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Fair Value Standard in Divorce May Not Be Gaining National Traction

Two recent appellate decisions suggest that the majority rule may be trending away from the fair value standard in divorce, preserving (where applicable) the trial courts' broad, equitable discretion to dispose of marital assets according to the particular facts of the case.

Court discounts an LP interest. *In re: Alexander v. Alexander* (Ind. App.)(May 20, 2010), the wife held a 5% limited partnership interest in a family-owned farming business. Her parents retained full control as general partners, including the right to prevent a partition and to redeem a departing LP's shares. Accordingly, the wife's expert applied a 25% minority discount and 15% marketability discount to value her interest at roughly $234,000, which the trial court accepted.

The husband appealed, urging the Court of Appeals (Indiana) to preclude the application of discounts in valuing marital assets in divorce, based on the analogy to shareholder oppression cases. Indeed, a majority of U.S. jurisdictions currently reject minority and marketability discounts when determining fair value appraisals in statutory buyback cases. This is generally believed to prevent a windfall to the majority owners at the minority's expense. Given the parents' rights in this case, it was clear that they would be the likely buyers should the wife need to sell her LP interest to effect the distribution of marital property. The wife might even sell to her parents the day after divorce, the court noted, at "considerably more" than the trial court's value.

Nevertheless, the wife had no immediate plans to sell her LP shares, and there was no danger of a windfall to the other partners. According to its broad discretionary powers, "a trial court should be able to determine the present value of a spouse's ownership in light of marketability and minority shareholder discounts," the court ruled, affirming their application in this case.

Court discounts a *controlling* interest. *In re: Marriage of Thornhill* (Colo. Appeals Court)(June 1, 2010), the Colorado family court adopted a 33% marketability discount for the husband's *controlling* (70%) interest in a $1.7 million oil and gas operation. The wife appealed, but the Colorado Court of Appeals affirmed, rejecting the wife's argument that discounts should be precluded when valuing marital assets for divorce, based on the state precedent in statutory fair value cases. See also *IRM Thornhill* (Colo. App.).

This time the wife appealed to the state Supreme Court, which reviewed the leading statutory fair value precedent in Colorado. That case turned on the statute's explicit use of the fair value standard and (similar to the rationale expressed in *Alexander*, above) precluded discounts to prevent a windfall to majority owners at a minority shareholder's expense. By comparison, the state's marital dissolution statute does not contain the same "fair value" language, the court observed; it simply directs family courts to divide marital property "in such proportions as the court deems just after considering all relevant factors." A non-owning spouse cannot always be characterized as a "potential victim" of oppression in divorce cases, the court added.

More importantly, unlike the law in shareholder cases, "there is no clear national trend suggesting that a *per se* rule against marketability discounts is the majority view when it comes to valuing ownership interests in closely held corporations in divorce proceedings. If anything, the trend appears to go against such *per se* rules," the court observed. Although New Jersey has extended the rule prohibiting discounts from shareholder dispute cases to divorce, several states (e.g., Oregon, Florida, and South Dakota) "have left the decision of the appropriateness of marketability discounts in valuations within marital dissolutions proceedings to the trial court's discretion."

Finally, compared to the statutory fair value standard—which rejects a case-by-case approach

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to appraising minority interests as too uncertain and unfair—the Colorado marital dissolution statute specifically contemplates an ad hoc approach to preserve equitable distribution. For all these reasons, the court declined to adopt a *per se* rule, finding that trial courts may, in their discretion, apply discounts when valuing a spouse's business interest for purposes of divorce.

Reasonable Compensation Analysis Must Incorporate Applicable Legal Test

***Multipak Corp. v. Commissioner,* T.C. Memo. 2010-139 (June 22, 2010)**

Over 30 years, a CEO brought a foundering packaging company to financial stability. In 2002 and 2003, his compensation exceeded $2 million, nearly double the amount of prior years. The IRS claimed all but roughly $650,000 per year was unreasonable under IRC Sec. 162, and the taxpayer appealed.

Five-factor test controls. The Tax Court applied the five factors in *Elliott's Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983), to determine reasonable compensation in this case, as follows:

1. *The employee's role in the company*. During his entire tenure, the CEO "made every important decision" for the firm, the court said, and his dedication "directly contributed" to its profitability. Although sales declined in 2003, the firm stayed current on its payables and was essentially debt-free. Overall the court found this factor weighed in the taxpayer's favor.

2. *External comparison.* The taxpayer's expert compared the CEO's compensation with the average executive pay from various S&P data, adjusting the comparables for their differences in size and types of compensation (including stock options). After these adjustments, the CEO's compensation was still high, among the upper range of the comparables, but still reasonable, the expert said. Further, the 2003 dip in sales was largely due to the economy, and there was no evidence the company paid bonuses to absorb taxable profit.

By contrast, the IRS expert applied the "independent investor" test derived from *Elliott's* (i.e., whether a third-party investor would be satisfied with the rate of return after investing in the company). Using data from comparable, industry, and the taxpayer sources, he concluded that $1.46 million would have reasonably compensated the CEO in 2002 and $670,100 in 2003.

The court wasn't "completely convinced" by either expert, finding their comparables "too dissimilar" to the taxpayer. Moreover, the taxpayer's expert did not perform the independent investor analysis, as "*required by the applicable case law*," the court held (emphasis added). Overall, this factor was neutral.

3. *Company character and condition.* The taxpayer was prominent in its industry and enjoyed record high revenues, despite its 2003 sales decline. The CEO contributed significantly to this success, weighting this factor in the taxpayer's favor.

4. *Conflict of interest.* The court examined this factor under the *Elliott's* independent investor test, noting that an investor would likely be satisfied with the 2002 rate of return but not in 2003, thus making this factor a wash.

5. *Internal consistency.* The compensation was not *per se* unreasonable simply because the CEO was a shareholder-employee, the court held. Moreover, the incentive-based compensation plan was a valuable motivator, weighting this factor in its favor.

Overall, the court found the CEO's compensation of $2.02 million in 2002 was reasonable. It adjusted his salary to $1.28 million in 2003, however, to produce a 10% return on equity, sufficient to satisfy "the overall character of the company" and an independent investor.

Important Delaware Chancery Case on Terminal Growth Rate, ERP, Betas, and Best Experts

***Global GT LP v. Golden Telecom, Inc.* (Del. Ch.) (April 23, 2010)**

In 2007, Russia's leading long-distance provider (Golden) announced a merger with the largest cellular provider at $105 per share. The market reacted with suspicion, however, because two of Golden's largest stockholders owned more of the buyer than they did of the seller, and they sat on both companies' boards. After the deal closed in 2008, some of Golden shareholders disputed the merger price and petitioned the Delaware Chancery Court for a statutory fair value appraisal. Finding the seller sat on both sides of the deal and failed to hold a true, open auction, the court found the merger price had "no reliable bearing" on fair value—and the battle of the experts began.

The parties' experts relied primarily on the discounted cash flow (DCF) analysis, finding few if any guideline comparables in the Russian telecomm market. They also believed Golden's management forecasts were reliable, and the court agreed. Their DCFs produced widely disparate per-share values, however—the petitioners' at $139 per and the respondents' at $88—due primarily to the experts' selection of inputs, which the court considered as follows:

1. *Terminal growth rate.* The company's expert estimated Russian inflation at 3% and adopted this as his terminal growth rate. When confronted with independent data that predicted 3.9% average inflation, he admitted that he "largely made up" the 3%. The court rejected his rate, preferring the petitioners' expert rate of 5%, based on the midpoint between estimated inflation and long-term Russian GDP growth.

2. *Equity risk premium (ERP)*. The company's expert chose 7.1%, based on the long-term, historical rate in Morningstar/Ibbotson data. Crucially, however, Ibbotson has developed an alternative *supply-side* model, because "the historic approach wrongly assumes" that the past relationship between stocks and bonds would remain stable, the court found. Based on this and additional "solid" academic and professional support, it adopted the petitioners' expert's selection of Ibbotson's supply-side 6% ERP.

3. *Beta*. The company's expert selected 1.32, based Bloomberg's five-year historic beta. The petitioners' expert used a lower beta of 1.2, based on the forward-looking "Barra" model (which considers 13 factors such as volatility, momentum, size, trading activity, growth, and earnings). In another case before the Delaware Chancery, however, the same expert had used an historic raw beta similar to Bloomberg's. He also failed to pinpoint the "epiphanic moment" that prompted him to endorse a forward-looking approach, the court noted. Nor could he provide sufficient authority for the switch, (as he did for switching from historic to supply-side ERP). Bloomberg's data were not free from doubt, but its "historic beta is considered to have a fair amount of predictive power and to be a reliable proxy for unobservable forward-looking betas," the court said, ultimately settling on a beta of 1.29 from historic as well as industry data.

Based on these inputs, the court calculated a fair merger price of $125.49 and entered judgment accordingly.

Defendant Uses Daubert *to Deconstruct Expert's DCF*

***Warren Distributing Co. v. InBev USA, LLC* (D. N.J.)(May 28, 2010)**

In 2007, Anheuser Busch purchased several domestic and European brands from a large national brewer (InBev U.S.A.), but decided to use its existing distribution network rather than its predecessor's. Pursuant to a new law in New Jersey, which required a successor brewing company to pay its fair market value to its wholesalers for any terminated brands, Anheuser Busch offered the former distributors 2.5 times gross margins for their domestic brands and 3.3 times gross margins for the European brands.

Three distributors turned down the deal and sued both the former and successor brewing companies for breach of contract. To support their claim for damages, the defendants' expert calculated over $45 million in damages (the equivalent of an 8.4 multiplier). The defendants filed a *Daubert* motion, arguing the expert's evidence was unreliable and a poor analytical "fit."

In particular, the expert analyzed one of the defendants' deals with a cooperative distributor, claiming it occurred under duress. The defendants said this was impermissible "mindreading," and the court agreed. "An expert cannot testify about a person's intent, motive, or state of mind," it held, and struck the portions of his opinion that dealt with duress (a factual issue the plaintiffs could establish through other witnesses). At the same time, the expert could testify that the deal with other distributors involved a 7.32 multiplier (rather than the stated 2.5 and 3.3), because it was based on valuing the transactions. "Any shortcomings … can be exposed during cross examination," the court held.

The defendants also claimed the expert's discounted cash flow (DCF) analysis was "per se inadmissible" for determining appropriate payments to wholesalers, simply because the market approach had been used "so many times" in these cases, including several times by the plaintiffs. But, "This is simply not so," the court held. Provided a DCF is otherwise reliable, it can be used to calculate the value of distribution rights. "Moreover, DCF does not seem to be wildly different from the market multiples approach in that it, too, ultimately provides a multiplier, albeit one based on a number of different variables."

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Finally, the defendants challenged the expert's DCF for using a discount rate based in part on data from a consulting expert who had a stake in the case. Plus, he used an "arbitrary" debt-to-income ratio and "highly speculative" long-term sales projections, they said, which were derived from the mere "say so" of the plaintiffs. The court dismissed these arguments, however. The expert's report gave sound, well-articulated reasons for how he arrived at the discount rate and debt ratios. Likewise, his report "clearly spelled out" the six different sources (including the plaintiff's projections) he used to reach his forecasted sales. Any allegations of bias or inappropriate assumptions could be better examined at trial through-cross examination, the court held, and admitted his DCF analysis under *Daubert*.

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