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Expert at center of successful stock purchase agreement appeal

***K-O Enterprises, Inc. v. O'Brien,* 2005 Mo. App. LEXIS 1006 (June 30, 2005).** *Judge Cohen.*

Your valuation expert's credentials can be critical to success in shareholder disputes, as two brothers found out recently when terminating their stock purchase agreement.

Valuation facts

Kevin O'Brien was a 75 percent shareholder of K-O Enterprises, Inc. (K-O), a swimming pool service business, and his brother, Mark O'Brien, owned 25 percent. Pursuant to a stock purchase agreement, in the event that Mark left K-O, K-O had the right to purchase Mark's stock "upon the termination of [Mark's] employment for any reason, regardless of who initiated Mark's termination." However, if upon a termination of Mark's employment, the value of the stock had not been determined within twelve (12) months preceding such termination, the stock value:

> shall be its fair market value as of the end of the fiscal year preceding his...termination of employment...as determined under the business valuation by the accountant then providing the accounting service to [K-O] using regularly accepted accounting principles consistently applied. The determination of the accountant shall be final and binding on the parties.

Kevin terminated Mark. As there had been no determination of the value of K-O within the 12 months preceding Mark's termination, K-O's accountant, Alton, performed a valuation of K-O. He used what both he and Kevin contended was the "regularly accepted accounting principles consistently applied," to perform the business valuation.

Ultimately, Alton determined that the value of K-O at the end of the fiscal year preceding Mark's termination was $131,316.00. Moreover, Alton determined that due to Mark's 25 percent minority interest in K-O and the lack of marketability of shares in a closely held corporation, Mark's interest should be discounted by one-third for a total of $21,886.00.

Instead of tendering his stock pursuant to this valuation, Mark brought suit against Kevin. One of Mark's arguments was that Alton did not have valuation experience. Mark used statements from Alton's deposition to demonstrate that Alton: (1) was unaware of whether any industry-wide method existed as to how to determine the value of a company; and (2) failed to consider unrecorded profits coming from cash and trade transactions the inclusion of which would have materially affected the valuation.

Mark also presented the affidavit of his CPA with 32 years of experience in accounting and valuations. Among other things, Mark's CPA concluded that the original valuation:

> (1) did not reflect the standards of value as required by regularly accepted accounting principles; (2) did not make the necessary adjustments as required by the PPC's Guide to Business Valuation (or other authoritative text among valuation professionals); (3) did not acknowledge and adjust for any non-business or personal expenses; (4) and did not recognize and include the effect of all cash receipts or the value of labor and materials.

Ultimately, Brandvein concluded that, utilizing only the information available to him, an accurate valuation of K-O was approximately $600,000.

Despite Mark's evidence, the trial court granted summary judgment to K-O and Kevin, and ordered Mark to tender his shares.

Holding and rationale

The appellate court agreed with Mark that summary judgment was inappropriate and accepted Mark's argument that the original valuation failed to use "regularly accepted accounting principles" as required by the stock purchase agreement. The court said that "Mark's most compelling proof of remaining issues of material fact was an Affidavit" from Mark's valuation expert.

The court also rejected K-O's contention that GAAP or "Generally Accepted Accounting Principles" are distinguishable from "regularly accepted accounting principles."

Accordingly, the court held that Mark met his burden of showing that the propriety of the method used to value the stock was, in fact, a genuinely disputed issue for trial.

Evidence from valuation experts supports larger partition discount for fractionalized, non-controlling interests

***Estate of Baird v. Commissioner,* 2005 U.S. App. LEXIS 13905 (5th Cir. July 11, 2005).** *Judge Jolly.*

Establishing value and costs related to the partition of non-controlling interests, can help reduce future estate taxes. In this case, the issue was whether the taxpayers were allowed to deduct administrative and litigation costs, in addition to other discounts from their pro rata share of fractional, non-controlling interests in timberland. The Tax Court had ruled for the IRS.

John Baird's estate included a 14/65 undivided interest in a Louisiana trust that held 2,957 acres of timberland in 16 noncontiguous tracts, and his wife's estate included a 17/65 interest in the same trust.

Fractionalization discount

Both estates claimed a 50% fractionalization discount from the pro rata fair market value of the timberland. A fractionalization discount accounts for the fact that the sum of all fractional interests in property is worth less than the whole. It also takes into account the restrictions on sale or transfer of the property when more than one person or entity holds undivided fractional interests in the property.

The IRS took the position that the only additional discount allowable when valuing the estates' non-controlling fractional interests was the estimated 3% cost of partitioning the property based on an IRS forester's report. The estates protested this position, using reports by several business valuation experts who demonstrated a substantial body of data suggesting that the discounts for undivided interests should be significantly higher than the pro rata share of the estimated cost of partition.

Holding and rationale

The Fifth Circuit reversed and found that before the IRS issued the notices of deficiency, the taxpayers had provided enough information to the IRS to alert it to the fact that the in-kind partition described in the forester's report was not viable. The court also concluded that the IRS's estimate of the costs of a hypothetical in-kind partition was speculative and unsupported.

The Fifth Circuit, therefore, concluded that the Tax Court abused its discretion by determining that the IRS satisfied its burden of proof of substantial justification for its position.

Enterprise goodwill disallowed if based on non-solicitation agreement

***Held v. Held,* 2005 Fla. App. LEXIS 14138 (September 7, 2005).** *Judge Gross.*

The presence of a non-compete can reduce the fair market value of a professional service firm in divorce and other cases. The issue in this case was whether the trial court overstated enterprise goodwill in valuing husband's insurance agency, Joseph Held Company.

Although husband and wife agreed that book value was around $2.9 million, they hotly contested the existence and value of the company's enterprise goodwill above the adjusted book value. The trial court determined that such goodwill was around $7.6 million.

To arrive at its valuation, the court relied mostly upon the testimony of the wife's valuation expert. Central to the court's determination to include enterprise goodwill, was the assumption that in any sale of the business, the husband would sign a non-solicitation/non-piracy agreement preventing him from doing business with the Company's existing customers. The court reasoned that the non-solicitation agreement had nothing to do with personal goodwill of the business, but was part of enterprise goodwill.

Holding and rationale

The appellate court found that for the purpose of distinguishing enterprise goodwill from personal goodwill in the valuation of a business, there is no distinction between a "non-solicitation/non-piracy agreement" and a covenant not to compete, because both limit a putative seller's ability to do business with existing clients. The court also noted that a covenant not-to-compete is attributable to the personal reputation of the seller/spouse and not to the enterprise goodwill of the business.

Accordingly, the court reversed and ruled that the trial court impermissibly inserted into enterprise goodwill an aspect of personal goodwill—the value of the husband's personal relationship with the company's 60 clients. The court remanded, directing the trial court to use only the adjusted book value in determining the agency's fair market value.

New tax deductions may increase your firm's value

American Jobs Creation Act of 2004 Positively Impacts Company Value, **Bret G. Brewer,** *The Value Examiner,* January/February 2005, pp. 25-28.

Corporate tax reductions can increase value if they enhance future earnings. One example of this is the American Jobs Creation Act of 2004. One change brought about by this new law is the replacement of extraterritorial income exclusion with a new tax deduction for domestic production activities. Qualified U.S. production activities' (QPA) receipts in this case are the taxpayers' receipts derived from the following:

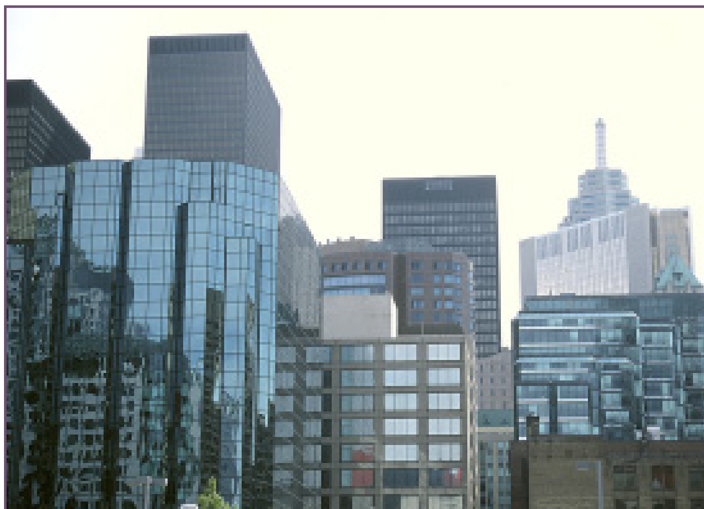
1. Any lease rental, license, sale, exchange, or other disposition of: qualifying production property (tangible personal property, computer software, and certain sound recordings) that was manufactured, produced, grown, or extracted in whole (or significant part) by the taxpayer within the U.S.; any qualified film produced by the taxpayer.; and electricity, natural gas, and potable water produced by the taxpayer in the U.S.

2. Construction performed in the U.S.

3. Engineering and architectural services performed in the U.S. for construction projects in the U.S.

Any company, regardless of size or formation, may take advantage of this deduction if its activities fall within the above descriptions. The deduction for any applicable year cannot exceed 50 percent of the taxpayer's (employer's) W-2 wages for that year. This amount does not reduce self-employment earnings, but it does reduce regular taxable income and alternative taxable income. This results in an after-tax cash flow increase to a company that takes the deduction, which increases the attractiveness of the company when compared to non-qualified companies.

Because the majority of business valuations make use of some form of future expected earnings, this deduction needs to be considered when valuing a company that is expected to use this deduction. Additionally, historical cash flows (which remain a likely indicator of the future) may be subject to an additional adjustment for QPA effects. The deduction, which lowers taxable income, creates increases in projected cash flows causing a higher present value of cash flows.



Affected businesses will most likely experience, under certain circumstances, higher future cash flows than were expected prior to October of 2004. Our appraisers can help you determine if the time and cost to track the QPA is not worth the deduction. Regardless, appraisers should assess the probability and scope of this deduction as it relates to the business being valued.

Taking bigger risks may enhance value

Value and Risk: Beyond Betas, **Aswath Damodaran,** *Financial Analysts Journal,* March/April, 2005, pp. 38-43.

Our firm can help you model the future impact of "risk management" on your firm's financial performance. But, as this article shows, there are two kinds of risk. The standard definition is "risk reduction," but Damodaran wishes the term to be more broadly defined to include actions a firm can take to exploit uncertainty. This may include increasing, rather than decreasing, a firm's exposure to some types of risk when a firm believes that increasing the risk will give it an advantage over its competitors.

Hence, it's important to distinguish between risk hedging, which is protecting against risk and is product/financial-based, and risk management, which is using risk to gain advantages and is strategic in focus.

The author looks at risk hedging and risk management in simulations using typical valuation metrics (discounted cash flow valuation, relative valuation, and option-pricing models). While hedging risk in simulations reduces the standard deviation in the value of the firm as a stand-alone investment, this may not translate into an increase in firm value.

On the other hand, risk management can lead to big payoffs, but it often fails to draw emphasis from a firms' financial managers. This is due to a few reasons. One is that, due to an emphasis on strategic rather than financial considerations, risk management is pushed into the realm of corporate strategy. Also, tracing the benefit from risk management is much more difficult than tracing the payoff from risk hedging.

Critical components for calculating personal goodwill

Identifying and Measuring Personal Goodwill in a Professional Practice, **Mark O. Dietrich,** *CPA Expert,* Spring 2005, pp. 6-11.

Distinguishing personal goodwill from enterprise goodwill can influence tax planning, and valuations, whether for partnership, marital dissolution, or allocation of purchase price for tax or financial reporting purposes. In the marital realm, personal goodwill is not a divisible asset in some jurisdictions, and the status of such goodwill is uncertain in many others. In tax planning, allocating proceeds of a sale of a business to personal goodwill and/or a noncompete agreement can reduce or eliminate the amount recognized as corporate gain and the related corporate-level tax.

In differentiating personal from enterprise goodwill, there are two fundamental issues: (1) identifying which portions of cash flow are attributable directly to the individual's characteristics; and (2) identifying which cash flows attributable to otherwise enterprise-level tangibles and intangibles would be lost if the individual competed. The noncompete value is a portion of the value of personal goodwill.

A noncompete agreement that is unenforceable is not worth much. An analyst should factor enforceability into the value of a noncompete. Courts in many states have moved to restrict enforceability of noncompetes when public policy is an issue, such as noncompetes that, by their nature, restrict free access of a patient to his or her physician. Some other states have interpreted noncompetes to find that separate consideration is not necessary.

Reasonable compensation can be a key assumption when valuing a professional practice. One must understand both how much compensation is earned and what the sources of that compensation are. Simply taking median or mean compensation for a particular position, without considering the individual's productivity, work habits, would be insufficient.

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