

Court Vacates \$1.3B in Copyright Damages for Lack of ‘Real World’ Data

Oracle USA, Inc. v. SAP AG, 2011 WL 3862074 (N.D. Cal.) (Sept. 1, 2011)

In another high-profile, high-stakes litigation concerning high-tech intellectual property, a jury awarded the plaintiff (Oracle USA) \$1.3 billion in damages against the defendant SAP, the world’s largest business application software manufacturer. Interestingly, prior to trial, SAP admitted that it infringed Oracle’s copyrights in its “TomorrowNow” initiative, which SAP shut down in 2008 due to the litigation.

Thus the only issue at the 11-day trial, held in November 2010, was damages. After the verdict, news sources reported that not only was the jury award the largest in 2010—and the largest ever for copyright infringement, but it also equaled SAP’s fourth quarter 2010 net income. (See, e.g., www.bloomberg.com/news/2010-11-23/sap-must-pay-oracle-1-3-billion-over-unit-s-downloads.html.) Both parties contested the verdict on different grounds. In particular, SAP moved for judgment as a matter of law and a new trial, claiming the jury award was “grossly excessive” and based on “fictitious” evidence.

Copyright law permits damages based on FMV of copyright. The district court first outlined the general nature of damages permitted under

federal copyright law, which are typically determined by the “loss in the fair market value of the copyright,” it said. Further, these damages are measured by “the profits lost due to the infringement or the value of the use of the copyrighted work to the infringer.”

According to applicable precedent (Ninth Circuit), a retroactive license fee can provide one measure of actual damages, the court added. That is, when the infringer could have bargained with the owner for a license to use the copyrighted work, then “actual damages are what a willing buyer would have been reasonably required to pay a seller for the plaintiff’s work.”

In this case, the jury awarded the \$1.3 billion in damages as the fair market value calculations for such a hypothetical license (rather than lost profits as measured by the infringer’s gains). In its claim that the award was unduly speculative, the defendant contended that no court has ever awarded a lost license fee, measured “hypothetically” or otherwise, to a copyright plaintiff who did not actually lose license fees—or who could not show sufficient evidence of “real world,” benchmark transactions.

Moreover, here the parties agreed that there were no comparable licenses to the hypothetical that could have issued between them and in fact, that such a license “never would have existed” between them. In the absence of such evidence, the plaintiff’s damages expert simply “invented” the price of a hypothetical license, the defendant argued, based on factors such as the amount that Oracle executives claimed they would have charged for a license (unsupported by any benchmark deals), and the value of the infringed intellectual property as a whole, including the costs of acquisition and development. His wide range of values for such a “hypothetical” license—from \$881 million to \$2.69 billion—were not tied to any objective evidence of the actual price, structure, or customer use of the copyrighted database. Instead, the expert focused on what the willing *seller* would have agreed to, the defendants maintained, rather than what a willing buyer would reasonably pay.

Oracle responded by pointing to evidence of the “billions” invested in its intellectual property (IP), including its rights to protect it. The defendant’s infringement was “vast” and willful, intending to convert customers to SAP applications, including its TomorrowNow initiative, which was supposed to generate “billions” in revenues for SAP and disruption to Oracle by usurping its IP.

In addition, Oracle argued that its expert relied on *Georgia-Pacific* factors to consider what a “prudent” copyright owner and licensee in the parties’ positions would have considered in a hypothetical negotiation, including: the level of infringement; the value of the infringed works; and the “top-level business decisions” behind the infringement. The expert adequately explained his consideration of each factor to the jury, the plaintiff said, how he weighed each party’s “negotiating perspective” along with their financial and strategic motivations. Finally, the expert applied an “established valuation methodology” to determine the fair market value of the defendant’s infringing use.

A benchmark license is not the “only objective measurement of a reasonable license fee” permitted under applicable law, the plaintiff concluded, and pointed to both sides’ reliance on database pricing lists as empirical evidence to support the expert’s conclusions.

Objective evidence is critical. In this case—and under applicable law—the plaintiff was required to show that, but for the infringement, the parties would have agreed to license the copyrighted software. However, “Oracle offered no evidence of the type on which plaintiffs ordinarily rely to prove that they would have entered into such a license, such as a past licensing history or [its] previous licensing practices,” the court found.

Indeed, Oracle admitted that it had never permitted a competitor to use its software, and that such a comparable license would be “unique” and “unprecedented.” No analogous licenses existed and experts on both sides agreed that no benchmark comparable licenses existed. Such objective evidence is critical to price a hypothetical license, the court explained, because any

Georgia-Pacific or similar framework permitted under federal copyright law is “simply a construct designed to help calculate actual damages suffered as a result of the infringement.” The Ninth Circuit has “never upheld a hypothetical license award absent such actual proof,” the court held.

As a result, the plaintiff’s expert simply “confused the jury” by presenting “fictitious and speculative negotiating factors,” the court said. Although he claimed to use factors resembling those in *Georgia-Pacific*, he in fact took them from the defendant’s financial documents to suit his projections. Rather than providing evidence of actual infringement or an objectively verifiable number of lost customers, the expert relied on the purported value of the IP as a whole, based on “self-serving” testimony from Oracle executives regarding the price they would have demanded during the admittedly “fictional” negotiation, the court held, in granting both the plaintiff’s motions and reversing the \$1.3 billion award.

Maximum amount of proven damages. In the alternative, the plaintiff could agree to accept a remitter from the defendant, based on the maximum amount of damages supported by the evidence at trial, the court held. The plaintiff argued that this amount was at least \$472 million, based on its expert’s calculations of actual lost profits to Oracle through 2015, but the court found this was not supported by sufficient proof. Instead, it accepted the expert’s calculations of \$272 million, based on the defendant’s revenues from its TomorrowNow initiative, which clearly wound down in 2008. Absent any reliable evidence to show an “ongoing impact” of infringement for an additional seven years, the court ordered the plaintiff to accept a \$272 million award or proceed to a new trial on damages.



BVR's Industry Transaction & Profile Annual Report on HVAC Companies

Includes industry overviews, HVAC company profiles, trends and forecasts and actual transaction reports with ratios and multiples.

\$249 (+ \$9.95 S&H)
www.bvresources.com/publications



What Does Your Report Roadmap Look Like?

If you don't know where you are going, any road will take you there.

—Lewis Carroll

I recently reviewed a valuation report for an experienced appraiser. The body of the report started off with an introduction that focused on the engagement (premise of value, standard of value, type of report, etc.) and included a three-line reveal about the company being valued (date incorporated, type of entity, and business description). The economic overview and industry outlook proceeded next.

That's right! I was presented with economic and industry data before I had any understanding about the business and how that data might relate to its operations. So while I knew the company was incorporated in State A, the ensuing economic analysis and industry outlook was drilling down to conditions in State B. Twelve pages later I read that the company did, in fact, do business in State B. In the interim, I was in a State of Confusion. And that is something you need to avoid with the user of your report.

When I asked my client why she followed this particular template, she said that years ago it was THE format suggested by one of her credentialing organizations. And she has been doing it that way ever since.

There are two points that I strive for in my report structure: 1) The report must have a logical flow that leads the user down the path I want to take them; and 2) That flow cannot be interrupted by rest stops of narrative fluff. (Narrative fluff is any report writing that explains the theory behind your valuation procedure rather than the procedure itself—e.g., discussing the theory of weighted average cost of capital before you: a. explain why WACC is appropriate in this valuation; and b. reference the analysis that develops the inputs to the formula.)

Let me suggest a roadmap that will accomplish these goals. We'll start with the "front end" of the report.

1. Cover Page. Without opening the report, the user should know the name of the company (and type of legal entity), what's being valued, as of what date, and the purpose of the valuation. After that, the user should see

whom the report was prepared for and the date of the report. Bonus points for the appraiser's firm information, i.e., who prepared the report.

2. Transmittal Letter. There are some basics that need to be communicated—and you know what they are. This letter is not meant to be a standalone document that represents all the work you did, so don't overcomplicate it. For example, I think making reference to the fact that your report is subject to the Statement of General Assumptions and Limiting Conditions is sufficient . . . no need to then include the top three (or four) biggies, which I often see.

3. Executive Summary. I think this can be the coolest section of a report. I designed mine so the user has all the facts: the obvious stuff like the company description and the interest being valued, the premise and standard of value, the date of the valuation, and the purpose of the valuation and intended use of the report. But also information about: the methods considered and the ones used, key inputs like the discount rate, growth rate, and value multipliers, and the percentage discounts and premiums applied and the methods for determining them. And finally: the major valuation assumptions (or hypothetical conditions), the conclusion of value, and any subsequent event information.

Let's move on to the body of the report.

4. Introduction. This opening section should contain all the background information the user needs to understand the engagement: the subject company, the interest being valued, the valuation date and the reason for that date, the type of report, the scope of work performed, the premise and standard of value, and other standards-required disclosures. If you're doing a purchase price allocation, here's a good place to include a description of the underlying transaction.

5. Company Background. No ifs, ands, or buts—this section should explain "the who, what, where, when, why, and how of what the company is and does" to the user. Does yours?

6. Economic Overview and Industry Outlook. This is the first potential flow interrupter. In the body of the report, all you need is your analysis and summary of the economic overview and industry outlook *and their effect on the valuation*. Do not insert, verbatim, the reports you obtained from your subscription sources—they belong in an appendix.

I think the order of the next sections are obvious and don't need any particular elaboration . . . with the understanding that you limit your discussion to work performed, findings, conclusions, and opinions—no narrative fluff.

7. Financial Statement Analysis and Adjustment.

8. Valuation Methods Considered and Used.

9. Valuation Methods Considered and Not Used.

10. Reconciliation of Valuation Methods Used.

11. Discount and Premium Analysis and Application.

12. Conclusion of Value.

That covers the front end and body of the report. What goes in the back end? Here's my order.

13. Report Appendices.

Statement of General Assumptions and Limiting Conditions (SGALC).

Representation of Valuation Analyst/Appraiser's Certification.

Professional Qualifications of Valuation Analyst.

Summary of Information and Data Sources (SIDS).

While any of these items can be potential flow interrupters if you put them in the body of the report, I see it occur most often with the SGALC and the SIDS. Think about those awful drug television commercials. What if the actor or narrator ticked off the drug's nasty side effects before you learned what problem the drug solves? Well, putting the SGALC in the your report introduction provides the same turnoff . . . all you've done is tell the user what you didn't do or aren't responsible for. As for the SIDS, it's essentially a bibliography, and I've never seen a book, manuscript, or article put it anywhere but at the end.

14. Report Exhibits.

Company's collateral marketing materials.

Economic Overview.

Industry Outlook.

Other supporting analyses.

Sometimes I find it difficult to convey in words what a company does, how it does it, or where its products are applied. If the company has collateral marketing materials that illustrate these points, an appendix is a great place to put them.

The economic overview and industry outlook are the original reports you obtained from your subscription source. If users concur with your analysis and summary in the body of the report, they didn't have to wade through a long narrative to get to it. If they disagree, they can drill down into the detail that's in the appendix.

Other supporting analyses are a catchall for anything else that buttresses what you did and why you did it, including valuation theory. One example of my supporting analysis is a narrative on the theory behind cost of capital and the data sources (Ibbotson, Duff & Phelps) that I used to derive my discount rate. Another example is the restricted stock and pre-IPO studies, including the theoretical underpinnings for their use in developing a discount for lack of marketability for private companies.

15. Valuation Schedules. Last. Why? So they are easy to locate! The user shouldn't have to thumb through a thick report to find them, sandwiched between your conclusion of value and wherever you have those schedules now.

I hope you agree that the above roadmap provides the user of your report with a more logical and cleaner flow for your valuation work product. And in this time of compressed/competitive pricing, this roadmap gives you an opportunity to be more efficient and effective without sacrificing quality.

Rod Burkert, CPA/ABV, CVA, is the founder of Burkert Valuation Advisors LLC and offers a report review service for sole practitioners and small firms. Rod is a past-chairman of NACVA's executive advisory board, a member of the editorial board of The Value Examiner, and an instructor in several NACVA training programs.

BVR's Economic Outlook for the Month

(excerpt from the September 2011 Economic Outlook Update¹)

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 1.9% in the fourth quarter of 2011 and 2.1% in the first quarter of 2012.² The forecasters expect GDP to grow 1.6% in 2011, 2.1% in 2012, and 3.3% in 2013.

They forecast personal consumption will increase at a rate of 1.8% in both the fourth quarter of 2011 and the first quarter of 2012. They expect personal consumption to increase 2.1% in 2011 and 2.0% in 2012.

The forecasters believe unemployment will average 9.2% in both the fourth quarter of 2011 and the first quarter of 2012. They believe unemployment will average 9.1% for all of 2011 and 9.0% for 2012.

They also believe consumer prices will rise at a rate of 1.9% in the fourth quarter of 2011 and 2.0% in the first quarter of 2012. They expect consumer prices to increase

3.1% in 2011 and 2.1% in 2012. They expect producer prices to increase at a rate of 1.7% in the fourth quarter of 2011 and 1.2% in the first quarter of 2012. The forecasters anticipate producer prices will rise 6.0% in 2011 and 1.6% in 2012.

The forecasters expect industrial production to increase at a rate of 2.3% in the fourth quarter of 2011 and 2.7% in the first quarter of 2012. They forecast industrial production will increase 3.9% in 2011 and 2.8% in 2012.

The forecasters believe the 3-Month Treasury Bill rate will be 0.1% at the end of the fourth quarter of 2011 and will remain at 0.1% through the end of the first quarter of 2012. They believe the rate will be 0.2% at the end of 2012. They forecast that the 10-Year Treasury Bond yield will be 2.5% at the end of the fourth quarter of 2011 and 2.7% at the end of the first quarter of 2012. They believe the 10-Year Treasury Bond yield will rise to 3.5% at the end of 2012.

1 The *Economic Outlook Update*[™] is published monthly and quarterly by Business Valuation Resources, LLC (BVR). For more information or to purchase, please contact BVR at customerservice@bvresources.com or (503) 291-7963.

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

Historical Economic Data 2004-2010 and Forecasts 2011-2021

	HISTORICAL DATA							CONSENSUS FORECASTS**							2017 -2021
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016		
Real GDP*	3.6	3.1	2.7	1.9	-0.3	-3.5	3.0	1.6	2.1	3.3	3.4	3.0	2.7	2.5	
Industrial Production*	2.3	3.2	2.2	2.7	-3.7	-11.2	5.3	3.9	2.8	3.5	3.4	3.3	3.1	2.7	
Personal Consumption*	3.5	3.4	2.9	2.3	-0.6	-1.9	2.0	2.1	2.0	2.7	2.8	2.7	2.6	2.4	
Real Disposable Personal Income*	3.6	1.3	4.0	2.4	2.4	-2.3	1.8	1.6	1.9	2.8	3.2	3.0	2.9	2.7	
Nonresidential Fixed Investment*	6.0	6.7	8.0	6.5	-0.8	-17.8	4.4	7.7	6.4	6.6	6.3	5.2	4.4	3.8	
Nominal Pre-Tax Corp. Profits*	24.0	16.8	10.5	-6.1	-16.4	-0.2	28.9	6.7	3.9	7.3	7.1	6.0	5.0	4.5	
Total Government Spending*	1.4	0.3	1.4	1.3	2.6	1.7	0.7	-2.0	-0.9	NA	NA	NA	NA	NA	
Consumer Prices*	2.7	3.4	3.2	2.8	3.8	-0.4	1.6	3.1	2.1	2.0	2.2	2.2	2.3	2.2	
3 Month Treasury Bill Rate	1.4	3.2	4.9	4.5	1.4	0.2	0.1	0.1	0.2	3.1	3.6	3.9	4.0	4.0	
10 Year Treasury Bond Yield	4.3	4.3	4.8	4.6	3.7	3.3	3.2	2.5	3.2	4.9	5.1	5.4	5.5	5.3	
Unemployment Rate	5.6	5.1	4.6	4.6	5.8	9.3	9.6	9.1	9.0	NA	NA	NA	NA	NA	
Housing Starts (millions)	1.956	2.068	1.801	1.355	0.906	0.554	0.587	0.590	0.700	NA	NA	NA	NA	NA	

Source of historical data: U.S. Department of Commerce, U.S. Department of Labor, U.S. Census Bureau and The Federal Reserve Board.
Source of forecasts: Consensus Forecasts—USA, September 2011.

Notes:

*Numbers are based on percent change from preceding period. Consumer Prices are the percent change between annual averages. Historic Unemployment Rate, 3 Month Treasury Rate and 10 Year Treasury Yield are the annual averages.

**Forecast numbers are based on percent change from preceding period (excludes Unemployment Rate, Housing Starts, 3 Month Treasury Rate and 10 Year Treasury Yield). Consumer Price Index information is the percent change between annual averages. The 2011 through 2016 forecasts for the 3 Month Treasury Rate and 10 Year Treasury Yield are for the end of each period. Forecasts for 2017-2021 signify the average for that period.

BVR TRAINING EVENTS

To register for any of our conferences, or for more information, visit our website at www.BVResources.com/training or call (503) 291-7963.



November 1, 10:00am – 11:40am Pacific Time
Supporting Your Case: Discovery and Evidence
Jonathan Dunitz and Nancy Fannon



November 3, 10:00am – 2:00pm Pacific Time
Advanced Workshop on Valuation Issues Under ASC 805 and Business Combinations
Mark Zyla



November 4, 10:00am - 12:00pm Pacific Time
Judges Roundtable: View From the Bench
Hon. David Laro, Hon. Joseph Robert Goeke, and Jay Fishman



November 11, 10:00am – 11:40am Pacific Time
Valuing a Majority Fractional Interest
Part 4 of BVR's 2011 Online Tax Summit
Neil Mills-Mazer



November 15, 10:00am – 11:40am Pacific Time
Damages for Violating Noncompetes and Other Claims Involving Physicians, Hospitals & Healthcare Facilities
Featuring: Mark Dietrich and Kevin Yeanoplos



November 17, 10:00am – 11:40am Pacific Time
Asset or Income? Double Dipping in Divorce
Don DeGrazia and Stacy Collins



November 29, 10:00am – 11:40am Pacific Time
Physician Compensation in an Era of High Demand and Limited Providers
Daniel Stech and James Connors



December 1, 10:00am – 11:40am Pacific Time
Valuations in Agribusiness: Food Processing Companies
Jim Alerding and Ron Nielsen



December 8, 10:00am – 12:00pm Pacific Time
Delaware Chancery Roundtable: Views from the Bench, Council & Witness Stand
Neil Beaton, Vice Chancellor Donald Parsons, and Stephen Norman



December 9, 10:00am – 11:40am Pacific Time
Accountable Care Organizations: What Are They and What Do You Need to Value?
Mark Dietrich and Carol Carden



December 13, 10:00am – 11:40am Pacific Time
Getting the Information You Need: A Guide to Electronic Discovery
Richard Gelb and Daniel Gelb



= Webinar



= Online Healthcare Symposium



= Litigation Series

CALENDAR

November 6-8, 2011

AICPA Business Valuation Conference
Las Vegas, NV
(888) 777-7077
www.cpa2biz.com

November 6-8, 2011

AICPA National Tax Conference
Washington, DC
(888) 777-7077
www.cpa2biz.com

November 11, 2011

ASA Fair Value Summit
San Francisco, CA
www.asabv.org

November 15-19, 2011

IBBA Conference
Phoenix, AZ
www.ibba.org

November 17-18, 2011

AICPA National Healthcare Industry Conference
Baltimore, MD
(888) 777-7077
www.cpa2biz.com

December 5, 2011

AICPA National Conference on Current SEC and PCAOB Developments
Washington, DC
www.cpa2biz.com

January 4-8, 2012

Law Education Institute National CLE Conference
Snowmass, CO
www.lawedinstitute.com

January 17-19, 2012

AM&AA 2012 Winter Conference
Las Vegas, NV
www.amaaonline.com

April 25, 2012

ACG InterGrowth 2012
www.acg.org

May 6-9, 2012

CFA Institute Annual Conference
Chicago, IL
www.cfainstitute.org

May 11, 2012

AICPA/AAML National Conference on Divorce
Las Vegas, NV
www.cpa2biz.com

July 23, 2012

AICPA Advanced Estate Planning Conference
Las Vegas, NV
www.cpa2biz.com

For an all-inclusive list of valuation-related Seminars and Conferences, BV Education classes and credentialing programs—plus BVR Conferences, go to BVResources.com, and click on the “BV Calendar” menu.



What It's Worth

Business Valuation Resources, LLC
1000 SW Broadway, Suite 1200
Portland, OR 97205-3035

COST OF CAPITAL

Treasury yields¹

30-day: 0.01% 5-year: 0.87% 20-year: 2.51%

Duff & Phelps' 2011 Premiums Over Long-Term Risk-free Rate²

Historical Equity Risk Premiums: Averages Since 1963
Data for Year Ending December 31, 2010.

Measure Used for Size ³	1st	13th	25th
5-Year Average EBITDA	4.0%	8.9%	13.3%
5-Year Average Net Income	3.8%	8.9%	13.5%
Sales	5.4%	9.2%	12.4%
Total Assets	4.1%	8.8%	13.1%

Prime lending rate:¹ 3.25%

Dow Jones 20-bond yield:⁴ 3.69%

Barron's intermediate-grade bonds:⁴ 6.39%

High yield estimate:⁴

Mean 11.6% Median 8.6%

Dow Jones Industrials P/E ratios:⁴

On current earnings:	12.2
On 2011 operating earnings est.:	11.5
On 2012 operating earnings est.:	10.3

Long-term inflation estimate:⁵ 2.4%

Long-term rate of growth GDP:⁵ 2.7%

1 Source: The Federal Reserve Board as reported by the BVR Risk-Free Rate Tool™, located in the Free Downloads section at BVRResources.com, October 3, 2011.

2 Source: 2011 Risk Premium Report ©Duff & Phelps LLC. All rights reserved. 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 Report and thoroughly understand the derivation of the numbers used. Complete current and historical Duff & Phelps cost of capital data available at BVRResources.com.

3 Each measure for size is organized by Duff & Phelps, LLC into 25 portfolio ranks, with portfolio rank 1 being the largest and portfolio rank 25 being the smallest. Smoothed average premiums are presented here because they are considered a better indicator than the actual historical observation for most of the portfolio groups. Premiums may be adjusted for differences between historic market risk premiums and expected equity risk premium as described in the Report.

4 Barron's, October 3, 2011.

5 10-year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, June 9, 2011.