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Fall 2013 Newsletter

Fishman/Pratt/Morrison Book on Value Standards is a Must

A 2nd edition of this text, first published in 2003, has just been released. It explains in clear language, through case law, the exact meaning of the following standards of value:

Fair Market Value [used in federal estate and gift tax matters;]
Fair Value in Shareholder Dissent and Oppression;
Partnership and LLC Buyouts;
State Standards in Marital Dissolutions;
Fair Value for Financial Reporting.

I have been using the first edition since it came out, and this updated edition very thoroughly covers the increasing complexity of state and federal statutes in a practical way.

For example, Connecticut is classified as a fair market value jurisdiction [as opposed to a Value-to-the-Holder state] for the purpose of marital dissolutions, following *Eslami v. Eslami* [591 A.2nd 411 1991 Superior Court] which excluded practice goodwill "unless marketable." Another key decision *Ferguson v. Ferguson* [1998 Superior Court] did apply a lack-of-marketability discount. In *Dahill v. Dahill* [also Superior Court 1998] the Court did not accept the formula contained in a buy-sell agreement since "none of the triggering events of that agreement had occurred." Finally, the *Stearns v. Stearns* [494 A. 2nd 595 Appeal 1985] decision ruled that a buy-sell agreement should be one factor to consider, but not necessarily be determinative.

For Fair Value in Dissent and Oppression, Connecticut generally rejects discounts [see *Devivo v. Devivo* [2001 Super. Court] except in extraordinary circumstances. §33-855(4) defines fair value as the "value of the shares immediately before the effectuation of the corporate action to which the shareholder objects, using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack-of-marketability or minority status except, if appropriate, for amendments to the certificate of incorporation." §33-896(a)(1)(B) provides dissolution as a remedy for oppression or oppressive behavior. §33-900 allows a buy-out election in lieu of dissolution.

New York, where I also practice, is considered somewhat of a hybrid between Value-to-the-Holder and Fair Market Value standards for marital dissolution. *McSparron v. McSparron* [662 N.E. 2d 745 NYS Court of Appeals 1995] included the value of professional licenses and authorities such as lawyer or accountant, on the "merger" theory of the license and the career of the professional. Case law has applied this extensively, including for self-employed individuals whose work is not generally considered to be all that "professional." Since, on the other hand, some family courts have allowed discounts to marital valuations, New York should thus be considered a hybrid state and a review of the applicable case law is an important step in such valuation.

On the corporate, fair value front, New York generally rejects minority discounts, but allows lack-of-marketability discounts.

New Jersey is also a hybrid state for marital dissolution purposes, following *Dugan v. Dugan* [457 A.2d 1 NJ Supreme Court 1983] which states that professional goodwill exists, and that the practitioner's inability to sell it should not effect its consideration as an asset. Likewise *Piscopo v. Piscopo* [557 A.2d 1040 NJ Superior Court App. Div.1989] made goodwill attributable to celebrity status subject to equitable distribution. Other key decisions include *In re. Marriage of Bowen* [473 A.2d 73 NJ Supr. Court 1984] which decided that buy-sell agreements should be considered a factor in valuating a business, but are not determinative. In *Stern v. Stern* [331 A.2d 257 NJ Supreme Court 1975] the court refused to adjust value for dissolution based on a partnership agreement which periodically revised capital accounts based on intangible contributions.

For "fair value corporate oppression and equitable adjustments," New Jersey rejects discounts except in oppression and allows control premiums on a case-by-case basis, as the next article in this newsletter should make clear.

Please consult with an attorney for more state law guidance. J.E. Fishman, S.P. Pratt & W.J. Morrison *Standards of Value* Theory & Applications 2nd Edition 2013 Hoboken, NJ: Wiley Finance ISBN 978-1-118-13853-3.

NJ Oppressed Shareholder Lawsuit Took 18 Years !

Three siblings [Patricia, Norbert and Frank] inherited a regional trucking and freight consolidation firm catering to retail chains from their father; not able to agree on much, they filed several lawsuits for control against each other starting in 1995. The New Jersey Superior Court, Appellate Division, recently issued its decision in *Wisniewski v. Walsh*, dated April 2, 2013 which delves into a number of important issues involving methods commonly used to value private companies, the lack-of-marketability discount and the key-man discount.

The first lawsuit, filed by Patricia against her brothers in 1995 in New Jersey Chancery Court, was followed by a shareholder oppression action filed by Norbert against the other shareholders. In 2000, the Chancery Court conducted a lengthy trial and determined that Norbert was actually the oppressing shareholder, and ordered him to sell his one-third interest to his siblings at its fair value as of the date of Norbert's action. Based on expert valuation reports, the value was determined to be $12.4 million.

Further litigation followed, which resulted in the valuation date being changed to Norbert's last working day at the Company. After hearing, the value was then increased to $32.2 million. All findings were appealed and cross-appealed. The "buyers" [Patricia and Frank's estate] objected to the trial court not having applied a lack-of-marketability discount to the seller's interest. They also objected to the use of the Discounted Cash Flow method by the expert for the "seller." The seller, on the other hand, indicated that the court erred by applying a 15% "key man" discount based on Frank's role in the business; in fact, he argued that a 20% control premium should have been applied instead.

In order to use a discounted cash flow approach, the seller's expert prepared his own projection of future revenues and expenses, making sure to normalize insider salaries and reasonably growing historical revenues of this established business. The other expert had compared the Company with firms which were sold in the same industry and extrapolated value, i.e. a market approach. The Appellate Court declared the DCF as "the most reliable method and the most consistent with the legal standard of fair value." Also, since the trial court had critically reviewed both valuations, its determination could not be overturned lightly, and thus was not.

The appellate court reversed the trial court by requiring a lack-of-marketability discount as necessary, refusing to reward the "seller" for his conduct which harmed the Company and the other shareholders and required a forced buy-out. The matter was remanded to the trial court for calculation of the DLOM. New Jersey case law does not include much on the subject, except for *Balsamides v. Protameen Chemicals* [160 NJ 352 - 1999] where the seller, however, was one of two 50% owners. Essentially, the appellate court believed that the seller's behavior warranted a discount.

Control premium. The Appellate Court refused to sanction a control premium on the grounds that the DCF method used to value already yields a control value. Given that the issue does not appear to have come up in New Jersey courts, the court reviewed Delaware's jurisprudence. There it found that the courts generally reject a control premium in cases where the DCF method is used and ruled accordingly.

Key-Man Discount. The trial court had applied a 15% key-man discount to account for Frank's death, as he had been instrumental in growing the Company. The trial judge based his belief on expert testimony that a buyer would require it. The reviewing court agreed for the most part, and stated that the seller was not disputing Frank's importance to the business, nor his expert's having increased the discount rate to reflect that reliance. The court simply did not like a separate discount, but did not want to overturn the trial judge.

Overall, the decision is well reasoned and will help determine fair value in New Jersey.

AICPA Publishes Revised "Cheap Stock" Practice Aid

A committee of Certified Public Accountants has just revised this practice aid entitled Valuation of Privately-Held-Company Equity Securities Issued as Compensation. Under the fair value standard defined by ASC 718, minority shares can be valued using this reference for businesses having complex capital structures. The fair value standard, used in valuations for financial reporting, is now categorized by the authors as clearly different from the fair market value standard used in tax work.

Basically, the recommended methods are: the probability-weighted expected return method or PWERM; the option pricing method or OPM; the current value method or CVM and any hybrid thereof. The new practice aid also codifies the "back-solve" method where, typically, a "round of financing" is used to value other classes of securities. This field of study is important to investors and investees in private equity or venture capital-funded firms. AICPA Accounting & Valuation Guide: Valuation of Privately-Held-Company Equity Securities Issued as Compensation Jersey City, NJ 20013 ISBN 978-1-93735-222-6

Your Business Should be Ready for Sale Now !

Private businesses, which represent the bulk of many industries in this country, often are sold in transactions which their ownership did or sometimes did not anticipate. The precipitating event could be the death of the owner, a divorce proceeding, a forced restructure, or a shareholder dispute. It could also involve the departure of a key employee, the owner getting tired of the day-to-day work load and selling, a business reversal, or a life-changing experience on the part of the owner. It could, of course also be based on normal estate planning considerations, which do not apply if the owner has no son/daughter with an interest in the business and qualifications to run it. In fact, in many instances, the triggering event is outside of the control of the ownership.

Accordingly, your business should be, at all times, easy for a prospective owner to understand, its internal documentation should be clear and compelling, its accounting records should be up to date, and its management team should be complete. The value of the business, of course, is primarily a function of profit or cash flow, to which the market assigns a multiple. The seller can influence profitability, but not the multiple. Call us for help !

J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business communities from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key developments in BV which could interest clients and prospects. Court decision analysis is prepared from the perspective of a BV analyst, not that of an attorney.

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