J.L. PIERSON & CO. LLC

NYNJCT-BV.COM

(203) 325-2703 Business Valuation (203) 434-4648

When Determining Market Value, Rely on More than Revenue Forecasts

***Susan Fixel, Inc. v. Rosenthal & Rosenthal, Inc.*, 2006 Fla. App. LEXIS 1101 (February 1, 2006).** *Judge Rothenberg.*

Accuracy and reliability are the cornerstones of any business valuation—but sometimes the hard data are simply not there. And sometimes errors can mar even the most careful assessments.

The *Fixel* case concerned claims for breach of fiduciary duty and negligent misrepresentation, resulting in the total loss of a business. To determine damages based on the market value of its business at the time of its alleged destruction, the plaintiff offered expert testimony calculating damages from future revenue and cash flow projections, which one of the plaintiff's principals had prepared. The projections assumed that the plaintiff company would receive $3 million from investors—though this funding never came through. The company was also a start-up, which never turned a profit and incurred constantly increasing costs. Lastly, no comparable company data was available. As a result, the court found the expert's valuation "too speculative," and didn't even permit him to testify at trial.

Speculative data fail to support lost profits and market value calculations

The company tried to argue that while a lost profits calculation may require more evidence than projected earnings, a market valuation of the business could rely on forecasts—but the court disagreed. "It is as inappropriate to use purely speculative forecasts of future revenue to determine the market value of a business as it is to use such speculative forecasts in determining lost future profits."

A critical error in the report didn't help matters: the court found that the expert had relied on the wrong date when determining the company's market value. Pursuant to applicable law, the correct time for valuing a destroyed business is on the date of the loss—which in this case would have been the time when the company ceased operations. For reasons the Court does not mention, the expert relied on a date almost a year earlier—a mistake that unfortunately rendered his report unpersuasive.

Another Reason to Hire BV Analysts to Provide Fairness Opinions

***Ha-Lo Industries, Inc. v. Credit Suisse Boston*, 2005 U.S. Dist. LEXIS 23505 (October 12, 2005).** *Judge Gettleman.*

Fairness opinions are rife with potential conflicts of interest, none so obvious as when an investment firm's fee is tied directly to the completion of a deal, which in turn depends upon that same firm issuing an opinion that the deal is financially "fair."

That's what happened here, when plaintiff Halo-Industries, a promotional products company, wanted to acquire a technology platform for internet expansion, and hired defendant investment banking firm as financial advisor. Defendant's fee was specifically tied to the purchase price; if the deal fell through, defendant would end up with no more than its retainer and a modest "break-up" fee.

As defendant had no specific expertise in technology systems, it advised plaintiff to hire Ernst and Young to assess this aspect of the deal. E&Y's report came back negative, indicating that the target's systems were incomplete, requiring significant investments. Plaintiff's CEO allegedly presented a positive picture to the Board, however, and the company proceeded with the acquisition; defendant, who disputed receiving E&Y's report, issued its fairness opinion and earned its $2.5 million fee.

Despite investing millions post-merger, plaintiff later filed Chapter 11 bankruptcy—and filed suit against defendant bank for "gross negligence" in rendering its fairness opinion.

Among its claims: 1) the investment bank had valued the target using a methodology that would overstate its value; 2) it had disregarded relevant information about value and public information about the target's management practices; and 3) it had permitted self-interest in a lucrative fee and future business to override reasonable judgment.

Continued to next page...

'Simple mistakes' in valuation lead to Fifth Amendment plea

Before the facts went to a jury, defendant filed a motion for summary judgment, arguing that the claims lacked legal merit. In denying the motion, the U.S. District Court (N. Dist. Illinois) touched on several undisputed facts, primary among them defendant's admission that any errors in its valuation of the target resulted from "simple mistakes."

Given that the investment analyst who'd gathered the data had asserted his Fifth Amendment right to avoid self-incrimination rather than testify how the "simple mistakes" occurred, the court could not, as a matter of law, absolve the defendant from bad faith.

For now, the case is moving forward—while fairness opinions are headed for further scrutiny. If more "independent" opinions are called for, then business appraisers may be among the more experienced professionals to answer the call.

Goodwill Hunting: Does a Motion Picture Director Create Professional Goodwill?

***In re Marriage of McTiernan,* 2005 Cal. App. LEXIS 1692 (October 28, 2005).** *Judge Flier.*

You may have seen this director's movies—including the blockbusters *Die Hard* and *Hunt for Red October.* But would you have guessed, even in California, that his career supported a finding of professional goodwill valued at $1.5 million?

Credit the testimony of Professor Arthur de Vany, Ph.D. (UC Irvine) for persuading the trial court that the husband "[had] developed an earning capacity and reputation in his profession…which greatly exceeds that of most [of his peers]." Moreover, the husband's success was dependent on:

> …his personal skill, experience and knowledge…and in that respect, the profession which he practices is similar to that of an attorney, physician, dentist, accountant, editor, architect, or any other professional who has established a successful professional practice, with quantifiable expectation of future patronage, based upon his or her personal skill, experience, and knowledge.

The trial court adopted the academic's excess earnings approach, and found that—rather than merely possessing personal skill and experience, the movie director husband owned a business asset that could be characterized as goodwill, subject to division.

There's no business like show business

The goodwill of a *business* is property and is transferable—and that became the issue on appeal, whether the definition of business could include a movie director as a "person doing business" in his field, sufficient to generate a saleable asset of goodwill.

The appeals court went on a hunt of its own, looking to the historical definition of goodwill and the "plain" language of the business and professional codes. Its findings: "No California case has held that a natural person, apart and distinct from a 'business,' can create or generate goodwill." In the case of professionals, it is the practice which generates goodwill, not the principals. Expanding the definition of a business to include natural persons would implicate "much of the working population," the court said, and there would be no distinction between a popular movie director and musicians, artists, and actors.

"Something that cannot be…sold has no value on the market. Dividing such a non-transferable quantity" would create an obligation without ensuring a source of funds. Endowing persons with the capacity to generate goodwill would create an asset predicted on "nothing other than predictions about earning capacity," the court concluded—which in Hollywood would be a risky business, indeed.

New York Court Decides Who Has Burden to Prove Valuation Date For Active/ Passive Asset

***Mahoney-Buntzman v. Buntzman,* 2006 N.Y. Misc. LEXIS 533 (February 8, 2006**)

New York is one of the "bigger" players in the checkerboard that national dissolution cases often resembles, as its decisions directly effect a large population—and its precedent often persuades other courts to move in one direction or another. Although the law is well settled in many states regarding which party to a divorce has the burden to prove that an asset is "active" or "passive"—this one took a first look at which party has the burden to show the date of valuation.

Should the party claiming separate property also prove its valuation date?

Here, the husband held over a million shares of stock and stock options in a public company, of which he was co-owner. About six months after the divorce began, he cashed in 300,000 shares at $4.00 per;

Continued to next page...

within another six months, and with proceedings still pending, he sold another 300,000 shares for nearly three times as much—or $11.50 per share, netting a total of over $3.5 million.

Not surprisingly, the husband argued that the appreciation in the stock was "active," and was his separate property; and that the court should value the appreciation as of the commencement of the divorce began, as per state law. The wife just as predictably argued that the appreciation was passive, and the court should value it as close to trial as possible, so that she could claim an equitable share of the appreciation (also per state law on division of passive assets.)

On interlocutory review, the NY Supreme Court recognized that the party claiming that the appreciation is "active" and therefore separate property has the burden to prove this characterization. The law is clear and comprehensive on this point: "[T]he distinction between active and passive assets has been repeatedly discussed, and the proper characterization of a particular class of asset as active or passive has often been explained." However, there was a dearth of decisions on a critical related issue. "[T]he question of which, if either, party in a matrimonial action bears the burden of establishing the proper valuation date has not been made similarly clear."

The husband argued that because the wife had the burden to show the value of an asset in which she claims a portion, she should also have the burden to prove its appropriate valuation date. The Court disagreed, saying that her need, as the non-titled spouse, to prove baseline value does not relieve the titled spouse of his need to prove the separate character of the asset. "Nor does it free him of the obligation of proving that the stock assets are active and not passive."

But the wife's arguments didn't pass muster either; she said that the trial court should have discretion to determine the valuation date for active/passive assets. This confused the ultimate determination of the valuation date—which is the court's discretionary duty, with which party should bear the burden of persuading the court.

Ultimately, the Court held that the party who has the burden to prove the character of an asset should also bear the burden of proving its appropriate valuation date, as this maintains consistency with prior court decisions and efficiency with allocation of the parties' responsibilities. And with this New York decision, practitioners around the country are alerted to the issue in their own states, and how this case may influence the fixing of a valuation date for active/passive marital property.

Do Minority Discount and DLOM Apply in 'Fair Value' Analysis?

East Park Ltd. Partnership v. Larkin, et al., **2006 Md. App. LEXIS 32 (March 6, 2006).**

There's rarely any question that discounts apply to a fair market value analysis of a business interest, as the "willingness" of most arms-length buyers is likely to depend on such factors as minority control and/or lack of marketability. But are discounts for lack of control and marketability appropriate in a "fair value" analysis; i.e., in the context of withdrawing limited partners (and, by analogy, dissenting shareholders)?

On a case of first impression in Maryland, the Court of Special Appeals said that—absent unusual circumstances, they are not. "Because no open market transaction takes place when a partner withdraws from a limited partnership, we hold that, ordinarily, discounts should not be applied."

'Fair value' open to interpretation

Unlike fair market value, for which "countless cases" and statutory provisions establish a clear definition, the term "fair value" in the Maryland uniform partnership and limited partnership laws appears without clarification or guidance. Ditto for the dissenting shareholder provisions of the state's Corporations and Associations Act, which use "fair value" without explanation. There was no local case on point, although the Court noted that the majority of states to consider the issue in the dissenting shareholder context have concluded that discounts do not apply to a fair value analysis. These opinions plus the legislative purpose behind the relevant statutes helped sway the Court—along with the "competent and material" evidence from expert valuators.

The first expert for the withdrawing limited partners, testified that the fair market value of the LLP's only asset, a shopping center, was $19.5 million. A second expert accounted for the property's liabilities to reach a going concern value of approximately $14.64 million.

To prove its version of value, the partnership provided a state tax assessment of the property at $13.9 million. More importantly, it also proffered expert opinion that the "fair value" of the limited partners' interests necessitated applying a 25% discount for lack of control and a 31.27% discount for lack of marketability.

Continued to next page...

At trial, the court agreed with the limited partners' experts, finding that the fair market value of the shopping center was $19.5 million, and its "net" or going concern value was $14.64 million. As for what constituted "fair value," the lower court also determined:

- It is not the same as fair market value, for if that had been the intent, the state legislature would have used the FMV term in the uniform partnership laws. Also, in the context of "cashing out" a limited partnership interest, it would be incorrect to apply a fair market analysis where third parties are not involved, but only withdrawing partners surrendering their interests.
- In the shareholder dissent statutes, "fair value" requires reimbursement for a withdrawing shareholder's proportionate interest in a going concern, or "the intrinsic value of the shareholder's economic interest in the corporate enterprise."
- By analogy to shareholder cases, the objective is to ascertain the actual worth of what the withdrawing limited partner loses because he/she is not willing to "go along with" a controlling partner's decision; this includes the appraisal of all material factors that affect going concern value, such as nature of the partnership operations, its assets and liabilities, future prospects, etc.
- Although fair value does not necessarily equal liquidation value, in this case the two are indistinguishable, as the sole asset at stake (real property) had no goodwill or other intangibles.

In conclusion, as the withdrawing limited partners would not be selling their interests in the open market, discounts would not apply; or as the trial court put it, "the remaining partners would end up acquiring the…interests for less than they were worth if those interests had remained in the hands of the withdrawing partners."

The appeal court confirmed the ruling and its reasoning, noting in particular that testimony by the limited partners' expert was supported by case law and statutes, whereas the partnership's expert had admitted that he was unfamiliar with the partnership laws, and had simply equated fair value with fair market value. The court also confirmed that "the application of discounts is appropriate only under a fair market value analysis; that is, in determining what price a willing buyer would offer, and a willing seller would accept, on the open market."

J.L. PIERSON & CO. LLC

P.O. Box 2392
Darien, CT 06820-0392
http://www.NYNJCT-BV.COM
(203) 325-2703

Change Service Requested