

## ***Tax Court's Adjustment to Reasonable Compensation***

### **Menard v. Commissioner, 2009 (Federal Court of Appeals, 7th Circuit, on appeal from US Tax Court)(March 10, 2009)**

The CEO of The Home Depot was paid \$2.8 million in salary in 1998. The CEO of Lowe's received \$6.1 million (neither including bonus). Yet when the CEO of the nation's third largest retail home improvement chain, Menards, posted roughly \$20.6 million in salary (including bonus), the IRS stepped in and disallowed \$19 million as a corporate deduction. The reason: The IRS claimed that it was a disguised dividend.

**The Tax Court applied a unique formula.** The CEO, John Menard, founded the Wisconsin-based Menards hardware stores in 1962. He worked six or seven days a week, up to 16 hours a day, and was involved in every detail of company operations. Under his management, revenues grew from \$788 million in 1991 to \$3.4 billion in 1998. The company's return on shareholder equity in 1998 was 18.8%. By contrast, Home Depot returned a 16.1% return on investment that year, and Lowe's rate of return was lower.

Menard owned all the voting shares in the company and 56% of the non-voting shares. He was paid a modest base salary and a portion of a profit-sharing plan; in 1998, he earned \$157,500 and \$3 million from these sources. A bonus program, adopted by the board of directors in 1973, for his "commanding" management role, awarded him an additional 5% of company earnings (before taxes) at the end of each year. In 1998, the 5% bonus yielded the CEO an additional \$17.5 million, conditioned on the IRS allowing its deduction from corporate income.

At trial the IRS not only persuaded the Tax Court that the bulk of the CEO's compensation was excessive, but that because it was conditional and paid at year's-end, it was also intended as a dividend, especially since the company didn't pay formal dividends to other shareholders.

As to the "excess," the Tax Court found that any compensation above \$7.1 million for Menard was

too much. The court used its own unique formula to arrive at this conclusion:

(1) Divide Home Depot's return on investment (16.1%) by its CEO's salary (\$2.84 million);

(2) Divide Menard's return on investment (18.8%) by the result of step (1); and then

(3) Multiply the result (\$3.32 million) by 2.13, or the ratio of the compensation of Lowe's CEO to that of Home Depot's CEO.

The appellate court considered the Tax Court's formula an arbitrary and dizzying adjustment. It disregarded differences in the full compensation packages of the three executives being compared (the Home Depot CEO made more than \$124 million from 1998-2004), differences in whatever challenges faced the companies in 1998, and differences in [their] responsibilities and performances (Menard was by far the most active, hard-working).

**Not a concealed dividend.** The Tax Court ignored the substantial level of risk in Menard's compensation structure, given its direct tie to company earnings. Not to mention the fact that the 5% bonus program had been in place for 25 years before the IRS "pounced," the court said. It did not look like a dividend, because corporate dividends are generally tied to specific dollar amounts and do not serve the same incentive purpose to the passive shareholder.

The Seventh Circuit reversed the Tax Court's decision.

## ***Divorce Experts Agree on Nothing but the Definition of Fair Market Value***

### **Brickner v. Brickner, 2009 (Ohio Court of Appeals 12th District (March 16, 2009)**

When competing valuation opinions leave little room for consensus, frustrated courts are forced

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to cobble an outcome from what little agreement the experts were able to admit, and the appellate court is likely to uphold it.

**Never seen such different valuations.** During their twenty-year marriage, the Brickners co-owned a company that provided home-based support for the disabled. At their divorce trial, the husband's expert used the cost and market approaches to value the company at \$314,131 and \$640,292, respectively. The wife's expert used the cost and income approaches to find respective values of \$250,000 and \$380,000.

"I can honestly say I have never in the life of trying cases found valuations more different," the trial judge said. The judge went on to find that the market analysis was unreliable and disregarded it, choosing instead the higher of the two cost analysis outcomes.

The appellate court found that in light of the widely divergent opinions and the trial judge's careful consideration of them, the decision was neither unreasonable nor unconscionable, and the valuation was affirmed.

## ***Bankruptcy Court Cannot Just 'Split the Difference' in Divergent Discount Rates***

**United Air Lines, Inc. v. Regional Airports Improvement Corp., 2009 (Federal Court of Appeals, 7th Circuit, on appeal from Bankruptcy Court)(May 5, 2009)**

In United Airlines' Chapter 11 reorganization, the bankruptcy court considered how much the airline owed lenders that financed the improvements to its gates at Los Angeles International Airport (LAX). The original 2004 loan amount was \$60 million. According to the bankruptcy code, United would have to pay the full, present value of the assets that served as security; i.e., the improved, leased space at the airport. Any excess would be unsecured debt, which the airline could write down.

Absent a liquid market for improved space at an airport, the fair market value of the property turned on the amounts that would be agreed upon by a hypothetical willing buyer and willing seller.

**The appropriate rental rate.** The airline expert used \$17 per square foot, the historic market rate that LAX charged to airlines, for United's

leased space. The lenders disagreed, arguing that this was the rate that the airport offered prior to the 1984 Olympics for unimproved space. The trustee's expert looked at rental rates charged by a consortium of airlines that operated out of the airport's second terminal (LAX2). In 2004, the year of the loan, the consortium leased gates to other carriers at \$63 per square foot. The bankruptcy court determined that an estimation of market rental rates was too speculative, and adopted the airline's \$17 figure. On review, the district court agreed.

The Seventh Circuit found fault with both lower courts. The Seventh Circuit disagreed, finding that the price was more likely somewhere between the \$17 and \$63, noting that, "Any potential rental price higher than \$30 would make the collateral worth at least [the] \$60 million [loan amount]," the court ruled, even with the discount rate that the bankruptcy court selected. That is where the court turned its attention next.

**A judge must choose the right discount rate.** In the DCF analysis, the lender's expert chose an 8% discount rate, citing the rate that LAX currently paid on unsecured general revenue bonds. By contrast, United's expert selected 12% as the rate that investors would demand, given the industry's volatility. "The bankruptcy judge added the two estimates and divided by two," the Seventh Circuit explained. "An arbitrator might choose such a method, and perhaps a jury would do so behind closed doors, but a judge should choose the right discount rate rather than split the difference between the parties," it said, with emphasis.

Instead of looking at the general industry risk, it would have been more credible to look at the risks of this airport, the court added. If the airport could raise money at 8% without giving security, then secured debt investors would not demand more, and that "is all we need to know" to conclude that the discount rate could not exceed 8%.

Using the \$17 per square foot rental rate, bankruptcy court projected industry-rate increases over the term of the loan (2021) to reach \$146 million. Discounted by 8%, the court arrived at a present value of \$46 million. Increasing the rent to \$23 would make the lenders fully secured, the court held, in reversing the lower courts' judgments. "Because improved space in [LAX2] fetches almost three times the price needed to make these loans... secured, the lenders are entitled to a full recovery."

## ***Six Issues an Expert Should be Aware of When Selecting COC Data in Volatile Times***

Deriving a defensible cost of capital (COC) in litigation involving the valuation of private companies or economic damages is particularly tricky in a volatile economy. Movements of just a few basis points in COC calculations can cause significant fluctuations in value.

Here are some things to watch for in particular:

1. Spot yields on T-bonds may not be the best proxy of the risk-free rate of return. Because yields have dropped dramatically, the spot yield may cause an expert to underestimate the actual COC of the company being valued. Longer-term average Treasury yields or forward rates on Treasuries may be a better alternative.
2. Understand the differences in the sources for the equity risk premium (ERP). Experts debate how far back they need to go to measure the ERP. Data from Ibbotson/Morningstar Stocks Bonds, Bills & Inflation (SBBI) Valuation Yearbook, goes back as far as 1926, whereas the Duff & Phelps Risk Premium Report (RPR) captures data since 1963. In fact, understanding the differences between the data and the sources, and being able to support their application to COC measurements is what's more important. Ask an expert why, not just what.
3. Know the difference between levered and unlevered beta. Levered beta measures the systematic risk, including business and financing, borne by a company's equity shareholders. Unlevered or "asset" beta removes the company's financing decision from the beta calculation, reflecting only business risk. An expert should know the difference and be able to explain their choice in a valuation.
4. Know the differences between beta sources. Valuation experts derive beta from Bloomberg; Standard & Poor's Compustat; Capital IQ; the Ibbotson® Beta Book; and the Value Line Investment Survey, among others. Results differ depending on the choice. Sources differ as to time periods, the frequency of data observations and the appropriate adjustment

factors. There is no "wrong" option, so long as the expert understands the differences and can rationalize their choice.

5. Industry ERP is treated differently in CAPM and the Build-up model. Industry risk can be incorporated into the modified CAPM (through the beta), whereas experts must include an adjustment for the industry ERP in the Build-up model, because it does not include a beta element.
6. Company-specific risk premium (CSRP) measurement. There are several quantitative models for estimating the CSRP. The CSRP is an input to all the cost of capital models and experts need to use their judgment and be able to defend it.

A credible expert is a winning expert. Look for the words "commonly accepted" as a good foundation for an expert's choices. As importantly, look for an expert who can explain their rationale and conclusions in plain English to a lay person, or judge.

## ***The Most Credible Experts Admit the Weaknesses in their Reports Up Front***

As judges boost their knowledge and more IRS engineers and appraisers become BV-credentialed, they are better able to spot the weaknesses in valuation reports. Should you admit them up front? "Absolutely," says U.S. Tax Court judge, the Honorable David Laro. "If you don't address them, the other side will, or the court will have questions." If an appraiser discusses and analyzes, for example, omitted methods, and explains why they were not applicable to a particular case, they automatically raise the sophistication level of their report.

What other elements must a report have? Ethics, independence, intellectual honesty, and transparency, Laro said. "When you offer a report that is free of bias and advocacy, independently arrived at and transparent, then this is the best we can have." Howard Lewis, former national program manager of the IRS and current IBA executive director, seconded these requirements, as applied to the Service. "It is not the job of the IRS to be advocates," he said. IRS appraisers and examiners

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are “charged with the responsibility to be fair, honest and unbiased.” At the same time, they regularly see only the worst-case appraisals, and this system-bias led even Lewis to develop a bias early in his career, which he focused on correcting in later years, in both himself and his fellow engineers. The point: “Understand the perspective of the IRS,” he said.

## ***Top five key factors in expert damages testimony***

Having a qualified business appraisal expert to assist in determining damages is critical at trial. But it will backfire if the expert does not adhere to the Federal Rules of Civil Procedure, or if the expert’s conclusions are thrown out due to a successful Daubert challenge. Here are five key factors to consider:

1. The expert witness report must be court-ready. The expert’s report is direct testimony and needs to contain all the content needed to

establish (or refute) alleged damages.

2. Experts need the essential information first. Information requests need to be prioritized. Establishing damages will be difficult, if not impossible, if that essential information is unavailable.
3. Experts need to read the depositions and interrogatories. The result will be a more robust opinion and a more thorough and defensible report.
4. Daubert challenges are both real and unpredictable. Even the most respected business appraisal experts have lost Daubert challenges.
5. A good expert reveals the truth to the court. A judge or jury wants someone they can trust: Expert witnesses reveal the truth to the court in their testimony and their reports. To do that, in addition to great work, an expert needs to follow the rules flawlessly, and speak clearly and confidently.

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