Business Valuation Update

(March 2016 issue)

Business Valuation Resources, LLC
Thank you for visiting Business Valuation Resources, the leading data, research, and training provider for the business valuation profession. For more information about any of our premier valuation products or services, please contact us:

bvresources.com
+1-503- 291-7963
info@bvresources.com

BVR
What It's Worth

The comprehensive Mergerstat Review is designed to save time for the business valuation and M&A markets

The **2016 Factset Mergerstat Review**, available exclusively through BVR, is the must-have source for data and analysis on the M&A market. It delivers comprehensive rosters, data, and statistics on M&A transactions that involve U.S. companies, including privately held, publicly traded and cross–border transactions. The Review also lists unit divestitures, management buyouts and certain asset sales.

BONUS: Mergerstat Review book includes monthly review (PDF via email)

With the **Factset Mergerstat Monthly Review** (PDF delivered monthly via email), you'll stay current on what's happening in the M&A market including the latest activities, trends, and deal data by industry. It's an ideal resource to add insight and impact to valuation reports, pitch books, client presentations, market overviews, and competitive reports.

Arm yourself with insights into trends in pricing – Key highlights include:

- Transaction roster by SIC: Utilize the comprehensive transaction roster organized by SIC code – never miss a major comparable transaction
- Detailed data: Arm yourself with insight into trends in prices, methods of payment, premiums and other critical factors in the M&A market - drill down in individual industries with transaction-level details
- Monthly Updates: With the **Factset Mergerstat Monthly Review** you won't be blindsided. You'll have the latest M&A news and trends, industry activity and value comparisons, private equity updates, top advisor activity and top U.S. deals.

Pre-order your copy today at: **bvresources.com/publications**

If you prefer, fax this form to our secure line: (503) 291-7955 or call (503) 291-7963

❑ **Yes!** I'd like to pre-order the **2016 Mergerstat Review (available May 2016)** in the following format:

❑ Print $499 .00 (+$ 9.95 S&H) ❑ PDF $499 .00 (delivered via email) ❑ Print & PDF $629 .00

(Multi-user PDF pricing is also available. Please contact us at (503) 291-7963 ext. 2 for more information)

Name: _____ Firm: _____

Address: _____ City,State,Zip: _____

Phone: _____ Fax: _____ E-mail: _____

Billing Information:

❑ Visa ❑ Mastercard ❑ AMEX ❑ Check payable to: Business Valuation Resources, LLC

Credit Card #: _____ Exp. Date: _____ Sec. Code: _____

Cardholder Name & Address (if different): _____

BVR What It's Worth

BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Vol. 22, No. 3, March 2016

Complications With Event Studies in Securities Litigation

By Adrian M. Cowan, Ph.D., and Paul J. Seguin, Ph.D.

Editor's note: This is an excerpt from a chapter in the forthcoming 4th edition of The Comprehensive Guide to Economic Damages, *edited by Nancy Fannon and Jonathan Dunitz. The entire chapter gives a primer on event studies, how they are used in securities litigation, robustness tests, complications, and more. The book, formerly titled* The Comprehensive Guide to Lost Profits and Other Commercial Damages, *will be available from BVR (www.bvresources.com) soon.*

In this section, a number of frequently encountered complications a researcher may face and how one can address them in a statistically robust fashion is addressed. Confounding events can be particularly problematic. In addition, other important considerations for the expert are the subjective nature of event studies and the type of security under investigation.

The *event window* is readdressed first. In Section 2 (earlier in the full chapter), it was assumed that:

continued on page 5...

DLOMs in N.Y. Statutory Fair Value Cases—A Follow-Up to Matthews

by William C. Quackenbush, MBA, ASA, MCBA, BCA, ABAR

As an appraiser, I have had the opportunity to prepare many valuations for New York statutory fair value cases, and I have testified in some of them. I'd like to weigh in on the topic of discounts for lack of marketability (or DLOMs) as a follow up to the recent *BVWire* posting (see sidebar) and the article in *Business Valuation Update* by Gil Matthews on the topic.[1]

In the 1985 *Blake v Blake Agency, Inc.* decision,[2] the court stated that the statute designed to "afford a minority shareholder the right to bring a proceeding to dissolve the corporation and to

1 Gil Matthews (Sutter Securities), "NY's Unfair Application of Shareholder-Level Marketability Discounts," *Business Valuation Update*, January 2016.

2 107 A.D.2nd 139 (1985).

continued on next page ...

In This Issue

BUSINESS VALUATION UPDATE

Executive Editor:	Andrew Dzamba
Publisher:	Sarah Andersen
Executive Legal Editor:	Sylvia Golden, Esq.
Managing Editor:	Monique Nijhout-Rowe
Desktop Editor:	Warren Simons
Senior Copy Editor:	David Solomon
Customer Service:	Retta Dodge
VP of Sales:	Lexie Gross
President:	Lucretia Lyons
CEO:	David Foster

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 $429. Low-cost site licenses are available for those who wish to distribute the *BVU* to their colleagues at the same firm. Contact our sales department for details. Please contact us via email at customerservice@BVResources.com, phone at 503-291-7963, fax at 503-291-7955 or visit our web site at BVResources.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.

distribute its assets among the shareholders … was enacted for the protection of minority shareholders, and the corporation should therefore not receive a windfall in the form of a discount because it elected to purchase the minority interest pursuant to [statute]. Thus, a minority interest in closely held corporate stock should not be discounted solely because it is a minority interest." Unfortunately, while in the same decision the court rightly rejected a discount for lack of control, it allowed a discount for lack of marketability without much discussion.

Gil picks up the story in 1995's *Beway* case and brings the reader up-to-date on the issue, rightly describing a nearly schizophrenic trail of decisions over the past 20 years regarding DLOMs. I would argue that in this case schizophrenia is contagious, with the court infected by BV testimony with the same symptoms. It is no wonder that Peter Mahler wishes that the BV community would speak with one clear voice on the issue. Indeed, in this instance, poor case law is often the result of bad or weak appraisal work creating poorly informed triers of fact.

I would suggest the following "valuation-speak" in appraising a minority interest under statutory fair value:

> To determine the value of a non-control interest not burdened with the penalties, if any, regarding the subject interest's lack of control vis-à-vis a control level value, including any illiquidity or lack of marketability attributable to the lack of control nature of the oppressed interest—essentially the value of a pro-rata share of the whole.

Yet it seems that the New York courts have had trouble accomplishing this goal, in good part because of the valuation work presented to them in expert testimony. I suggest that two issues are in play here that stir up the pot.

First, there continues to be some debate in the BV profession as to whether some DLOM is ever appropriate at the enterprise level. Is a 100% equity ownership interest in a privately held

company less liquid than the underlying publicly traded stock data upon which the value is calculated in an income approach (discount rates) or market approach (market multiples) that must be addressed through some sort of valuation adjustment?

Call for Change in New York's DLOM Stance Gains Steam

New York's out-of-step position with respect to the discount for lack of marketability in fair value proceedings is a hotly debated issue—and it's getting even hotter. A "new note" in the debate was sounded in an article in the January issue of *Business Valuation Update*, according to a blog post, "The DLOM Debate Heats Up," by attorney Peter Mahler (Farrell Fritz) in the New York Business Divorce blog (www.nybusinessdivorce.com).

Stands alone. In the article "NY's Unfair Application of Shareholder-Level Marketability Discounts," Gil Matthews (Sutter Securities) writes that New York "stands alone in that it *favors* (and some lower courts believe *requires*) the imposition of a marketability discount on dissenting shareholders in fair value determinations. There is broad consensus that DLOMs should seldom, if ever, be permitted in appraisal or oppression cases." Matthews points out that New York is out of line with both the Model Business Corporation Act (MBCA) and the American Law Institute (ALI) "as well as the widely accepted view in other states and in legal literature."

Mahler gives his perspective on the issue and says that it "would be nice if the business valuation community could speak with one, clear voice on the issue, which would then facilitate consideration by legislators or, should they defer to the courts, appellate judges, of any needed changes to New York's policy toward DLOM in fair value proceedings."

Stay tuned for more on this issue!

Note: See the *BVWire* for continuing coverage of this and all key business valuation topics. Go to www.bvresources.com and click on Free Ezines (registration required).

Both Shannon Pratt and John Stockdale consider such a possibility in their writings. Pratt[3] states:

> The rationale for a marketability discount on controlling interests of closely held companies is that the controlling owner of a closely held business who wishes to liquidate his or her controlling ownership interest generally faces the following transactional considerations:
>
> - Uncertain time horizon to complete the offering or sale;
> - Cost to prepare for and execute the offering or sale;
> - Risk concerning the eventual sale price;
> - Noncash and deferred transaction proceeds; and
> - Inability to hypothecate (that is, the inability to borrow against the estimated value of the stock).
>
> All of the above considerations make the sale of the controlling interest in a closely held business risk difficult and costly. For this reason, many valuators believe that such controlling interests suffer from some measure of lack of marketability that needs to be represented via a discount adjustment to value.

And both Pratt[4] and Stockdale[5] make reference to studies focused on control-level interests such as the following:

> *DiMattia* (2008):[6] examined public stock prices for companies that have received tender offers

3 Shannon P. Pratt, "Business Valuation: Discounts and Premiums," 2nd Edition, 2009, p 201.

4 Pratt, pp. 207-210.

5 John Stockdale Sr., *BVR's Guide to Discounts for Lack of Marketability,* Volume 1, 5th ed. p 317ff.

6 Ronald D. DiMattia, "*Controlling Interests – Discount for Lack of Marketability: The Empirical Evidence,*" CPA Expert, Summer 2008, 1-6.

and the merger arbitrage that resulted from these offers. Merger arbitrage is the practice of betting on the outcome of a merger. Since some mergers are never completed, and some chance that the final price could change from the offer price during the time between the announcement and closing, trading prices for these company stocks tend to be less than the tender offer price. Referenced in the Di-Mattia article were two studies: (1) Branch and Yang (2006),[7] who found an average spread between price and tender offer one day after the announcement; and (2) Micah Officer (2007),[8] who found an average spread between price and tender offer of failed mergers one day after the announcement.

The BV profession needs to discuss more rigorously the issue of illiquidity and lack of marketability for control interests in privately held companies.

Loeplin, Sarin and Shapiro study:[9] Published in 2000, the Loeplin study of matched pairs of private- and public-company acquisitions between 1984 and 1998 (excluding financial companies and regulated utilities) showed that there was evidence of a discount for private companies over public companies.

DeFranco, Gavious, Jin, and Richardson study:[10] In 2007, these researchers compared private-company acquisitions from *Pratts Stats* to acquired public companies from Compustat. They performed a multifactor regression analysis to control for differences in size, sales, growth, R&D expenditures, and EBITDA (the latter two as a percentage of revenues) and found a discount when comparing EBITDA multiples.

However, Chris Mercer (Mercer Capital) takes the position that no discount for lack of marketability is appropriate:

> The argument against the existence of a marketability discount applicable to controlling interests is simple. If enterprise value is determined based on expected cash flows, expected growth of those cash flows, and the riskiness of those cash flows, then what additional factors would support a discount from this value?[11]

Further, the New York statute itself suggests an "either-or" option: liquidate and pay out pro rata or buy out pro rata. Are adjustments concerning marketability or liquidity necessary to create equivalency in the two value options? It is ostensibly this thinking that has led jurists in New York to rule that real estate holding companies are less likely to require DLOM adjustments than operating companies, attributing illiquidity to more ethereal "goodwill."[12]

My first point here is not to state my unambiguous opinion on the topic in this short space, but rather to suggest that the valuation profession needs to

7 Ben Branch and Taewon Yang, "Merger Deal Structures and Investment Strategies," *The Journal of Alternative Investments,* Winter 2006.

8 Micah Officer, "Are Performance Based Arbitrage Effects Detectable? Evidence From Merger Arbitrage," working paper, Feb. 20, 2007, 15.

9 John Koeplin, Atulya Sarin, and Alan C. Shapiro, "The Private Company Discount," *Bank of America Journal of Applied Corporate Finance* 12, no. 4 (Winter 2000): 94-101.

10 Gus DeFranco, Ilanit Gavious, Justine Yiquing Jin, and Gordon D. Richardson, "The Existence and Explanations for the Private Company Discount," working paper, April 27, 2007.

11 Z. Christopher Mercer and Travis W. Harms, *Business Valuation: An Integrated Theory,* 2nd ed., Wiley 2008, p. 95.

12 See *Vick v. Albert,* 47 AD3d 482 [1st Dept 2008], *CINQUE v. Largo Enters. of Suffolk County, Inc.,* 212 AD 2d 608 - N.Y.S.2d 735, and *Giaimo (EGA Associates, Inc.),* 2011 NY Slip Op 50714(U) (Sup Ct NY County Apr. 25, 2011). Note, however, that in *Murphy (United States Dredging Corp.),* 74 AD3d 815, 2010 NY Slip Op 04794 (2d Dept June 1, 2010), the court essentially overruled 15 years of precedent and expanded DLOM's applicability beyond just goodwill. (These cases are available at *BVLaw* (www.bvlibrary.com/bvlaw).)

continue its discussion regarding control-level DLOMs.

Second, and I have opposition reports in my files to document this, some business appraisers and accountants who have provided expert witness work for statutory fair value in New York have applied DLOMs based on their analysis of restricted stock studies and pre-IPO studies, both of which generate evidence for DLOMs *for noncontrol* interests. This issue is more problematic.

None of the studies referenced in these valuations provide any evidence for lack of marketability for control-level interests—the adjustment that might be appropriate in New York statutory fair value cases. Thus decisions made based on this evidence are flawed. Applying non-control-level DLOMs continues, in Blake's words, to fail to protect the minority interest.

These flawed reports typically derive DLOMs of 30% to 50% based solely on the evidence of discounts attributable to noncontrol, minority interests with no discussion or empirical evidence connecting the studies referenced to the subject at hand: the pro rata share of the whole. This misapplication of market evidence has been, and continues to be, unhelpful to triers of fact.

To help Peter Mahler (Farrell Fritz) with clarification (see sidebar), the BV profession needs to discuss more rigorously the issue of illiquidity and lack of marketability for control interests in privately held companies. Also, the profession may need to police itself more on the second, as well as help educate the legal community and the triers of fact on these issues. ◆

William C. Quackenbush, *MBA, ASA, MCBA, BCA, ABAR, is a director at Advent Valuation Advisors (Newburgh, N.Y.). He served as the chair of the ASA's Business Valuation Committee and writes and speaks regularly on business valuation issues.*

Complications With Event Studies

... continued from front page

(i) the asset traded in a liquid and informationally efficient market; and (ii) there were no "confounding" firm-specific news events during the trading day. Under these assumptions, a single (close-to-close) trading day was used as the event window. However, as with the estimation window width, the width of the event window involves a trade-off. First, the window must be of a width sufficient to allow the news to be fully incorporated into the price of *f.* However, as this width increases, the amount of confounding news likewise increases. The first set of complications addresses alternative choices of event window widths.

Confounding events. As was discussed above, one key decision involves the choice of the *event window* and the inherent trade-off. As above, the event window should be sufficiently long to allow the asset price to fully reflect the at-issue information but sufficiently narrow to reduce the impact of confounding events.

As an example, before the opening of trading on December 5, it is announced that an analyst has initiated coverage of *f* with a "strong buy." However, the at-issue event occurred at 2 p.m. during the trading day when a strategic partner of *f* announces it has cancelled a contract with *f.* Had we used a one-day event window as we did in Example 1 above, the close-to-close (December 4-to-December 5) return would contain or reflect both pieces of information. Thus, if possible, we would select an event window that included the cancelled contract but would exclude the analyst upgrade.

In this example, two solutions are plausible. First, one can choose to use consecutive *opening* prices to compute an open-to-open return ($R_{f,t}$ is calculated using the opening prices of December 5 and December 6). As the coverage initiation should be incorporated in both these prices, *differences* in these prices will not reflect this confounding event.

Assume the researcher decides that the estimation period will contain 120 close-to-close (total,

or with dividend) returns to both the firm, *f,* and the market index, *m*. Using these returns, a regression is run, and, after appropriate specification testing and remedial measures, the resulting estimates of α and β are -0.002% and 0.870, but the t-statistic associated with the estimate of "a" is insignificant.[1] Economically, this means that, if the index doesn't change over an interval and the return to *m* is zero, it is *expected* that the return to *f* will likewise equal zero.

Using the open-to-open return for both *f* and *m*, which are $R_{m,t}$ = 1.1% and $R_{f,t}$ = -1.5%, the abnormal return is calculated as:

$$AR_{f,t} = R_{f,t} - \{a + bR_{m,t}\}$$

$$= R_{f,t} - \{0 + [0.87 \times 1.1]\}$$

$$= -1.50\% - \{0.957\%\} = -2.457\% \approx -2.5\%$$

As above, the researcher can induce that losses to shareholders due to the contract cancellation were roughly 2.5% of the preannouncement market cap.

An alternative approach for choosing an event window that focuses on the at-issue announcement involves using *intraday* returns. For example, assume the researcher concludes, perhaps based on an analysis of contemporaneous volume, that news of the cancelled contract was fully incorporated within one hour from the intraday announcement. So, by 3 p.m. on December 5, the price of *f* fully reflects or incorporates the news of the cancelled contract. Thus, to compute the one-hour abnormal return, the researcher would continue to use estimates of α and β from before (-0.002% and 0.870) even though they were estimated using daily and not hourly data. As above, the estimate associated with α is insignificant.[2]

The only change would be to use the corresponding *one hour* returns to both *f* and the index. Assuming the researcher finds that the return to the S&P 500 and the firm for the 2 p.m.-to-3 p.m. hour are 0.320% and -1.645%, respectively,

$$AR_{f,t} = R_{f,t} - \{a + bR_{m,t}\}$$

$$= -1.645 - \{0 + [0.870 \times 0.320\%]\}$$

$$= -1.645\% - \{0.278\%\} = -1.923\%.$$

Now the researcher will conclude that losses were roughly 1.9% of the preannouncement market cap.

Confounding factors are particularly problematic and require a significant attention to detail on the part of the expert. In *In re Omnicom Group, Inc. Securities Litigation,*[3] defendants successfully argued for summary judgment based in part on the failure of the plaintiffs' expert to disaggregate confounding factors. The court noted that identifying *some* confounding factors is not sufficient to determine the portion of loss attributable to the misrepresentations. The plaintiffs' expert in *In re Scientific Atlanta, Inc. Securities Litigation*[4] failed to identify a new characterization of previously known information as a confounding factor and segregate the loss associated with this factor as opposed to the alleged fraudulent act. The plaintiffs in this case alleged that defendants engaged in channel stuffing and improper accounting practices for the purposes of hiding declining product demand. The plaintiffs failed to prevail at summary judgment in part as the court held that insufficient evidence was presented that allowed for a disaggregation of the loss related to fraud-related and non-fraud-related causes. This again highlights the import of identifying all confounding factors in the development of the event study.

1 As this parameter represents the expected return to holding the equity for one period assuming the index does not change, this parameter can be expected to be close to zero.

2 Should one find a significant estimate of α even after performing diagnostics, one would prorate this estimate if the event window interval differs from the estimation period interval. Although exact pro rationing can be nontrivial, it rarely has a meaningful impact on estimates of abnormal returns.

3 *In re Omnicom Group, Inc. Securities Litigation,* 541 F. Supp. 2d 546 - Dist. Court, SD New York 2008.

4 *In re Scientific Atlanta, Inc. Securities Lit.,* 754 F. Supp. 2d 1339 - Dist. Court, ND Georgia 2010.

Trading halts/trading delays. In previous sections, it has been assumed that trading in the at-issue firm, *f,* is continuous around the announcement. A more likely scenario is that the announcement occurs during nontrading hours, i.e., "after hours" or "preopening," and leads to a *trading delay,* or the news is released during the trading day but causes *a trading halt*. Briefly, a trading *halt* is enacted when news impacting an exchange-listed equity cannot be delayed until the end of a trading session (a *regulatory* halt), or the news causes an imbalance between buy and sell orders so great that market makers cannot absorb it (a *nonregulatory* halt). In either case, trading is suspended in the impacted equity until news is disseminated and a new price can be established.[5] However, tempting as it may be to use the change in price during the halt or delay, it is an open question whether the resultant price is an equilibrium one or whether it fully captures the information. Indeed, expanding the window beyond the halt/delay in both directions can be justified. First, informational leakages may occur before the actual announcements. Second, as opening or reopening trading may be the primary objective of market makers, the post-announcement price may not fully reflect the news. Again, the researcher should define the event window based on examination of contemporaneous levels of volume.

Subjectivity of event studies. Experts need to make many subjective decisions in the development of an event study. A knowledgeable expert will limit the subjectivity in the study to a minimum.

In analyzing event studies at the class certification stage, courts have acknowledged that "many decision points in designing an event study require some subjectivity."[6]

Therefore, it is incumbent upon the expert to justify the decision process as reliable and reasoned and take the steps necessary to minimize the subjectivity.

For example, the very identification of news events and the determination of which events are material are subjective. When news should be reflected in the market price is a function of when that news becomes available. The more specific the guidelines for the definition of the event and the expected impact period of the event, the more likely any impact of the event will be captured. Thus, it is important not only to clearly define the event, but also to clearly establish the period during which the defined event will influence security prices.

The courts argue that subjectivity should be minimized and that the expert articulate objective criteria in the selection process. There are two key components to this objectivity. First, the criteria used by the expert needs to be clearly articulated. Second, the objective criteria must be articulated *before* the selection of the event dates. Unfortunately, despite the need for clarity, the identification of surprise events, i.e., events that would warrant a market movement in the price of the stock, is not always easy as a practical matter.

'Alternative' securities. As securities litigation based on fraud on the market has not been limited to highly traded equities listed on a national exchange, so too event studies have been applied to alternative securities including, but not limited to, corporate bonds, preferred stock, options, and other derivative securities. Three factors that the type of security under investigation influence are: (i) the evaluation of efficiency under the *Cammer* and *Krogman* factors; (ii) the interpretation of the market response to information; and (iii) the type of prices available to conduct the study. Here, we discuss three classes of securities where the above three factors may meaningfully vary, i.e., nonequities, illiquid assets, and newly listed equities.

Despite the presence of peer-reviewed, reliable academic research conducted using event studies for both bonds and preferred stocks, class action lawsuits that involve these financial instruments require care to show that they trade in efficient markets. Unfortunately for an expert, rulings have

5 Lee, Ready, and Seguin.

6 *Diamond Foods,* citing *Countrywide,* 273 F.R.D. at 618.

not been consistent in this area. For example, in *In re American Int'l Group, Inc. Sec. Litigation,*[7] the U.S. District Court found that there was insufficient support to find that AIG's bonds traded in an efficient market. The more recent trend appears to recognize differences in the stock and bond markets as evidenced by recent rulings that bonds do operate in efficient markets. In *In re Bennett v. Sprint Nextel Corp.*,[8] *In re Winstar Communications Securities Litigation,*[9] and *In re HealthSouth Corp. Securities Litigation,*[10] courts found that the bonds did trade in efficient markets. The courts appear to apply the *Cammer* factors but in a nuanced framework to address differences between the markets between stocks and bonds as discussed in *Plumbers & Pipefitters v. Burns.*[11] In addition, additional factors are under consideration, e.g., reports of bond rating agencies.

One cannot expect a news event to impact the various securities of a company in exactly the same way.

Further, one cannot expect a news event to impact the various securities of a company in exactly the same way (Hartzmark, Schipani, and Seyhun, 2011), so it is incumbent on an expert to delineate any anticipated influence of news on the at-issue security. The importance of this was highlighted in the motion for class certification in *Bennett v. Sprint Nextel Corp.,* 298 F.R.D. 498 (D. Kan. 2014), which dealt with Sprint bonds and the alleged violation of the Securities Exchange Act of 1934 as the result of false and misleading statements. That court found that, "unless the statement disclosed information that altered Sprint's likelihood of default, the price of the Sprint Bonds would not be expected to change in any meaningful way." The failure of the defendant's expert to evaluate the substance of the information released on event days caused the court to find that the event study was unreliable.

Illiquidity also requires care by the expert, and more effort is required to show efficiency. The mere fact that a security trades on a national exchange is not conclusive evidence of efficiency: In *In re Federal Home Loan Mortgage Corp. (Freddie Mac) Securities Opinion Litigation*, No. 09-832, the court found that "Plaintiff has not shown by a preponderance of the credible evidence that the market for Freddie Mac's Series Z preferred shares was efficient during the class period." Thus, an expert would be required to evaluate the trading characteristics of that particular issue with respect to the *Cammer* factors to determine efficiency.

Illiquidity also increases the complexity of any analysis as prices that are both current and reliable may not be readily available. For example, because corporate bonds may not trade on a daily basis, historical price quotations for bonds will often be a so-called matrix price. Rather than a transaction price, a matrix price is derived from the prices of other bonds with similar characteristics, i.e., similar credit ratings, durations, options, etc. Given that it is not a transacted price, the courts generally require that matrix prices must be shown to be consistent with the general direction of movement in the price of the security. (See, for example, *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.,*[12] *Plumbers and Pipefitters, National Pension Fund v. Burns.*[13]) Thus, although transaction prices are always the preferred price to use in an event study, matrix

7 *In re American Int'l Group, Inc. Sec. Litigation,* 265 F.R.D. 157 (S.D.N.Y. 2010).

8 *Bennett v. Sprint Nextel Corp.,* 298 F.R.D. 498 (D. Kan. 2014).

9 *In re Winstar Communications Securities Litigation,* 290 F.R.D. 437 (S.D.N.Y. 2013).

10 *In re HealthSouth Corp. Securities Litigation,* 261 F.R.D. 616 (N.D. Ala. 2009).

11 *Plumbers & Pipefitters, Nat'l Pension Fund v. Burns,* 967 F. Supp. 2d 1143 (N.D. Ohio 2013).

12 *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.,* 546 F.3d 196 (2nd Cir. 2008).

13 *Plumbers & Pipefitters, National Pension Fund v. Burns,* 967 F. Supp. 2d 1143 (N.D. Ohio 2013).

prices may be used if shown to be consistent and reliable proxies.

Finally, there exists the situation where historical prices simply do not exist. Such is the case with newly issued equities (IPOs). In some of these cases, courts have recognized a "fraud *created* the market" theory.[14] Under this theory, reasonable investors, absent the fraud, would not have initially invested in the security. Although circuit courts disagree on the acceptance of this theory, it is an avenue in the support of the presumption of reliance in a new issues market.[15] ◆

***Adrian M. Cowan, Ph.D.**, is co-founder of Analytic Focus LLC, a national statistics, finance, and economics consulting organization. She is a former associate professor in finance in the Business School at St. Mary's University. **Paul J. Seguin, Ph.D.,** is a senior affiliate consultant for Analytic Focus LLC.*

14 Michael Kaufman, "Fraud Created the Market," 63 *Ala. L. Rev.,* 2012, 275, 282.

15 See, for example, *Eckstein v. Balcor Film Investors,* 8 F.3d 1121, 1130 (7th Cir. 1993), and *Ross v. Bank South, N.A.,* 885 F.2d 723, 729 (11th Cir. 1989).

How to Avoid Tripping Up Over Subsequent Events

If you're not considering events that happen after a valuation date, you may be compromising your valuation report. Worse, if you're in court, your report could be tossed out. "Hold on," you might be saying. "Events subsequent to the valuation date should be excluded from a valuation analysis." Yes, that's generally true, but there are exceptions. The trick is knowing when you should—and should not—take this information into account.

At the recent AICPA FVS conference in Las Vegas, David Laro, a senior judge of the U.S. Tax Court made it a point to say that some courts have examined subsequent events that are relevant to the taxpayer's perceptions at that time. In some cases, subsequent events were reasonably foreseeable as of the valuation date, so they are relevant to the valuation.

Two categories. There are two categories of subsequent events or information: (1) those that affect value; and (2) those that do not affect value but that do give evidence of value that existed at the valuation date. In general, those that affect value should not be considered—unless they are foreseeable. On the other hand, those events that give evidence of value that existed as of the valuation date may indeed be considered.

This concept is explained very well in several key court cases:

> A distinction may be usefully drawn between later-occurring events which *affect* fair market value as of the valuation date, and later-occurring events which may be taken into account as *evidence* of fair market value as of the valuation date. When viewed in this light—as evidence of value rather than as something that affects value—later-occurring events are no more to be ignored than earlier-occurring events.[1]

> Subsequent events or conditions which affect the value of the property can be taken into account only if they are reasonably foreseeable on the valuation date. Conversely, subsequent events which merely provide evidence of the value of the property on the valuation date can be taken into account regardless whether they are foreseeable on the valuation date.[2]

1 *Estate of Jung v. Commissioner,* 101 T.C. 412, 101 T.C. No. 28 (U.S. Tax Ct., Nov. 10, 1993). Available at *BVLaw* (www.bvlibrary.com/bvlaw).

2 *Morton v. Commissioner,* T.C. Memo 1997-166, 73 T.C.M. (CCH) 2520 (U.S. Tax Ct., April 1, 1997). Available at *BVLaw* (www.bvlibrary.com/bvlaw).

In practice. You will typically come up against three broad scenarios during an engagement: (1) the subject company follows its historical path, which can be either normal growth or decline; (2) foreseen or predictable changes or events affect the company; and (3) the company is hit with changes or events that are unforeseen or unpredictable.

When the company is sailing along as historically expected, it is certainly appropriate to use the company's financial information for the year following the valuation date. This is especially true when financial information preceding the valuation date is missing or not available. It is also appropriate to use the company's financial information for the year following the valuation date if it reflects changes caused by foreseen or predictable events. For example, the company may have launched a great new product, landed a big new client, or is modernizing its plant to increase efficiency.

However, it is *not appropriate* to use the company's financial information for the year following the valuation date if it reflects changes caused by unforeseen or unpredictable events. For example, the surprise loss of a key customer or supplier, an act of Mother Nature that significantly interrupts operations, or an unforeseen change in government regulations that affect the business.

'Knowable' interpretation. Every valuation expert knows that for information to be taken into account it must be "known or knowable." This is sometimes interpreted to mean that financial results through the valuation date that haven't yet been published as of the valuation date are not usable. But a reasonable interpretation is that this unpublished information—although it's not officially compiled—meets the criterion of "knowable." In reality, most CEOs and CFOs have a pretty good idea of what their results were, even though they have not been formally compiled or published.

This same interpretation can also hold true for guideline public company data. For example, if the valuation date is a calendar year, some appraisers would only use data through September 30 for the guideline companies because year-end results would not have been released. However, it would be reasonable to use actual year-end results for the guideline companies. Reasons: The information coincides with the company's year-end, and analysts' predictions of year-end results are available.

What to do. Use professional judgment to determine when it is appropriate to use subsequent events or information as part of the valuation process. If a subsequent event is significant, consider disclosing it in your valuation report, but make it clear that the information was not used to determine value as of the valuation date. If you're involved in a court case, consult the attorney to see whether the particular jurisdiction allows the consideration of subsequent events.[3] ◆

3 For a full discussion on subsequent events, see *Understanding Business Valuation: A Practical Guide to Valuing Small- to Medium-Sized Businesses*, 4th edition, by Gary Trugman and also *Business Valuation and Federal Taxes: Procedure, Law and Perspective*, 2nd edition, by David Laro and Shannon Pratt. Both books are available from BVR (bvresources.com/publications).

Appraiser Review: How *Pratt's Stats* Upgrades Improve Your Search for Comps

By Jessica Landay, CVA, and Ron Seigneur, CPA/ABV/CFF, ASA, CVA, CGMA

The guideline company transaction method[1] is commonly used by valuation professionals and is one of the most contentious methods of valuation, often due to the appraiser's general lack of knowledge of the underlying transactions. The *Pratt's Stats*[2] transaction database has recently added enhancements to help appraisers identify transactions of companies comparable to the subject company being valued, as well as to better determine comparability of the transacted companies and the subject entity. The new enhancements were released to *Pratt's Stats* subscribers through BVR on January 6.

New search criteria. The first change users will notice is that you can now search by secondary (or tertiary) SIC or NAICS code by checking a box below the SIC or NAICS code drop down list. This option allows the user to capture companies in the database that have more than one line of business. For example, if a reported transaction is of an enterprise with more than one identifiable line of business, the database will now search for all lines of business for the transacted company, since it has been expanded to include the secondary and tertiary SIC/NAICS codes of all transacted companies in the database. Including secondary industry codes in the search criteria will prompt the database to search for acquired businesses in which the selected SIC/NAICS code is an additional product or service line of the acquired business that generates less revenue than the primary SIC/NAICS code. If applicable, each transaction will have up to three SIC and NAICS codes assigned. Selecting this option allows the user to find more companies when searching by industry. The search results only show the primary SIC/NAICS code when viewing in the results summary page, but when exported to Excel or the *Pratt's Stats* Analyzer, the secondary and tertiary SIC/NAICS codes are provided for each transaction, if there are any. Also, when looking at the individual transaction detail, the secondary and tertiary industry codes are provided.

Another added function is that users can now select to include or omit transactions of companies classified as franchises, development-stage companies, and transactions in which real estate was acquired by using the drop down menu and selecting "all," "yes," or "no" for each of the three categories (the default setting is "all"). A search of the entire database for sales of development-stage companies resulted in only 19 transactions, of which only seven reported net sales, and therefore only seven transactions have transaction multiples. The database includes 791 transactions of franchises and 1,046 transactions in which real estate was acquired.

Users now have the ability to search for transactions by "sale region," whereas previously users could only search by country, state, and city. These nine regions are: East North Central, East South Central, Mid-Atlantic, Mountain, New England, Pacific, South Atlantic, West North Central, and West South Central. These regions are further defined in the updated FAQ. The advantage of this is that previously the user could only narrow the sale area to one state and would have to run multiple searches to find transactions by more than one state (or search by the entire country and eliminate the unwanted states from the results). Now, users can perform one search for a selected geographical region including multiple states.

The final enhancement to the search criteria is the user can now search by EBITDA (earnings

1 This method is also referred to as the merged and acquired company method or direct market data method.

2 Go to www.bvmarketdata.com.

before interest and taxes, depreciation, and amortization) and discretionary earnings (defined by *Pratt's Stats* as operating profit plus owner's compensation plus depreciation and amortization), in addition to net sales, operating profit, net income, and total assets, which were previously available in the database. The EBITDA range for all transactions in the database is -$1,449,989,000 to $4,092,000,000. The discretionary earnings range for all transactions is -$828,740,000 to $224,940,000.

Improved layout. In addition to the new search criteria, *Pratt's Stats* has created a new layout in the transaction detail view. In addition to the information that was previously available for each transaction, now there is a dedicated section for "Purchase Price Allocation Data" with 23 fields, as well as additional fields in the "Transaction Data" and "Income Data" sections. The purchase price allocation data allow users to determine the value of the various assets that were purchased in the transaction, providing greater opportunity for comparability to the subject company. Previously, the "Asset Data" section of the transaction detail contained a line item that said "Data is Purchase Price Allocation agreed upon by Buyer and Seller," and it was marked with a "Yes" or "No" to indicate whether it was balance sheet or purchase price allocation data. This new addition of a separate section specifically for Purchase Price Allocation data reduces confusion for the user.

Transaction costs are another new addition, which are captured and reported in the "Transaction Data" section of the transaction detail, when available. The user must determine the effect of the transaction costs on the value of the business being acquired and make the appropriate adjustments for use in valuing the subject entity.

The transaction detail now includes additional line items for interest income, other expense, other income, and tax benefit in the "Income Data" section of the printout. The inclusion of these items allows the user to determine why operating profit differs from earnings before taxes (EBT). Previously, only interest expense was provided, and the operating profit less interest expense did not always equal earnings before taxes. This information was previously noted in the "Additional Transaction Information" section of the transaction detail, when available, and required the user to carefully read the notes of each transaction.

Revised print formats. Because of the additional information included for each transaction on the transaction detail view, the printable report is best viewed on 8.5-inch-by-14-inch paper; if it is viewed or printed on 8.5-inch-by-11-inch paper, each transaction will now take up two pages, as opposed to the one 8.5-inch-by-11-inch page each transaction formerly occupied.

The report package print function (the red box appearing on some transactions to the left of the industry code in the transaction results summary view) now prints 25 transactions compared to 10 transactions previously. This saves time for the user, allowing he or she to print more transaction details with less mouse clicking (100 transactions can now be printed in four print operations compared to 10 before the change).

The downloadable versions of the transaction data—*Pratt's Stats* Analyzer and Excel format—include 45 new fields, as well as changes to some of the previously included fields. For example, "Company Name" is now "Target Name," "COGS" is now "Cost of Goods Sold," and "Liabilities Assumed" is now "Debt Assumed." Columns have been added to provide the contact information of the acquiring company, if available. Another addition is the amount of the selling price that the seller financed. All historical transactions in the database have been updated to include the newly added transaction information, if that information was available for the transaction. A total of 149 columns of data is now included in the Excel download. Additionally, some columns in the *Pratt's Stats* Analyzer and Excel format downloads were reordered to group related items

together. Because of this, analysts using a template previously built from the Excel exports or the *Pratt's Stats* Analyzer will be required to modify their templates in order to accommodate the recent changes.

The FAQ page[3] has also been updated to reflect the recent changes to the database. To update templates due to the field name changes and placement, the FAQ page provides a crosswalk between the old field names and the new field names (located in the first question under the Data Principles and Collection section of the FAQ page).

The more data that are available about transactions for use in the guideline company transaction method, the easier it is for valuation professionals to determine the comparability of the transacted company to the subject company. While these enhancements to the *Pratt's Stats* database improve the usefulness of the transaction data, they do not make the expanded transaction information appropriate for use in the business appraisal process without proper scrutiny and application by the valuation analyst. We have yet to see any transaction database that includes enough transaction data to be perfectly used in the market approach. However, *Pratt's Stats* provides the most data of any database we have considered and utilized, and these enhancements add to the utility of the data. A future enhancement that would be incredibly helpful to the business valuation community would be the inclusion of historical financial data of the transacted ("target") company, allowing analysts to dig deeper into selling price of the company, as well as make better comparisons to the valuation subject.

Jessica Landay, *CVA, is a senior financial analyst at Seigneur Gustafson LLP in Lakewood, Colo. She has passed all exams en route to completing the Accredited Senior Appraiser (ASA) designation from the American Society of Appraisers. She can be contacted at jessica.landay@cpavalue.com.* ◆

Ronald L. Seigneur, *CPA/ABV/CFF, ASA, CVA, CGMA, is managing partner at Seigneur Gustafson LLP in Lakewood, Colo. He can be reached at ron.seigneur@cpavalue.com.*

Ask the Experts

Q: *How has the ability to buy insurance online without the need for an agent affected local insurance agencies?*

A: "For certain commodity-type products, such as term life and auto insurance, there has been a significant impact on local agencies," says Lucas M. Parris, CFA, ASA, a vice president at Mercer Capital who leads the firm's insurance industry team. "An individual can compare prices, apply online, and purchase a policy directly from the carrier without talking to an agent. This is an ease-of-use issue, and I don't see this trend reversing. And to the extent that this model extends to other types of insurance, such as home and other personal lines, it will be a negative." However, agencies that focus on commercial insurance will not be as affected. "An owner of a business or commercial property is not going to feel as confident about price and policy terms when using an online form, as compared to discussing his particular situation with a real person." He says, "The ability to sit down face-to-face with the agent will always have some appeal to the business owner, and the underwriters are likely to be able to better price the risk."

For more information. Parris recently conducted a BVR webinar, Valuing Insurance Agencies. To acquire a recording, go to www.bvresources.com/dlc.

3 Go to www.bvmarketdata.com/pdf/PrattsStats-FAQ.pdf.

Recent Case Points Up Danger of the Discovery Trap

By Sylvia Golden, Esq.

In a typical valuation engagement for litigation, there can be a slew of written communication between the expert and the client or attorney. Draft reports, emails, letters, and memos can fly fast and free. The trouble is, this material may be discoverable and you may find yourself on the witness stand trying to explain a seemingly innocent document that has fallen into the hands of the opposition.

What's at stake. An appraiser's reputation is at stake if documents come to light that even hint at being an advocate or "hired gun" for the client. In a recent case, letters between the appraiser and the client and the client's attorney suggested that the appraiser used the client's valuation as the basis for the valuation. These letters, produced as part of the discovery process, cast doubt onto the appraiser's independence. The opposing side ended up winning the case. See *TWC I, L.L.C. v. Damos,* 2015 Iowa App. LEXIS 438 (May 20, 2015) (available at *BVLaw*).

The best protection against this kind of nightmare is familiarity with the discovery rules. Here is a quick review of Rule 26 of the Federal Rules of Civil Procedure, which applies in federal courts. States have their own rules, so make sure you check those out.

2010 Amendment. Rule 26 was amended in 2010 to simplify discovery obligations, limit disclosures, and protect the attorney's thoughts, opinions, and mental impressions (work product). The amendments require only disclosure of "facts or data" considered by the expert. But since courts have been slow to clarify the scope of protection, a sense of uncertainty remains among experts and attorneys.

Expert reports. Rule 26 (b)(4)(B) protects drafts of expert reports "regardless of the form in which the draft is recorded." But courts don't agree on what constitutes a nondiscoverable draft expert report. Some have said that an expert's notes, memos, lists, and outlines are discoverable because they are not strictly speaking "draft" expert reports. Others have considered them parts of the draft, which can be in any form, and protected them, or they have said that discoverable "facts or data" does not mean everything the expert needs to do his or her analysis.

Expert-attorney communication. The rules now protect all communication between counsel and testifying experts, "regardless of the form of the communication." But they still permit discovery of: (1) communications related to the expert's compensation; (2) communications that "identify facts or data that the party's attorney provided and that the expert considered"; and (3) communications that "identify assumptions that the attorney provided and that the expert relied on."

This means communications in which the attorney and expert discuss general hypotheticals using the assumptions are protected, but communications in which the attorney identifies facts or data on which the expert later relies in developing his or her opinion are not. And there is no protection for communication between the testifying expert and someone other than counsel.

Open questions. A host of questions remain unanswered. How much work product can the expert put in the draft? What happens when the attorney conveys facts, data, or assumptions that the expert already knows? What about an expert's notes of communication with the attorney? Under the rules, the communication itself is protected if it doesn't fall within one of the three exceptions, but a court may find the notes are discoverable.

What to do. Here are a few things experts can do to limit their exposure:

- Be careful in your collaboration with attorneys;
- Limit the number of draft reports. Fewer means less exposure;

- Limit communication with the attorney;
- Assume all notes and work papers will be discoverable, even if they summarize discussion with counsel;
- Limit the need for counsel to provide facts, data, and assumptions; and
- Consider using technology such as GoToMeeting for conferences with counsel. ◆

Sylvia Golden, Esq., *is executive legal editor at Business Valuation Resources. She received her J.D. from the University of California at Berkeley (Boalt Hall) and is an active member of the State Bar of California.*

Seven Tips on Cost of Capital From the AICPA FVS Conference

There was great interest in the several sessions on cost of capital at the AICPA Forensic and Valuation Services Conference 2015 in Las Vegas. Speakers acknowledged that this is a topic that has evolved into a very complex area with a voluminous amount of published material that can be "daunting." Here are some of the notable pieces of advice and insights that can kick your cost of capital estimates up a notch—and make them more defensible.

1. Don't avoid MCAPM. The build-up method and modified CAPM (MCAPM) continue to be valid methods for developing cost of capital. Some speakers say they frequently—or always—use both methods on an engagement. The most prevalent method, based on a poll of conference attendees, is the build-up method using Duff & Phelps data. The data are contained in the *Valuation Handbook - Guide to Cost of Capital,*[1] which one speaker called a "great contribution to the valuation profession." Most valuation experts don't use MCAPM for valuing smaller private companies. However, the method should not be automatically avoided because some industries will contain smaller public companies.

2. Consider normalizing the risk-free rate. Speakers and attendees alike say they typically use a spot rate for the risk-free rate. Historically, valuators utilized the 10-year or 20-year U.S. government bond yield as of the valuation date. However, in the past few years, utilizing a normalized rate that more likely reflects sustainable risk-free returns has been considered.

Beginning in late 2008, the government, together with the Federal Reserve Bank, implemented actions that effectively lowered interest rates in an attempt to stimulate the economy, similar to that done during and after World War II. Because of this, the use of a normalized risk-free rate may be appropriate. The Duff & Phelps handbook has calculated a recommended normalized risk-free rate to be used as of various time periods. The book also discusses the logic and methodology of calculating the normalized risk-free rate. If a normalized risk-free rate is used, a normalized ERP should also be used.

3. Revisit ERP approach. For the equity risk premium, most appraisers use the ex post approach (historical information). A show of hands during one conference session revealed that most experts use the Duff & Phelps handbook for the ERP. New to the historical ERP data in the book is the addition of an adjustment for "WWII interest rate bias." As mentioned above, the Fed lowered interest rates between 1942 and 1951. Some analysts believe this time period should be excluded from the historical return data because the rates were manipulated.

Speakers also point out that some renowned experts such as Aswath Damodaran (New York

1 The 2016 edition is available from BVR (www.bvresources.com).

University) and Ashok Abbott (West Virginia University) consider the ex ante approach. Damodaran's website offers "very rich" data on ERP that he published each year (typically in March) under the title "Equity Risk Premiums (ERP): Determinants, Estimation and Implications." This material is free and is available on his blog.[2]

4. Beware of the 'component detail method' for CSR. When developing the company specific risk (CSR) to be added into whichever method you're using, some analysts consider separate components of CSR and then place a risk factor (positive or negative) on each detailed component. For example, "management depth" may be +0.05%, "supplier pricing leverage" may be -0.10%, and so on, all adding up to an overall CSR percentage. There could be several dozen factors to the analysis. The trouble is, this is "great fodder" for cross-examination, speakers say. It implies precision when precision doesn't exist. No empirical evidence can back up the assignment of specific risk percentages for each individual component.

A variation of this method uses simple observation of a component and does not specify a percentage for each. This method merely indicates whether each component increases, decreases, or has a neutral effect on the CSR. But this can be attacked pretty much the same as the percentage method, speakers say. What may be easier to defend is a simple list of the CSR components—without individual percentages or any indication of effect. Of course, no matter what method is used, if the analysis is done properly, you come to the same overall conclusion.

5. Try IPCPL. The implied private company pricing line (IPCPL) is a newly developed tool that uses data from *Pratt's Stats* and is designed to better estimate the cost of capital for a small private company. It's not ready for court, but speakers urged attendees to take a look at it. One suggestion: use it as a sanity check alongside other methods. The IPCPL developers would welcome comments.[3]

6. Look at Pepperdine studies. The annual Pepperdine report on private capital markets is "very interesting," speakers say. It is a survey of business appraisers, brokers, banks, private equity groups, business owners, and investors that benchmarks the current climate and projected outlook for lending, investing, and acquiring capital. They point out, however, that no actual transaction data are in the report.[4]

7. Use a strong visual aid. Trying to explain how you developed a cost of capital figure can be quite a challenge. Some speakers say they use a chart in both their reports and in court that lays out the broad range of rates of return in the market. At the low end of the spectrum (less than 1%) are U.S. Treasury rates (e.g., 30-day bills, five-year notes) and at the high end are rates required by venture capitalists (up to 60%). The analyst can then more easily explain where the subject company falls within this spectrum based on its relative risk. This kind of exercise should be done anyway, as a way of stepping back to see whether a conclusion of value makes overall sense.

Of course, you can't simply point to a chart such as this and expect to be finished. It's a good sanity check, but you still must provide objective support for the discount rate you choose. For example, in one case, the analyst explained that he chose a discount rate of 35%, which he called "conservative," saying that venture capitalists generally require a 30%-to-60% return. However, the analyst "did not provide any objective support, either at trial or in his expert report, for selecting a discount rate in this range."[5] ◆

2 aswathdamodaran.blogspot.com.

3 For more information, there is an IPCPL section in BVR's Cost of Capital Resource Center (www.bvresources.com).

4 Pepperdine University Private Capital Markets Project (bschool.pepperdine.edu/).

5 *Morton v. Comm.,* T.C. Memo 1997-166. Available at *BVLaw* (www.bvlibrary.com/bvlaw).

BVU PROFILE:

What Is the Practice of BV Like in the Middle East?

Editor's note: Faisal Alsayrafi, ASA, CVA, CMEA, CPA, is founder, president, and CEO of Financial Transaction House (FTH) in Saudi Arabia, which offers a wide range of corporate finance advisory services to a diversified client base in the Middle East. He can be reached at faisal.alsayrafi@fthgulf.com or at +966 12 657 3030.

BVU: *How did you get into business valuation?*

Faisal Alsayrafi: I joined Arthur Andersen after graduating with a masters in accounting and MBA in finance from a U.S. graduate school. I worked closely with senior management providing consulting and became managing partner of corporate finance, M&A, and advisory services for the Middle East region where valuations services were a critical concern.

BVU: *Is business valuation regulated in your country?*

FA: Yes, valuation services are now regulated by TAQEEM for most of areas and disciplines of valuation. TAQEEM is the Saudi Authority for Accredited Valuers, a government regulator for business valuations in Saudi Arabia.

BVU: *What is the nature of the typical valuation engagements in your market area?*

FA: The environment is competitive and evolving. The engagements range from valuations for financial reporting, goodwill impairment to buy-/sell-side engagements (for business and machinery and equipment).

BVU: *What countries are in your market area?*

FA: Saudi Arabia, UAE, Qatar, Bahrain, Kuwait, Oman (GCC countries), and Egypt.

BVU: *Are there any areas of valuation practice that are particularly growing?*

FA: There is a growing interest in intellectual property and the valuation of IP assets, as well as valuation of machinery and equipment in connection with purchase price allocations.

BVU: *What sources of financial data do you use for business valuations?*

FA: One important source is the Tadawul, the Saudi stock exchange. As regulations have relaxed to allow more foreign investment, it has become more important as a barometer of value. Accredited valuers also use U.S.-based databases as a benchmark for valuation purposes (i.e., Business Valuation Resources for private company data).

BVU: *Are private equity or venture capital groups active in your market?*

FA: Private equity (PE) and venture capital (VC) are active, but they tend to acquire minority interests in vertically integrated companies and serve as family advisors. They are also very important in those instances where firms are in distress and in need of capital because the laws involving bankruptcy and turnarounds are new and evolving and PE and VCs offer more certainty.

BVU: *Are valuers involved in litigation? Is there a court system similar to ours in the U.S.?*

FA: Yes, there is a role for litigation support in facilitating dispute resolution. The court system in Saudi Arabia (independent) does not have judges that specialize, such as the Delaware Court of Chancery or courts in the U.S. where IP disputes are presented to judges with the training and education to handle those matters. As the number of businesses grow in response to diversification

efforts, the need for specialized courts will increase and we may see those become a reality.

BVU: *Is there anything unique to business valuation in your market area (e.g., scope of services, methodology, or reports)?*

FA: Most professional firms and qualified practitioners use U.S.-based approaches and standards such as USPAP/AICPA standards. In Saudi Arabia and most of the GCC, the International Valuation Standard (IVS) provides the governing standards as per Saudi TAQEEM regulations in connection with iiBV (International Institute of Business Valuers) advisory contractors.

BVU: *How do you develop a cost of capital?*

FA: Normally, professionals will develop a cost of capital in accordance with international cost of capital and CAPM methodologies.

BVU: *What set of standards do valuers use?*

FA: Currently, in Saudi Arabia, we all use the IVS.

BVU: *Are business valuers certified? What credentials do they have?*

FA: Currently, TAQEEM has developed licensing and accreditation requirements for appraisal practices using the help of the iiBV for business valuation discipline, which eventually will be the ASA basic course material (regulations are in draft form at this stage).

BVU: *In addition to the iiBV, are business valuers active in other valuation or finance organizations, such as the CFA, ASA, or RICS?*

FA: I believe the answer is "yes," and TAQEEM is reaching out to various professional institutes in the world. The most committed and networked entities are the iiBV, AI, RICS, and Malaysian Institute of Appraisals. There are other professional organizations that have expressed an interest in participating in training but have not executed as of yet. As for professionals providing valuation services across the various disciplines, there are those holding designations earned through the ASA, CFA, RICS, and NACVA. I'm the only person qualified in ASA, as Accredited Senior Appraiser, in the whole region! Then, there are a few others that have earned the CFA designation, others that have earned the CVA from NACVA and the RICS accreditation, which focuses on real estate. ◆

March Tip From the Field

Watch Out for 'Wild' Financials From Vet Practices

When valuing a veterinary practice, you'll most likely have to undo the messiness of the bookkeeping done by the owner and handiness of the tax accountant, according to Byron Farquer, DVM, CVA, and David McCormick, MS, CVA, both with Simmons & Associates, a firm that specializes exclusively in veterinary practice sales, appraisals, brokering, and consultation. What you'll see in the financials isn't always what is really available as cash flow and profit, they say. With the exception of corporate-owned practices (corporations that own multiple locations) and a small number of business management-oriented owner-veterinarians, the industry is still very much tied to informal mom-and-pop-style accounting. Veterinarians really love the practice of medicine, but far fewer love the tasks of management, they say. This leads to variations in bookkeeping style, accuracy, and year-to-year consistency. Vets also often have a lack of focus on profitability, so the financials can sometimes get "pretty wild."

For more information. Farquer and McCormick are contributors to *What It's Worth: Veterinary Practice Value* (www.bvresources.com/publications).

BV News At-a-Glance

A monthly roundup of key developments from the standard setters, regulators, and valuation professional organizations (VPOs), plus noteworthy new books, research papers, and studies of interest to business valuation experts.

Standard Setters, Regulators, VPOs

The Appraisal Foundation: Discussion draft issued: *Potential Areas of Change for the 2018-19 Edition of the Uniform Standards of Professional Appraisal Practice*. Written comment period has closed.

FASB: Six topics added to research agenda: four financial reporting issues (pensions and other post-retirement employee benefit plans, intangible assets, distinguishing liabilities from equity, and financial performance reporting), consolidations, and inventory and costs of sales … two proposed Accounting Standards Updates (ASUs) issued re: financial reporting by employers related to defined benefit pension and other post-retirement benefit plans.

IASB: Final standard (IFRS 16, *Leases)* requires companies to bring leases onto the balance sheet, effective Jan. 1, 2019.

iiBV: The National Association of Valuers of Serbia (NAVS) is the newest member valuation professional organization (VPO) … a special task force is considering the details of an international business valuation designation.

IVSC: A separate standards board for financial instruments has been set up … an exposure draft for the new version of IVS is expected this June; final version late 2016.

New Books and Guides

Business Valuation Update Yearbook 2016, BVR, bvresources.com/publications.

BVR Legal and Court Case Yearbook 2016, BVR, bvresources.com/publications.

Mark Edwards, James R. Hitchner, and Michael J. Mard, *Valuation for Financial Reporting: Fair Value Measurement in Business Combinations, Early Stage Entities, Financial Instruments and Advanced Topics,* 4th edition, Wiley, www.wiley.com, August 2016.

Mario Massari, Gianfranco Gianfrate, and Laura Zanetti, *The Valuation of Modern Companies + Website: Integrating Accounting and Financial Principles for Advanced Techniques,* Wiley, www.wiley.com, July 2016.

Research Papers and Studies

Paul A. Gompers, Steven N. Kaplan, and Vladimir Mukharlyamov, "What Do Private Equity Firms Say They Do?" (survey of practices in firm valuation, capital structure, governance, and value creation), SSRN: ssrn.com/abstract=2602116.

Dmitry Livdan and Alexander Nezlobin, "Accounting Rules, Equity Valuation, and Growth Options," SSRN: ssrn.com/abstract=2700427.

*2015-2016 Rosenberg MAP Survey (*annual study of CPA firm statistics), www.rosenbergsurvey.com.

Other

Willamette Insights (Winter 2016; www.willamette.com) has a series of articles devoted to gift tax, estate tax, and generation-skipping transfer tax valuation.

Note to readers: If we've missed anything here, please let us know, and we'll include it in the next issue. Email *the editor at* andyd@bvresources.com.

LEGAL & COURT CASE UPDATES

Affirmation of DLOM Rulings Augurs End to Shareholder Fight

***Wisniewski v. Walsh,* 2015 N.J. Super. Unpub. LEXIS 3001 (Dec. 24, 2015) (*Wisniewski II*)**

After two decades of fierce fighting among the parties in this shareholder dispute involving a closely held trucking company, the parties renewed their attacks on the trial court's findings regarding the applicable discount for lack of marketability. The selling shareholder reasserted his earlier claim that his expert's prevailing discounted cash flow analysis sufficiently accounted for factors related to marketability. The buyers, in turn, contended the trial court erred in failing to adopt their expert's considered DLOM analysis.

Circumstances justify DLOM use. Three siblings—a sister and two brothers—owned equal shares in a family trucking business that provided private fleets to customers across the country, with a particular focus on the retail industry. The sister's suit against the younger brother set off an avalanche of other suits. Most critically for this case, in 1996, the younger brother filed an oppressed shareholder action claiming his two siblings tried to oust him from the company. Subsequently, the trial court found that the plaintiff younger brother in fact was the oppressing shareholder and ordered him to sell his interest either to the company or to the two siblings at fair value.

Both parties retained illustrious valuators. Ultimately, the first trial court set a value without conducting an evidentiary hearing—a move that triggered the parties' first appeal. On remand, a different trial court heard expert testimony and largely adopted the discounted cash flow (DCF) approach the selling shareholder's expert proposed. However, the court agreed with the buyers' expert, who used a market approach to value the company, that a 15% key person discount was appropriate to account for the unique contributions the late board chairman (the older brother) had made to the company's success.

Neither party approved of the resulting value determination, and both appealed the valuation a second time on various grounds. The appeals court affirmed nearly all aspects of the trial court's findings, but it concluded that the valuation should have included a marketability discount.

It noted that a marketability discount was only applicable under "extraordinary circumstances" in forced buyout situations. Here it was justifiable. Under prevailing case law, "where the oppressing shareholder instigates the problems, … fairness dictates that the oppressing shareholder should not benefit at the expense of the oppressed." The trial court specifically had found that the younger brother, i.e., the selling shareholder and minority owner, had engaged in conduct that harmed the other shareholders—the siblings defending against his suit—and that necessitated the forced buyout.

Accordingly, the appeals court remanded for a second time, ordering yet another trial court (two trial court judges had retired over the course of the litigation) to determine whether the prevailing DCF analysis embedded a DLOM and to set the applicable DLOM rate. (A further discussion of *Wisniewski v. Walsh*, 2013 N.J. Super. Unpub. LEXIS 724 (2013), as well as the court's opinion, is available at *BVLaw*.)

Trial court reviews DLOM testimony anew. To answer the DLOM-related issues, a third trial judge reviewed the existing record. He found that, for his DCF analysis, the seller's expert had built up a 12% discount rate from a number of components including a 7% equity risk premium, a 3.5% size premium, and a 4% company-specific risk premium. The latter accounted for the company's

closely held nature, its dependence on the older brother (since deceased) as a key manager, relative undercapitalization, and concentration of its customer base on the retail industry.

At the valuation trial, the seller's expert explained that there was no reason to apply an independent DLOM because the company was successful and would likely take no longer to sell than other closely held companies of similar size and nature—typically about six to nine months—with assistance from "the right business intermediary." He foresaw no danger to the other shareholders of losing liquidity during the marketing period. They likely would continue to benefit from the company's generous cash flow. He noted that, in the years surrounding the valuation date, the business had distributed tens of millions of dollars to the shareholders.

The court said there was no danger that applying a separate marketability discount resulted in double counting.

He also explained that a marketability discount was more appropriate to valuing a minority share of restricted stock in a publicly traded company because owners have a difficult time selling their interests when the fluctuating market declines, making their interests relatively more illiquid. He pointed out that since he had accounted for certain risk factors in developing his discount rate he did not want to count those factors again by applying an independent discount for illiquidity.

Using a market approach to value the company, the buyers' expert considered factors specific to liquidity such as the company's size and closely held nature, its profitability, customer concentration in the retail sector, anticipated holding period, and dependence on the older brother's stewardship of the company to determine the DLOM. He said that studies on the subject and legal precedent supported a 35% rate.

The new trial court started its analysis by answering the appeals court's first question: Did the prevailing DCF analysis include a marketability discount? He found it did not. Even though the seller's expert, in building his discount rate, considered many of the same factors the buyers' expert considered for formulating his marketability discount, the seller's expert did not adjust for marketability specifically. He "utilized [the factors] in a different way" than adjusting for a lack of liquidity, the trial court noted.

In contrast, in analyzing those same factors, the buyers' expert "focused on the inherent illiquidity of closely-held companies and the anticipated holding period for a rational investor in his company," the court found. There was no danger that applying a separate marketability discount resulted in double counting since it did not appear the experts accounted for the same risks relative to marketability, the court observed.

In answering the follow-up question—what the applicable DLOM rate should be—the trial court rejected both expert opinions: the 0% the seller's expert proposed and the 35% the buyers' expert used. The prior appeals court decision specifically required the use of a DLOM, the court noted. At the same time, it said that applying a 30% to 40% rate, in accordance with the leading decision in *Balsamides v. Protameen Chems.*, 160 N.J. 352 (1999) (available at *BVLaw*), would unduly punish the seller and give a windfall to the buying shareholders. Other studies suggested a broader range, starting as low as 20%, the court said, depending on the equities in a given case. A relevant prior appeals court decision applied a 25% rate.

Just as the buyers' expert did, the trial court on second remand also considered Judge Laro's decision in *Mandelbaum v. Commissioner*, 69 T.C.M. (C.C.H.) 2852 (available at *BVLaw*) setting forth nine factors appraisers should weigh in determining a marketability discount. The court took particular issue with the buyers' expert's argument that the anticipated holding period in this case would be lengthy. It agreed with the seller's expert who noted that given the company's historical financial performance and growth it would not take

long to sell the company and the shareholders would receive sufficient earnings while trying to sell. There were strong indicators of liquidity that the buyers' expert failed to weigh appropriately, the court decided. It concluded that the equities in the case suggested a DLOM at the low spectrum of normal, that is, 25%.

End of the valuation game? Both parties challenged the trial court's DLOM-related findings in a third appeal. The seller in essence claimed that since his expert considered all the factors related to marketability in calculating a discount rate for his DCF analysis, applying a separate DLOM based on the same factors amounted to double counting and improperly devalued the seller's interest in the company. Also, considering none of the shareholders planned to sell their interest to a third party, a DLOM should not apply.

The buyers argued the trial court should have used the rate their expert determined based on relevant statements in *Balsamides* and his analysis along the lines of the Tax Court's *Mandelbaum* decision.

The appeals court rejected both sides' arguments. It first cleared up what it considered to be a misunderstanding on the seller's part: that consideration of the same factors to build a discount rate for a DCF analysis and to apply a separate marketability discount inherently double counts the same risks. Not so, the appeals court said. The same factors affect the value of the company in two distinct ways. First, they account for uncertainty in receiving the expected income stream from the asset. Second, they affect liquidity by limiting the pool of interested buyers in a sale.

There was no dispute that the seller's expert considered the relevant factors to assess uncertainty in building his discount rate. He also considered several factors related to liquidity, but not exclusively so, the appeals court observed. On the contrary, the expert was firm that the company had no liquidity problems that required special consideration. Therefore, the trial court's finding that the expert's discount rate did not embed a discount for lack of marketability was sound, the appeals court said. It dismissed the seller's alternative argument that no DLOM was appropriate where no one contemplated a sale, noting that this issue had been decided in the earlier appeal against the seller.

The appeals court also upheld the trial court's 25% marketability discount rate. The judge had a right to find a figure other than the figures the experts proposed, "so long as it was plausible, based on evidence in the record, and—in the final analysis—fair and equitable." The appeals court added that neither side made a convincing argument for second-guessing the trial court's "thoughtful and well-reasoned determination in this most difficult case."

There is reason to think that, in upholding the trial court's DLOM-related findings, the appeals court has brought this protracted conflict to conclusion. ◆

Subsequent Transaction Too Remote to Allow for Reliable Valuation

***Redstone v. Commissioner,* 2015 Tax Ct. Memo LEXIS 242 (Dec. 9, 2015)**

In this tax dispute featuring media mogul Sumner Redstone and a 43-year-old transfer of shares in his company to trusts benefitting his children, the U.S. Tax Court found the very late IRS examination was proper, the transfers were gifts, and the IRS expert's "mergers and acquisitions" method best captured the then fair market value of the shares.

Voluntary and involuntary stock transfers. Redstone Sr. established the family business by building drive-in movie theaters in the Northeast. Eventually, he and his two sons, Edward and Sumner, incorporated National Amusements Inc. (NAI) as a closely held company. The three decided that each of them would own a third of

the company's stock (100 shares each of common voting stock) but would make different amounts of contributions, with Redstone Sr. contributing nearly 48% of the company's capital. In 1968, Redstone Sr. transferred 50 shares of his common stock to a trust benefitting his grandchildren (Grandchildren's Trust).

In 1971, when Edward decided to leave the company, he demanded his 100 shares, but Redstone Sr. in particular refused to give the stock certificates. He argued his greater capital contribution to the company meant he had gratuitously given more stock than Edward was entitled to. To honor Redstone Sr.'s intent, the "extra" shares should be held in trust for Edward's children. Edward threatened to sell his interest to an outside party—a plan that contravened the other stakeholders' determination to keep the business in the family. Negotiations between the parties went nowhere. Ultimately, litigation resulted in a settlement that specified Edward was the owner of only 66 2/3 shares of NAI stock; the remaining 33 1/3 shares that had been in Edward's name would be held in trust for the benefit of his two children.

'Nobody sued me. I gave my kids a third of the stock voluntary, not as the result of a lawsuit. In [s]o doing, I did what I wanted and appeased my father too,' Sumner testified.

Under a June 1972 settlement, the company would repurchase the two-thirds of stock Edward was said to own. In a redemption agreement, the parties specified the 66 2/3 shares of stock were worth $5 million—an amount Edward would receive in quarterly installments. Edward then executed irrevocable declarations of trust for the benefit of his children. Under the parties' agreement, Sumner would be the sole trustee of each of the two trusts.

Three weeks after this settlement agreement, Sumner on his own volition decided to make the same arrangement for his two children. In July 1972, he transferred 16 2/3 of NAI shares to a trust benefitting his son and the same amount of shares to a trust benefitting his daughter. The remaining 66 2/3 shares were reissued to Sumner. He did not file a gift tax return for that calendar year.

In 1975, Sumner was the subject of a review from the Internal Revenue Service based on his contributions to political committees from 1970 to 1972. The IRS concluded "there was no necessity to solicit a gift tax return for 1972."

In 1984, NAI redeemed 83 1/3 shares held by the Grandchildren's Trust (50 shares) and the shares in the trusts benefitting Edward's children (33 1/3 shares). The aggregate redemption price was over $21.4 million—approximately $257,000 per share.

In a subsequent litigation involving family members, Sumner explained his motivation for transferring 33 1/3 of his NAI shares to the trusts benefitting his children. "Nobody sued me. I gave my kids a third of the stock voluntarily, not as the result of a lawsuit. In [s]o doing I did what I wanted and appeased my father too." And "Eddie had to find a justification for what he was doing in transferring. I wasn't sued. I just made an outright gift."

As a result of that litigation, in 2010, the IRS began to focus on the transfer of these shares and in 2011 initiated a gift tax examination covering the 1972 calendar year. The examination lasted for over a year. The agent working on it was not aware of the earlier 1972 review. The IRS determined the two transfers to Sumner's children were gifts and calculated a deficiency of over $737,600. It added nearly $369,000 for fraud and, in the alternative, $37,000 for negligence and $184,400 for failure to file a timely tax return.

Expert valuation testimony. Sumner petitioned the United States Tax Court for review. At trial both parties presented expert valuation testimony. The crux of the matter was to determine the value of the NAI shares in 1972.

IRS expert. The agency retained an expert in valuing closely held companies and stock interests in closely held companies. He explained he mainly relied on a "mergers and acquisitions" approach,

basing his valuation of the NAI stock as of July 1972 on the price the company paid three weeks earlier to redeem Edward's stock in accordance with the parties' settlement agreement. The expert considered that agreement the result of an arm's-length transaction that took place at essentially the same time as the transfers Sumner made. The $5 million price for Edward's 66 2/3 shares yielded a value of $75,000 per NAI common share.

According to the expert, the redemption of Edward's 66 2/3 shares of NAI stock was "a private transaction for a minority interest." Accordingly, the redemption price valued the shares "on a minority, non-marketable interest basis." He concluded that the 33 1/3 shares Sumner transferred to his children's trusts at about the same time had a value of $2.5 million.

When the IRS's expert objected this was not a recognized method for valuing corporate stock, Sumner's expert said it resembled the direct capitalization method.

The IRS's expert also performed "direct capitalization" and "guideline public company" analyses. He concluded that these methods required the application of a 34% discount for lack of marketability. The resulting values for the 33 1/3 shares were $2.4 million and nearly $3 million.

Petitioner's expert. Sumner's expert was an attorney and CPA with extensive experience in accounting, finance, and valuation. He used what he called "the engrafting method." When the IRS's expert objected that this was not a recognized method for valuing corporate stock, Sumner's expert said it resembled the direct capitalization method. Under this approach, he calculated ratios between the per-share price NAI paid to redeem the trust's shares in 1984—$257,000 per share—and NAI's net income for 1981 to 1983 and the book value of NAI's common shareholder equity in 1984. He explained that he then "applied these same ratios to comparable NAI data existing at or about the time" of Sumner's transfers. He concluded that the shares Sumner transferred into his children's trusts in 1972 were worth about $736,000—$22,079 per share.

Petitioner's objections. Besides contesting the valuation determinations, Sumner made various arguments as to why the court should set aside the deficiency determination.

For one, the 2011 examination amounted to an impermissible second examination in light of the 1975 review the IRS had undertaken in connection with political campaign contributions. The court dismissed that contention. The IRS's position has been that "compliance checks" and "compliance initiative projects" do not amount to "examinations," the court observed. Also, the focus of the 1975 review concerned taxpayers' political contributions that did not comply with the rules applying to the annual gift tax exclusion.

But even if the 2011 examination were a second inspection, the remedy would not be to set aside the gift tax deficiency the IRS calculated during the examination, the court said. Further, Sumner failed to object to the deficiency ruling on that ground during the examination, which lasted more than a year. He first broached the argument in 2014, nearly a year after the IRS had issued its deficiency notice. In other words, Sumner waived this argument.

Sumner also contended that the transfer was not a gift but a transaction that occurred "in the ordinary course of business," just as Edward's transfer had. He sought to portray the transfer as an overall reconfiguration of stock ownership, which helped to bring an end to Edward's litigation.

The court found that argument very unconvincing considering there was no evidence of a dispute surrounding Sumner's shares and or evidence of an arm's-length negotiation surrounding the ownership of the transferred shares. Even if the settlement agreement with Edward provided an impetus for Sumner to transfer stock to his children and to please his father, the transaction was not "in the ordinary course of business." Sumner was

motivated by kinship for his father and his children, the court decided. Most importantly, when testifying in the earlier family litigation, Sumner himself called the transaction "an outright gift."

Court's ruling centers on valuation date. In determining the amount of gift tax deficiency, the court adopted the IRS expert's approach. It noted that valuing the 33 1/3 shares of NAI stock Sumner transferred to his children based on the price the company paid only weeks earlier for Edward's stock made sense. These transactions occurred within a reasonable time of each other and the price the parties decided to put on Edward's stock was the result of hard bargaining between Redstone Sr. and Sumner on one side and Edward on the other side.

All parties had thorough knowledge of the company's financial condition. Their interests diverged: Edward tried to obtain as much as possible for his shares, whereas Redstone Sr. tried to pay him as little as possible. According to the court, the outcome of this negotiation—a per-share price of $75,000—represented the fair market value of the company's common stock as of the valuation date, that is, Sumner's transfer of stock into the trusts benefitting his children. The total value of the 33 1/3 shares was $2.5 million.

Finding the 1972 redemption price NAI paid to Edward was the most reliable indicator of value of the stock at issue, the court declined to examine the results the IRS's expert achieved under the direct capitalization and guideline public company methods. It noted, however, that the parties disagreed over inputs informing these other analyses. The disagreements were hardly surprising considering the valuation date was 43 years ago, the court said. To find data on NAI's then cost of equity, the appropriate "beta," NAI's growth rate, and a set of comparable companies presented a special challenge. At the same time, the $2.5 million valuation the court adopted fit within the range of values resulting from "various permutations of these other formulas."

The court objected to the valuation methodology Sumner's expert used principally because it relied on a stock sale that occurred much later than the valuation date.

The court acknowledged that under Tax Court law later occurring events, including sales of stock, "may be taken into account as evidence of fair market value of the valuation date," but it noted that those subsequent events must have occurred within a reasonable time in relation to the valuation date. Sumner failed to cite a case "in which a court employed, as its principal valuation metric, a stock sale that occurred as many as 12 years after the valuation date," the Tax Court observed.

It added that, even if it were possible to rely on the 1984 redemption price for determining the value of the NAI stock in July 1972, there would have to be adjustments to mark the passage of time. Specifically, the value calculation would require modifications for macroeconomic factors (inflation, interest rates, and stock market values) as well as factors specific to the industry (movies) and specific to the company (changes in NAI assets and lines of business). Sumner's expert made no such adjustments, nor did he provide reasons for failing to make the adjustments. The failure to do so or show why he did not do so rendered his valuation "altogether unreliable," the court decided.

No additions to gift tax. At the same time, the court found the IRS failed to prove that Sumner engaged in fraud to avoid paying a gift tax or even was negligent. In contrast, the evidence showed that he had relied on the advice of competent tax professionals who had advised him on his gift tax filing requirements on 34 occasions, beginning in 1970. When Sumner consulted with them regarding the tax consequences of transferring shares into the trusts benefitting his children, he was told a gift tax return was not necessary. Therefore, there was no justification for penalties. Sumner was liable for the $737,600 gift tax deficiency only, the Tax Court held. ◆

Ohio Appeals Court Clarifies Provision on Tax Affecting at Divorce

***Nieman v. Nieman*, 2015 Ohio App. LEXIS 5021 (Dec. 14, 2015)**

An Ohio divorce statute requires a court to consider the tax consequences of the property division. But case law says that taxes are only a proper consideration in valuing a business when they are not "speculative." Recently, the Ohio Court of Appeals reviewed a trial court's decision to tax affect even though the owner spouse did not contemplate a sale anytime soon and the distribution of assets did not require him to sell his business interests. This decision provides valuators with a test of what "too speculative" means.

Similar pretax valuations. The husband, an orthopedic surgeon, held a minority interest in four companies related to his practice. At divorce, the parties' assets were substantial, and for trial both spouses retained financial experts to determine the value of the husband's ownership stake.

The husband was 44 years old when he filed for divorce. He indicated he planned to remain in the community in which he was working at the time. He did not indicate he planned to sell his ownership stake in any of the businesses anytime soon or at any time before retiring. The record suggested he might have to sell his interest in one of the businesses when he retired. But it was unclear as to whether he would need to sell his interest in the other businesses at retirement or ever.

The appraisers' pretax valuations were close. The husband's expert calculated that the husband's interest in the four businesses before accounting for taxes was about $4.74 million. The wife's expert arrived at an aggregate value of just above $5 million.

The husband's expert also performed a valuation that considered the tax effects related to a possible sale of the ownership interests. He said he used the current tax rates. He explained that, since the tax rates and the husband's current income were known, the valuation was not based on speculation. He did not believe the tax rates would change much in the near future. Under this calculation, the value of the husband's interest dropped by over $1 million.

In support of tax affecting, the husband cited the applicable code, ORC Ann. Section 3105.171(F)(6), which provides that "the Court … consider the tax consequences of the property division upon the respective awards to be made to each spouse."

The husband claimed "there will be some tax consequences associated with the disposition of these assets … at the time the asset is distributed." At this particular time, he said, the parties were dividing the assets, which meant a distribution, disbursement, or transfer of assets was occurring." There was "a known set of economic circumstances and a known and determinable tax calculation as a result."

The wife's expert did not tax affect because it was "speculative" and not done as "a general practice."

The wife acknowledged the cited statutory provision but argued against factoring in the tax consequences where the asset was distributed pursuant to divorce but was not liquidated at the same time.

The trial court favored the husband's position even though "the considerations and offsets made at this time may in fact not be actually what would occur at the disposal of the asset in the future due to the changing nature of the economic conditions of the parties individually or any changing tax code."

According to the trial court, the wife's argument would make it impossible to consider the tax consequences except in a case in which there was an immediate disposition of the property. "Under the statute the Court can determine the current tax consequences and consider the same in distributing the property," the court decided.

The trial court valued the interests in the four businesses at approximately $3.3 million. The court's calculation also factored in noncompete clauses at $100,000 for two businesses. Applying a 40% tax rate to them, the court added the remaining $60,000 to the value of the two businesses. Even though the wife questioned whether it was appropriate for the trial court to value the noncompetes, she did not raise this issue on appeal. In the final analysis, the trial court deducted more than $1 million for tax consequences from the valuation of the husband's business interests.

A court would 'necessarily' engage in speculation if it imposed 'a present-day tax-affect upon the value of the businesses in this case.'

Test for 'too speculative.' The wife appealed. The gist of her argument to the state Court of Appeals was that the taxes in this case were too speculative based on prior appeals court decisions that dealt with similar circumstances. The trial court erred when it factored the tax consequences of a potential sale of the businesses into its valuation, the wife contended.

The Ohio Court of Appeals agreed with the wife's argument. At the start of its analysis, it noted that, notwithstanding the statute, the very court in an earlier decision said: "Tax consequences of property division … awards are proper considerations … as long as those consequences are not speculative." *See Day v. Day*, 40 Ohio App. 3d 155 (1988).

The appeals court noted that cases that have found taxes were "too speculative" involved the following situations:

1. It is uncertain whether, or at what point in the future, a business will be sold;

2. It is uncertain that the tax rates will be similar in the future; and

3. A sale is not made necessary by the trial court's division of the marital assets.

Under this "logic," the appeals court said, the tax consequences in the instant case were too speculative for the trial court to factor into its valuation. The husband indicated a desire to sell his businesses at the time of retirement, but the retirement date was uncertain. And retirement likely would occur in the distant future considering the husband was only in his 40s at the time of divorce.

The trial court used the current tax rates, but doing so required it to assume the tax rates would be the same or substantially the same in the future. But, said the appeals court, by the time the husband was ready to sell his business interests, "they could be worth far more, or far less. His percentage share could have grown larger or smaller, or the capital gains tax could rise or could be abolished." Consequently, a court would "necessarily" engage in speculation if it imposed "a present-day tax-affect upon the value of the businesses in this case."

Moreover, there was no indication that the distribution of the assets required the husband to sell his businesses, the Court of Appeals found.

The husband contended that the earlier appellate court decisions erroneously cited to the "speculative" language in *Day* even though in that case the appeals court allowed the trial court to deduct future tax consequences from a retirement plan. He also cited to other cases in which he claimed Ohio appellate courts gave trial courts discretion to consider speculative tax consequences.

The Court of Appeals dismissed the husband's claims. It noted that the line of cases the husband cited related to retirement plans; as such they were not as persuasive as the cases the wife cited. The latter decisions were "directly on point and related to business valuation in particular," the court said.

Under the facts, the taxes were too speculative, the Ohio Court of Appeals concluded, ordering the trial court to recalculate the value of the

husband's business interests without factoring in tax consequences of a potential sale. The appeals court added that the redetermination would require the trial court to distribute additional assets. ◆

Bankruptcy Court Favors DCF to Value Dissociated Interest

***Hanckel v. Campbell (In re Hanckel)*, 2015 Bankr. LEXIS 4202 (Dec. 11, 2015)**

Prior to filing for Chapter 7 bankruptcy, the debtor, who owned a stake in a family business, transferred his share to his father, the co-owner. Subsequently, the Chapter 7 trustee proved the transfer was a fraudulent conveyance, and the court declared it a dissociated interest belonging to the estate. Litigation followed as to the trustee's authority over the interest and as to its value. Recently, the Bankruptcy Court ruled on the best valuation methodology, the parties' challenges to expert testimony, and the appropriate valuation date.

Transferred interest sparks suit. In 2000, the debtor and his father formed a company that sold and repaired boats. Each man owned 50%. An operating agreement restricted membership and the transferability of membership in the company; it provided that certain events, including bankruptcy, could terminate the interest holder's membership. If that occurred, the dissociated member would receive the distributions to which he was entitled prior to the event, as well as the fair market value of the interest as of the date of the dissociating event. Although the mother was not an owner of the business, she in effect directed it. The father and mother owned the land and buildings the company used and leased them to the business.

During the financial crisis, the company struggled. Its problems were compounded by the debtor's financial problems with other investments. The mother made substantial loans to keep the company afloat. The father and debtor received salaries, but the company never made sufficient profit to make distributions to its owners.

In fall 2010, the family decided to "take [the debtor] out of [the company]." In summer 2012, two months after signing a dissociation agreement that made the father the sole owner of the company, the debtor filed for Chapter 7 bankruptcy. A former business partner then sued the debtor, alleging the transfer of his interest in the boat business was fraudulent. Ultimately, the Chapter 7 bankruptcy trustee, who was substituted as the plaintiff in that suit, won on the fraud claim.

Litigation between the family and the trustee ensued. The family claimed it was "impracticable" to operate the business without a nonfamily member. It asked the court to dissolve the company, distribute its assets, and assign zero ($0) fair market value to the debtor's interest. The trustee objected to the dissolution of the company and the zero valuation. He argued that Section 363(h) of the Bankruptcy Code authorized him to sell the estate's and family's interests in the company.

Throughout the company kept operating as before.

The court ultimately found the estate held the debtor's dissociated interest. In October 2015, a trial as to its valuation took place. Both sides presented expert testimony and claimed the opposing expert's opinion was inadmissible under *Daubert.*

Calculation report v. conclusion of value. The family's expert, an experienced CPA who stated he had 20 years of experience advising clients on whether to buy businesses, said there was "no template for valuing a boat dealership."

He decided to value the contested interest on the date the debtor filed for bankruptcy (2012) and based on the expert's understanding of the operating agreement. He also spoke with the family's lawyers and accountants and reviewed relevant

financial statements. Moreover, he reviewed and critiqued the opposing expert's report.

He explained he typically conducted two types of valuations. One was a calculation report, which represented a less formal valuation for which the appraiser and the client decided on the methodology. The other kind of valuation was a conclusion of value, which was more comprehensive and typically used multiple valuation approaches. Given the company's financial condition here, he decided to perform a calculation of book value only, which required him to total the company's assets and liabilities and subtract the latter from the former. Based on the available financial information, he found that the full value of the company not including repayment of the mother's loans in full was -$195,000. If there were repayment of the loans, the value would be -$580,000, the expert said. Under either scenario, the dissociated interest, which was held by the estate, was worthless.

The expert pointed to multiple risks related to the informal way in which the business was run. They made it unlikely that a hypothetical buyer would purchase the debtor's interest in the company, the expert said. For example, the company had no employment contracts and no noncompete agreements; it also did not have a formal lease. The debtor could leave the business and set up a competing business, the expert noted. He pointed out that the father's salary was considerably below market value. And, he said, the only reason the mother had not asked for repayment of the loans was because the company was a family business.

DCF 'nonsensical'? The trustee's expert, an experienced CPA and business valuator, submitted two expert reports. One was based on a valuation as of the date of the transfer of the interest to the father (prebankruptcy). The other valuation was based on values as of March 2015—about six months prior to the valuation trial. The expert testified as to the most recent report only. He relied on the company's business records and on information resulting from consultation with the trustee only.

He noted that the company's performance and prospects were not as dire as the opposing expert portrayed them. After the debtor's transfer of his interest, the business in fact showed improved sales. The most accurate way to value a going concern was to use a discounted cash flow (DCF) analysis, he said. To calculate cash flow, he assumed that the company's operating costs, salaries, rent, and debt would remain constant or vary at a predictable rate. He developed the discount rate by combining the standard 20-year Treasury yield, a common stock equity premium, and by accounting for risk factors specific to the company's being a family business that was closely held and not publicly traded.

He furnished the court with a table illustrating how changes in the growth rate and discount rate affected the company's value:

	Discounted Cash Flow				
Rate of Growth	21%	23%	25%	27%	29%
21.0%	$167,000	$148,000	$133,000	$120,000	$109,000
21.5%	$347,000	$310,000	$279,000	$253,000	$232,000
22.0%	$500,000	$447,000	$403,000	$367,000	$336,000
22.5%	$650,000	$582,000	$525,000	$479,000	$439,000
23.0%	$801,000	$717,000	$648,000	$590,000	$542,000

The trustee's expert concluded the company was worth $403,000 assuming a 22% growth rate and discounting cash flow by 25%. Therefore, the dissociated interest belonging to the estate was worth $201,500.

The trustee's expert admitted on cross-examination that he had not been aware of other risk factors specific to the company, which, he allowed, could lower the valuation. For example, he did not know about the company's lack of a formal lease, threats from floor plan lenders to leave (one had already left), and the loss of a boat manufacturer. His valuation also did not factor in the repayment of the mother's loans even though they appeared as debt on the books. He decided that, since the loans were no longer accruing interest,

they did not "act" like debt and for purposes of the valuation should not be treated as debt that was due immediately.

The family's expert critiqued the use of the DCF analysis in this instance. The company was in financial distress, he claimed. In this situation, it was "nonsensical" to use a valuation approach that envisioned payments to equity holders.

The family had a right to a determination of the value of the LLC interest that it had to purchase, the court found.

Multiple valuation issues. At different stages in the trial, the trustee challenged the court's authority to value the interest, arguing the value should be based on the trustee's sale of the asset. At that time, the court dismissed the objection. After trial, the trustee filed a motion for a new trial or to reopen the record based on new information that, he said, could affect the value of the company. Specifically, the family had filed a malpractice suit against the attorney who had advised the debtor to transfer his interest in the company. The trustee claimed the lawsuit was an asset of the company, and the family had an obligation to disclose it as part of the valuation process. The family countered the interest held by the estate did not entail any managerial rights.

In ruling on the trustee's motion, the Bankruptcy Court resolved the following valuation issues.

Authority to value debtor's interest. The court reminded the parties that the interest held by the estate was that of a dissociated member. It became dissociated as a result of the bankruptcy filing, but it was recovered by the trustee after the bankruptcy filing. State and bankruptcy law provided for the court to value the interest, the Bankruptcy Court decided. Among other provisions, it pointed to the state's LLC Act, which requires the LLC to purchase or "cause" the purchase of the dissociated interest. "Valuing that interest is part of causing the purchase," the court said. The family had a right to a determination of the value of the LLC interest that it had to purchase.

Challenges to expert testimony. The Bankruptcy Court rebuffed both sides' *Daubert* challenges. The family claimed the trustee's expert did not use the most recent financial information and did not interview the family members; therefore, his valuation was unreliable and irrelevant. The trustee contended the valuation the family's expert provided was inadmissible because he used an improper methodology and the wrong valuation date.

The court said both witnesses were experts in business valuation and their testimony was helpful to the court. Both appraisers supported their analysis with financial documents, and both used widely accepted methods. Both also explained why they chose the method they used and explained what was wrong with the other expert's approach. Their testimony was admissible.

Valuation date. The court observed that the facts of the case presented a conundrum in terms of the valuation date. What's more, there was no state case law on point, the court noted. Under the company's operating agreement, the dissociated member had a right to distributions and the fair market value of his interest in the company as of the date of the dissociating event, the court observed. The value of the distributions was zero ($0). The company's liquidity problems prevented it from making distributions in the past, and the trustee did not even argue that the estate was owed outstanding distributions.

Determining the fair market value of the interest at dissociation was problematic because the dissociation occurred through bankruptcy, the court explained. However, at the time of bankruptcy, the interest was not part of the debtor's estate owing to the transfer two months before bankruptcy. Only when the interest was recovered by way of the trustee's litigation did it become part of the estate, either at the time the court

ordered the recovery or at the time the court's order became final.

The court noted that the parties were litigating since the court's earlier ruling that the debtor's membership was a dissociated interest. However, the company kept operating as if the dissociating event never occurred. There was evidence that its business actually was improving. Since neither the state's LLC statute nor case law considered this sort of dissociation event, the court looked to a Montana case with a somewhat similar fact pattern for guidance. Based on that case, the court in the instant case decided the most sensible approach was to designate the trial date as the date of dissociation and valuation.

Valuation methodology. Using the trial date as the valuation date, the court found the DCF analysis the trustee's expert proposed was the better approach for valuing the contested interest. For one, the trustee expert's valuation was nearer to the date of trial. Also, the expert valued the company as a going concern, which made sense considering the business continued to operate and improve.

The family expert's valuation was based on data that were over four years old, the court observed. The expert failed to provide the court with any evidence of how that data could or would change over time. Also, valuing the interest at a fixed point in the past was "inconsistent with the ongoing actions of the members of [the company]," the court pointed out.

But the court gave a nod to the family expert when it made adjustments to the trustee expert's valuation. It noted the failure of the trustee's expert to consider certain risk factors specific to the company, which, by the expert's own admission, might decrease the anticipated profits. Consequently, the court decided to discount cash flow by 30%, one percentage point over the highest rate the trustee's expert used, and to lower the growth rate to 21.5%, as opposed to the 22% rate the expert had assumed for his valuation. The adjustment resulted in a value of $210,000 for the company and a value of $105,000 for the dissociated interest.

In conclusion, the Bankruptcy Court ordered the company to purchase the dissociated interest for $105,000. Payment of that amount to the estate would extinguish the interest, the court said. ◆

Court's Damages Model for SEP Infringement Fails Apportionment Rules

***Commonwealth Sci. & Indus. Research Organisation v. Cisco Sys.*, 2015 U.S. App. LEXIS 20942 (Dec. 3, 2015)**

Apportionment is key to determining damages in all patent infringement cases. But apportionment in the context of patents that are essential to standardizing technology, products, and services comes with its own rules. A guiding principle is that the royalty must only reflect the value of the patented technology's superiority, not any value resulting from its being adopted due to standardization. The Federal Circuit recently elaborated on this concept when it struck down a $16.2 million royalty award against Cisco, finding the trial court's damages model failed to account for standardization.

A prior licensing agreement. The plaintiff, Commonwealth Scientific and Industrial Research Organisation (CSIRO), was a research arm of the Australian government. CSIRO's work on wireless technology resulted in a patent that subsequently became included in the 802.11 wireless standard that provides protocols for products using the Wi-Fi brand. CSIRO pledged to license its technology on reasonable terms for the 802.11 and 802.11a standards, but it refused to provide assurance as to subsequent revisions of the standard.

In early 2001, the defendant, Cisco Systems, acquired a company, Radiata, which had a

technology licensing agreement (TLA) with CSIRO for the patent in suit. The royalty rates in the TLA were based on the volume of chips sold. Cisco and CSIRO amended the TLA in 2001 and 2003. Under the agreement, Cisco paid CSIRO royalties in the amount of over $900,000 until 2007.

In 2004, CSIRO developed a rate card by which it proposed to license the patent to other Wi-Fi participants based on sales volume and the date of accepting CSIRO's offer.

In 2005, in informal rate discussions, Cisco's vice president of intellectual property suggested to negotiate a license with CSIRO based on a $0.90-per-unit rate. The parties talked but never reached an agreement.

In July 2011, CSIRO sued Cisco for infringement of its patent. Two years later the parties stipulated to Cisco's infringement, and the case headed to trial on damages. Both sides presented expert testimony.

CSIRO claimed the benefits to the 802.11 products that used the patented technology over products that did not use it were mostly attributable to the patented technology. Therefore, the value of the patent was the difference in profit between the infringing and the noninfringing 802.11 products. Accordingly, CSIRO's expert compared the market prices of the products at the time of the hypothetical negotiation and attributed Cisco's profit premiums to the patent. After adjusting based on his analysis of the *Georgia-Pacific* factors, he determined a hypothetical negotiation between the parties prior to infringement would have resulted in a volume-based royalty table with rates from $1.35 to $2.25 per unit sold. He concluded that total damages amounted to nearly $30.2 million.

Cisco's expert looked to the TLA rates for his damages calculation. He determined for one brand of the infringing products a rate based on chip sales was in the range of $0.04 to $0.37; for the other brand, the range was $0.03 to $0.33. In total, Cisco owned CSIRO just over $1.05 million, the expert decided.

Experts' models flawed. The trial court declared both models defective. It decided the final apportionment underlying CSIRO's damages model was "arbitrary." At the same time, it objected to the use of the TLA by Cisco's expert. It said that the original TLA between CSIRO and Radiata, Cisco's predecessor, was not the result of a "purely disinterested business negotiation" because some of Radiata's personnel had had ties to CSIRO. Also, the TLA had imposed considerable obligations on Radiata. According to the court, another obstacle to using the TLA rates was related to timing. CSIRO and Radiata signed the TLA in 1998, but a hypothetical negotiation involving CSIRO and Cisco would have taken place between 2002 and 2003. During the four-to-five-year interval, the "[c]ommercial viability of the technology escalated sharply," the trial court observed.

Moreover, the court declined to use the TLA because it based royalty rates on chip prices. That is "like valuing a copyrighted book based only on the costs of the binding, paper, and ink needed to actually produce the physical product. While such a calculation captures the cost of the physical product, it provided no indication of its actual value," the court said.

Instead, the trial court looked to CSIRO's 2004 rate card to potential licensees and Cisco's 2005 informal rate suggestion to CSIRO for data points. It decided "a range of $0.90 to $1.90 is a reasonable starting point for negotiations between the parties in 2002 and 2003." It then performed a *Georgia-Pacific* analysis to determine any potential downward or upward adjustment. Factors 8, 9, and 10 having to do with the advantages of the patented technology weighed in favor of an upward adjustment, the court found. Several other factors required a downward adjustment. In the end, the court found that the parties would have been in a substantially equal bargaining position in a hypothetical negotiation. It found the $0.90-to-$1.90

range was appropriate for one line of products, but it made a downward adjustment to the other line of products, from $0.65 to $1.38, because Cisco's 2005 offer did not apply to that brand.

All things considered, the court awarded CSIRO over $16.2 million.

'Untenable' proposition. Cisco attacked the judgment at the U.S. Court of Appeals for the Federal Circuit. It made three arguments in favor of overturning the award, which the court analyzed in turn.

Smallest salable unit. Cisco contended the trial court's methodology was wrong because damages were not based on the "smallest salable patent-practicing unit," in this case the wireless chip.

By way of background, the Federal Circuit explained that, whenever infringement claims concern multicomponent products, the "governing rule" is apportionment—damage calculations must separate the value of the infringing feature from the value of the other noninfringing features.

A related principle is that when a damages model apportions to a royalty base, it must use the smallest salable patent-practicing unit as the base. *See LaserDynamics, Inc. v. Quanta Comput., Inc.,* 694 F.3d 51 (Fed. Cir. 2012) (available at *BVLaw*). The aim underlying that principle is to avoid compensating the patent holder for nonprotected features and to avoid misleading the jury by emphasizing the value of the entire product regardless of the contribution of the patented component.

The Federal Circuit went on to say that since the trial court here used a model that did not involve apportioning from a royalty base, the smallest salable unit principle did not come into play. Instead the trial court looked to evidence of actual rate discussions, including Cisco's 2005 proposal to CSIRO to take a license for the patented technology at $0.90 per unit. This rate served as the trial court's lower end. For the upper end, the trial court looked to CSIRO's rate card license offer to the public, which specified a $1.90-per-unit rate. Because these rates reflected the value of the patented component "and no more," the trial court's damages model had "already built in apportionment," the Federal Circuit found.

Cisco's proposition that a damages model had to start with the smallest salable unit was "untenable," the Federal Circuit said. It contradicted law that sanctioned using rates from sufficiently comparable licenses as a starting point and then accounting for differences in the technology and the parties' economic circumstances. Comparable licenses reflect the market's actual valuation of the patent, the court observed.

In sum, the Federal Circuit found the trial court's use of a damages model that looked to the parties' informal license rate negotiations did not violate the apportionment principles.

Standardization. Cisco argued the trial court failed to account for any extra value the patent in suit derived from being essential to the 802.11 standard.

The Federal Circuit agreed, outlining the "unique considerations that apply to apportionment in the context of a standard-essential patent ('SEP')." The underlying idea is that patented technology that is incorporated into a standard and as such becomes widely adopted is not necessarily widely used because it is superior to other technology, but because it is necessary to comply with the standard.

To prevent compensation to the patent holder related to standardization, "a SEP must be apportioned to the value of the patented invention (or at least the approximate value thereof), not the value of the standard as a whole," the Federal Circuit held. The value of the technology is distinct from the value that "artificially accrues to the patent due to the standard's adoption," the court emphasized.

In explaining the guiding principles, the Federal Circuit extensively cited to its prior decision in

Ericsson v. D-Link Sys., 773F.3d 1201 (Dec. 4, 2014), which analyzed apportionment for SEPs. The Federal Circuit noted that the trial court in the instant case did not have the benefit of that ruling and, therefore, failed to account for standardization. For example, in analyzing the *Georgia-Pacific* factors, the trial court erroneously increased the royalty award because the patent in suit was essential to the 802.11 standard.

Specifically, the trial court expressly found that certain factors, including Factor 8, which considers "[t]he established profitability of the product made under the patent; its commercial success; and its current profitability," militated in favor of an upward adjustment. Instead, the trial court should have adjusted its *Georgia-Pacific* analysis to eliminate any value standardization contributed to the patented technology's commercial success, the Federal Circuit noted.

Further, the Federal Circuit said, the trial court did not account for the possibility that the parties' informally offered royalty rates, which it used as a starting point, and especially CSIRO's rate card rates, might have included some value accruing to the patent from the standard's adoption. Because the trial court's damages model failed to filter out any value stemming from standardization, the Federal Circuit vacated the award and remanded for a new reasonable royalty determination.

TLA. Cisco claimed the trial court's rejection of the TLA in favor of other licensing rate evidence, such as CSIRO's rate card and Cisco's informal 2005 rate proposal, was error.

The Federal Circuit agreed that the trial court's reasons for rejecting the TLA were not altogether sound. It noted the trial court's objection that the TLA was signed in 1998, several years before a hypothetical negotiation in 2002 and 2003, during which time the trial court said "[c]ommercial viability of the technology escalated sharply." The Federal Circuit pointed out this view ignored evidence that, during the intervening time, when the hypothetical negotiations would have taken place, CSIRO and Cisco twice amended the TLA and that, during the amendment process, CSIRO had leverage to renegotiate royalty rates.

The Federal Court added that the TLA was the only "actual" royalty agreement between the parties. It focused on chips, and it was reached before one of the later, relevant versions of the standard (802.11g) was adopted. In remanding for a new damages analysis, the Federal Circuit ordered the trial court to re-evaluate the relevance of the TLA given all of these considerations. ◆

Comparable Transaction Exposes Error in Court's Enterprise Goodwill Ruling

***In re Marriage of Johnson*, 2015 Ill. App. Unpub. LEXIS 2673 (Dec. 2, 2015)**

In an Illinois divorce case, the flashpoint was the value of the enterprise goodwill of the husband's financial services business. The trial court credited the income-based valuation of the husband's expert and awarded the business to the husband at a relatively low value. The appeals court ordered a new trial on valuation, questioning the methodology underlying the valuation and finding the goodwill value was in obvious conflict with reliable market data.

Two components to business. The husband owned a financial services business that operated as an S corporation. He managed clients' investment accounts, gave portfolio-related advice, and provided estate and tax planning services. Since the principal place of business was in Centralia, Ill., the accounts were called the "Centralia accounts" for purposes of valuation and litigation. The accounts were primarily fee-based. At the time of trial, the husband had 265 clients and managed over $75 million in assets.

Nine months after filing for divorce, in August 2012, the husband bought client accounts from the estate of an Indiana financial advisor

who was killed in an accident (the "Indiana accounts"). The initial purchase price for those accounts was $460,000. But after a six-month "look back" period, accounts worth about $12 million had left. As a result, the husband received a downward adjustment of the purchase price to $366,255. The husband explained that the Indiana accounts were commission-based because the prior owner had conducted business that way. This meant the advisor had to make a transaction to generate revenue, the husband explained. He characterized the value of the Indiana accounts as "exceptionally lower than [the] Centralia business" and said he sought to change the Indiana accounts to a fee-based system. Ultimately, he hoped to increase business earnings, but he could not be sure of the size of the increase considering the Indiana accounts were transaction-based.

The wife's appraisers looked to the husband's acquisition of the Indiana accounts, which occurred 14 months before the valuation date.

The Indiana purchase also included a consulting fee agreement under which the husband paid the deceased advisor's son, who was licensed, $115,000 to work with the husband and introduce him to clients to develop relationships and retain as many clients as possible.

In 2012, the business showed a gross income of $478,000. This amount included income from August 2012 through December 2012 stemming from the Indiana accounts.

In October 2012, the husband retained FP Transitions, a firm that specializes in building and valuing financial services businesses. By its own account, the firm operates the largest open market for buying and selling financial practices. Under the market approach, it valued the husband's company at $1.11 million considering only the Centralia assets under management. The same firm subsequently valued the business at $1.24 million as of July 2013, considering both the Centralia and Indiana assets under management. For purposes of the litigation, the valuation date was August 2013.

Sway of multiattribute utility theory. At trial, the wife asked the court to order the sale of the company and the division of the proceeds. Or, if the court were to award the business to the husband, it should order him to pay the wife one-half of its value, excluding personal goodwill attributable to the husband.

Both parties presented expert testimony of the company's fair market value as of August 2013. Because the husband learned shortly before trial that the FP Transitions appraisers did not testify in divorce matters, he retained a different appraiser. This expert acknowledged FP Transitions' leading role in the financial services sector. But he decided to value the husband's company under a capitalization of earnings approach. He calculated that, as of the valuation date, the company's 110% value was $785,000. He decided to apply a 75% discount to account for the husband's personal goodwill and concluded the company's enterprise goodwill was $196,250.

The wife engaged two valuation analysts, who concluded the 100% value of the company was nearly $1.5 million as of August 2013. Discounting this amount by 67% to account for the husband's personal goodwill, they arrived at a fair market value of the company's enterprise goodwill of $495,000.

The wife's appraisers used a market approach. Specifically, they looked to the husband's acquisition of the Indiana accounts, which occurred 14 months before the valuation date. In addition, they considered the FP Transitions valuations, which were based on a similar methodology.

The trial court noted the enterprise goodwill was the parties' most substantial asset. Under state law, enterprise goodwill is a marital asset, whereas personal goodwill is not. In crediting the husband's trial expert, the trial court found it significant that this expert used the multiattribute utility theory to determine what portion of the

business represented enterprise goodwill and what part was personal goodwill. The trial court awarded the business to the husband at a value of $196,250.

Financial evidence belies court's valuation. The wife challenged the judgment at the state's appellate court. She contended the valuation of the company was "against the manifest weight of the evidence." Moreover, the allocation of marital property represented an abuse of discretion by the trial court.

The appellate court agreed with the wife. It noted at the start of its analysis that valuing a closely held corporation "is not unlike determining the fair market value of a professional corporation." One of the best ways to do so was to view a similar transaction, which is what the wife's experts did, the appeals court observed. It noted that the trial court had the benefit of a recent transaction—the husband's purchase of the Indiana accounts a year earlier—but chose to ignore it.

According to the appellate court, by crediting the husband's expert, the trial court valued the company's enterprise goodwill at $196,250—at a time when the company managed assets worth more than $75 million. The figure the trial court assigned to enterprise goodwill was less than the amount the husband had paid a year earlier for the Indiana accounts, which had only approximately $35 million in assets under management and which, by the husband's own testimony, were less valuable than the fee-based Centralia accounts. The trial court's adopted figure was even less than the difference between the purchase price for the Indiana accounts and the $115,000 consulting fee the husband had agreed to pay the deceased Indiana advisor's son for purposes of working with him on retaining clients.

"Even if we assume the $115,000 consulting fee was for personal goodwill and subtract it from the purchase price of $366,255, this still leaves a value of $251,255 for the enterprise goodwill of the Indiana accounts," the appellate court determined.

Under these calculations, the trial court's enterprise goodwill value, at $196,250, conflicted with the manifest weight of the evidence.

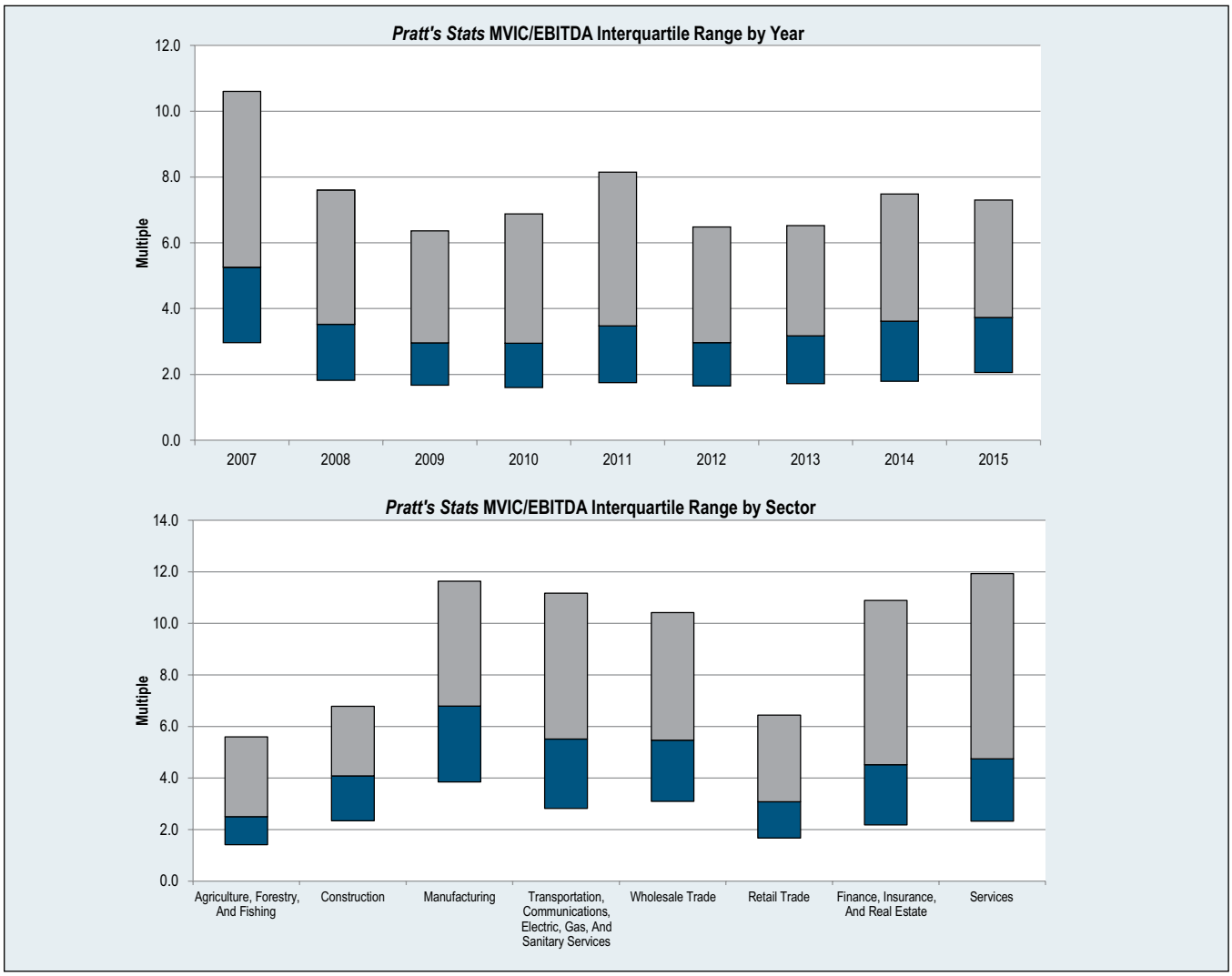
The appellate court dismissed the significance of the multiattribute utility theory to the valuation issue in front of the court. This theory seeks to determine what is enterprise and what is personal goodwill, but "it does not address the overall fair market value of the business before the discount for personal goodwill," the reviewing court said.

Finally, it pointed out that the trial court's erroneous valuation of the company's enterprise goodwill improperly decreased the value of the assets awarded to the husband. As a consequence, the valuation skewed the distribution of assets to the parties. Therefore, the appeals court also ordered a new trial on the distribution of property. ◆

Pratt's Stats MVIC/EBITDA Trends

The graphs display the interquartile range of the MVIC/EBITDA multiple by major sector and by year in the *Pratt's Stats* database. In *Pratt's Stats*, MVIC is the term used for selling price and is an acronym for market value of invested capital. In addition to showing the median MVIC/EBITDA value by sector and year, the interquartile range provides a measure of dispersion. Interquartile range is the difference between the 25th and 75th percentiles (also called the first and third quartiles), so the interquartile range describes the middle 50% of observations. The top of the gray rectangle indicates the 75th percentile, the bottom of the blue rectangle indicates the 25th percentile, and the line where the two rectangles meet represents the median. If the interquartile range is large, it means that the middle 50% of observations are spaced wide apart (like we see in the services sector), and, if the interquartile range is narrow, it means the middle 50% of observations are spaced close together (like we see in the construction sector).

Pratt's Stats is a private-company transaction database providing financial details on over 24,000 acquired private businesses. Business appraisers, financial advisors, investment bankers, M&A professionals, and business owners have used *Pratt's Stats* for nearly 20 years. *Pratt's Stats* comes with a free subscription to the *Pratt's Stats Private Deal Update*, a quarterly publication analyzing data from *Pratt's Stats*, and use of the *Pratt's Stats Analyzer*, an Excel-based tool to analyze data from *Pratt's Stats*. The *Pratt's Stats Private Deal Update* is available on the *Pratt's Stats* Subscriber Services page, and the *Pratt's Stats Analyzer* is available for download after searching the database. ◆



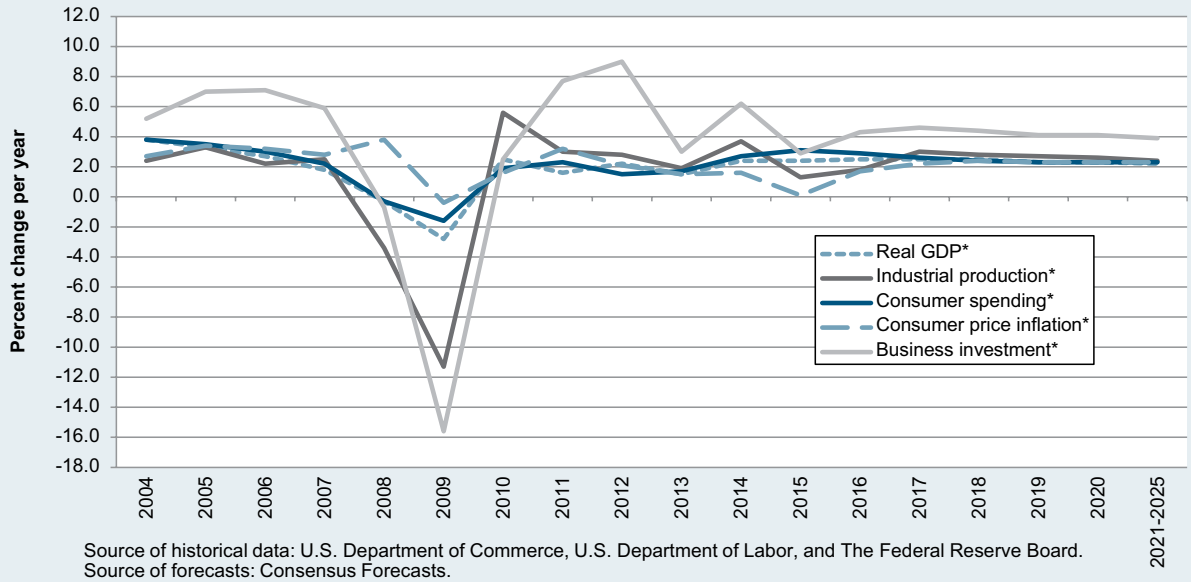
Economic Outlook for the Month

(excerpt from BVR's *Economic Outlook Update*[1])

This section is an excerpt from BVR's *Economic Outlook Update* (*EOU*). The *EOU*, a convenient and cost-effective resource, provides a review of the state of the U.S. economy and forecast for the future. Leading experts in the BV profession rely on the *EOU* as the basis for the current economic conditions and forecast portions of their valuation reports. ◆

1 The *Economic Outlook Update* is published monthly and quarterly by Business Valuation Resources, LLC (BVR). Visit www.BVResources.com/EOU or call (503) 291-7963, ext. 2.

Key Economic Variables Actual 2004-2015 and Forecast 2016-2025



Source of historical data: U.S. Department of Commerce, U.S. Department of Labor, and The Federal Reserve Board.
Source of forecasts: Consensus Forecasts.
*Numbers are based on percent change from preceding period. Consumer price inflation information is annual averages.

Quarterly Forecasts 1Q 2016-3Q 2016 and Annual Forecast 2016-2017

	Quarterly			Annual			
	1Q 2016	2Q 2016	3Q 2016	2016	*(prior forecast)*	2017	*(prior forecast)*
Real GDP*	2.5	2.6	2.6	2.4	*2.5*	2.5	*N/A*
Consumer spending*	2.7	2.8	2.8	2.8	*2.9*	2.6	*N/A*
Business investment*	4.3	4.4	4.4	3.9	*4.3*	4.4	*N/A*
Consumer price inflation*	0.9	2.1	2.2	1.5	*1.7*	2.3	*N/A*
Real disposable personal income*	2.7	2.8	2.8	3.0	*2.9*	2.6	*N/A*
Unemployment rate	4.9	4.8	4.7	4.8	*4.8*	4.6	*N/A*
Industrial production*	1.6	2.2	2.4	1.4	*1.8*	2.5	*N/A*

Source of forecasts: *Consensus Forecasts - USA*, January 2016.

Notes:
Quarterly figures are percent change from prior quarter, at seasonally adjusted annual rates (except unemployment, which is the average for that period).

Annual rates are percent change from preceding period (except unemployment, which is the average for that period).

Every month, Consensus Economics surveys a panel of 30 prominent United States economic and financial forecasters for their predictions on a range of variables including future growth, inflation, current account and budget balances, and interest rates.

BVR TRAINING EVENTS

To register for any of our events, or for more information, visit www.BVResources.com/training or call 503-291-7963. For subscription access to BVR events, please visit www.BVResources.com/passport.

Active and Passive Appreciation: An Empirical Method for More Accurate Determination
March 8, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: Ashok Abbott

Valuation in Divorce Litigation: Winning Clients and Testifying in Court
March 15, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: Melissa Gragg and Kristin Zurek

Forecasts and Projections for Small Companies
March 17, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: George Levie

Business Combinations: Case Studies in Purchase Price Allocations
Part 1 of BVR's Special Series on Fair Value
March 23, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: Nathan DiNatale

Business Combinations: Valuation of Intangibles
Part 2 of BVR's Special Series on Fair Value
March 24, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: Nathan DiNatale and Mark Zyla

***Valuation Handbook - Guide to Cost of Capital* and the Risk Premium Calculator: What You Need to Know in 2016 (Free Webinar)**
March 30, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: Roger Grabowski

ESOPs for Government Contractors
March 31, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: David Bogus

CALENDAR

AICPA Fair Value Measurements Workshop
March 21-22
New York, NY
www.aicpa.org

ACG Intergrowth 2016
May 2-4
New Orleans, LA
www.acg.org

AM&AA Certification Course
May 2-6
Chicago, IL
www.amaaonline.org

2016 IBBA Spring Conference
May 2-7
Orlando, FL
www.ibba.org

AICPA CFO Conference
May 5-6
New Orleans, LA
www.aicpa.org

69th Annual CFA Institute Annual Conference
May 8-11
Montreal, QB
www.cfainstitute.org

AICPA/AAML Conference on Divorce
May 19-20
New Orleans, LA
www.aicpa.org

70th CFA Institute Annual Conference
May 21-24
Philadelphia, PA
www.cfainstitute.org

ASA/USC 11th Annual Fair Value Conference
June 8
Los Angeles, CA
www.appraisers.org

NACVA and CTI's 25th Anniversary Annual Consultants' Conference
June 9-11
San Diego, CA
www.nacva.com

CICBV 2016 National Conference
June 16-17
Victoria, BC
www.cicbv.ca

AM&AA Summer Conference
July 7-9
Chicago, IL
www.amaaonline.org

AICPA Advanced Estate Planning Conference
July 18-20
Washington, DC
www.aicpa.org

ASA International Appraisers Conference
September 11-14
Boca Raton, FL
www.appraisers.org

For an all-inclusive list of valuation-related seminars and conferences, BV education classes and credentialing programs, and all BVR events, go to www.BVResources.com/bvcalendar.

PERIODICALS

BVR
What It's Worth
Business Valuation Resources, LLC
1000 SW Broadway, Suite 1200
Portland, OR 97205-3035

MARCH 2016 COST OF CAPITAL CENTER

Duff & Phelps' 2015 Premiums Over Long-Term Risk-Free Rate[1]

Historical Equity Risk Premiums: Averages Since 1963
Data for Year Ending December 31, 2014.

Measure Used for Size[2]	Exhibit	1st	13th	25th
5-Year Average EBITDA	A-6	4.5%	9.1%	13.5%
5-Year Average Net Income	A-3	4.8%	9.1%	13.0%
Sales	A-7	4.7%	9.3%	13.2%
Total Assets	A-5	6.1%	9.5%	12.4%

General Monthly Cost of Capital Data

Treasury yields[3]	30-day: 0.19%	5-year: 1.38%	20-year: 2.38%
Prime lending rate:[3]		3.50%	
Dow Jones 20-bond yield:[4]		3.40%	
Barron's intermediate-grade bonds:[4]		5.42%	
High yield estimate:[4]		Mean 9.4%	Median 9.6%
Dow Jones Industrials P/E ratios:[4]			
On current earnings:		16.7%	
On 2015 operating earnings est.:		15.9%	
On 2016 operating earnings est.:		15.6%	
Long-term inflation estimate:[5]		2.25%	
Long-term rate of growth GDP:[5]		2.25%	

BVR's Private Company Cost of Capital Index[6] (January 1, 2016)

Company Revenue ($thousands)	Cost of Capital
1,000	19.1%
5,000	17.3%
10,000	15.6%
15,000	14.7%

1 Source: *2015 Valuation Handbook—Guide to Cost of Capital* (A Exhibits) © Duff & Phelps, LLC. All rights reserved. *Risk Premium Report* cost of capital data include premiums where size is measured by eight size measures: market value of equity, market value of invested capital, book value of equity, five-year average net income, five-year average EBITDA, sales, total assets, and number of employees. Complete current and historical *Risk Premium Report* cost of capital data are available at BVResources.com/dp.

2 Each measure for size is organized by Duff & Phelps, LLC in 25 portfolio ranks, with portfolio rank 1 being the largest and portfolio 25 being the smallest. Smoothed average premiums are present 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 mark risk premiums and expected equity risk premiums as described in the *2015 Valuation Handbook—Guide to Cost of Capital*.

NOTE: The new *2015 Valuation Handbook—Guide to Cost of Capital* includes *two* sets of valuation data: (i) *Risk Premium Report* data; and (ii) CRSP Decile Size Study (previously published in the *Morningstar/Ibbotson SBBI Valuation Yearbook)*.

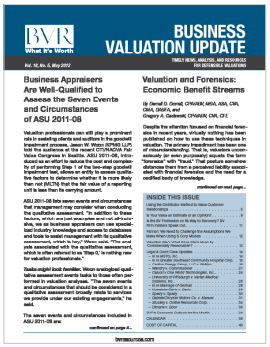
3 Source: The Federal Reserve Board as reported by the BVR *Risk-Free Rate Tool*, located in the Free Downloads section at BVResources.com, February 1, 2016.

4 Barron's, February 1, 2016.

5 10-year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, December 10, 2015.

6 After-tax cost of capital (calibrated for 35% tax rate and mid-period convention) for average/typical risk company. For use on unlevered, after-tax expected free cash flows. Based on *Pratt's Stats* data and Dohmeyer, Burkert, Butler and Tatum's Implied Private Company Pricing Line (IPCPL). See the IPCPL page at www.bvresources.com/IPCPL.

BVR
What It's Worth


BVR What It's Worth
BUSINESS VALUATION UPDATE
TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS
Business Appraisers Are Well-Qualified to Assess the Seven Events and Circumstances of ASU 2011-08
Valuation and Forensics: Economic Benefit Streams
INSIDE THIS ISSUE

Subscribe Today!
$429.00/year

Business Valuation Update

The *Business Valuation Update* (BVU) keeps you at the center of the business valuation profession. You'll get the new thinking from leading appraisers, detailed reports from valuation conferences, analysis of new approaches and court decisions, regulatory and standards updates, and more! Your subscription includes the monthly BVU (in PDF or print) and searchable, online access to all previous issues — everything you need to stay current on your challenging and rewarding profession.

Benefit with the BVU:

- Stay current on changes at FASB, TAF, IASB, DOL, and the many other regulatory agencies and courts that influence how valuation is practiced
- Get analysis of "landmark" cases in key business valuation issues such as discounts for lack of marketability, control premia, the effect of taxes in S Corporations, and more
- Access excerpts from BVR's monthly *Economic Outlook Update* including historical economic data and forecast charts
- Quickly access all current and historical issues—so you can always find the valuation approach, case, or source you need
- Better support your valuation conclusions by incorporating the latest research and findings in your reports or expert witness testimony
- Access cost of capital highlights from Duff & Phelps, monthly economic update summaries you can use in your reports, and a calendar of the best CPE from ASA, NACVA, the AICPA, BVR and others

Subscribe Today at bvresources.com/bvu

If you prefer, fax this form to our secure line: (503) 291-7955 or call (503) 291-7963

❑ **Yes!** I'd like to subscribe to Business Valuation Update for $429.00/year.

Name: _____ Firm: _____

Address: _____ City,State,Zip: _____

Phone: _____ Fax: _____ E-mail: _____

Billing Information:

❑ Visa ❑ Mastercard ❑ AMEX ❑ Check payable to: Business Valuation Resources, LLC

Credit Card #: _____ Exp. Date: _____ Sec. Code: _____

Cardholder Name & Address (if different): _____