

## **The Tax Court Excludes Draft Reports from Discovery**

Following the trend in federal district and circuit courts, the U.S. Tax Court recently amended its Rules of Practice & Procedure to exclude the draft of expert reports from discovery “regardless of the form in which the draft is recorded.”

Also in order to align with the federal rules, Rule 70 now protects communications between experts and attorneys from discovery with three important exemptions relating to communications that contain:

- The expert’s compensation;
- Facts or data that the attorney identifies for the expert; and
- Assumptions that the attorney provides to the expert.

The new Tax Court rules also protect the reports and opinions of any consulting, i.e. non-testifying expert. The rules became effective in July, 2012. Since no opinion has been issued relating to the revised rules, some “grey” issues can be expected to arise.

## **The Delaware Court of Chancery Continues to Have Profound Influence on Business Valuation**

Because it hears more business valuation cases than any court in the land, The Chancery Court has had occasion to decide important business Valuation theory and practice over the years. While the job of the business appraiser is, of course, not to cite cases as the basis of value conclusions, the decisions will undoubtedly help guide the profession in presenting more convincing reports in any venue and for any client.

Selection of the appropriate Equity Risk Premium [“ERP”] is an important step in developing a reasonable cost of equity. In *Global GT LP v. Global Telecom, Inc.* CA No. 3698-VCS filed January 27, 2010 the Chancery Court rejected the blind use of the Ibbotson ERP and instead chose a lower estimate. It supported its decision by noting that Ibbotson uses as reference the period of 1926 to the present, but that the starting year was utterly arbitrary. Instead, the Court suggested using the “supply-side” ERP calculated by Ibbotson.

In *Re. Appraisal of Orchard Enterprises, Inc.* CA 5713 filed July 18, 2012, the

Court approved the use of sum or lag beta for applying the CAPM model to a small private company. Later, the Court objected to using a particular sub-set of the Ibbotson size premium data without first inquiring about comparability of smaller public companies - of which many are financially weak if not distressed - to a healthy, if small private company. In *Tull N. Gearreald et al. v. Just Care, Inc.* CA number 5233-VCP filed April 30, 2012 the Court distinguished between the impact of illiquidity on the cost of capital and illiquidity of a shareholder's interest.

In recent years, the Court has indicated that there is never just one acceptable solution to a BV problem. We should carefully listen to these judges.

### **Five Drivers of Physician Practice Value**

Many hospitals, although not many in the Northeast U.S. are buying physician practices these days, and this article goes over some of the observed key value drivers.

**Practice Extenders:** Physician's assistants and nurses can generate healthy revenues at lower compensation cost. Many sold practices accordingly use them as much as possible. In addition, malpractice cost is generally less for extenders personnel than for physicians, and as a result of the new healthcare law more people will be covered and the existing physician population may become overextended.

**Ancillary services:** Many of the larger practices feel they can justify in-practice CT or MRI machines, which also impacts the growth of the top line. Clearly, the compensation scheme before and after the buy-out must take this in account; everything else being equal, the new services would fall to the bottom line and result in a higher value, rather than be distributed among the physicians. Key regulations, of course, do apply.

**Payer Mix:** this has a high impact on the value of the practice. Entities with a high proportion of commercial insurer/reimbursers are worth more because the government-controlled payers such as Medicare pay less for the same service, and are expected to react less quickly to market changes. Reimbursements for primary care, however, is expected to benefit under the government-sponsored payors.

**Commercial rate reimbursements:** while a higher proportion of commercial insurers is good for a practice, it becomes a difficult area for the larger practices: while on one hand they can negotiate advantageously with the insurer, that can be a double-edge sword as larger insurer may use their market clout to reduce rates and slow down annual increases.

**Overhead considerations:** An overhead pegged too high will, of course, reduce profitability and thus value. Accordingly, it is wise to periodically benchmark overhead and staffing levels to recognized industry statistics. The buyer will only be

interested if there is a positive carry !

While determining the fair market value of a practice in accordance with legal and regulatory requirements is complex, it is also important to review with the relevant parties how the above key drivers affect the final number, in order to assure a no-surprise take-over.

### **Healthcare Value Statistics Show Interesting Patterns**

According to Edwin Levin Associates, the level of M&A activity involving only providers of healthcare, i.e. practices, expressed in number of transactions, was 13% higher in 2011 than 2007.

Based on Goodwill Registry data for 2002 through 2011, the specialty areas where goodwill is most significant to the practice values include: general dentistry where goodwill amounts to 46.9% of selling prices and other dentistry specialties such as oral and maxillofacial surgery [44.6%,] orthodontia [48.3%,] pedodontia [49.9%,] periodontia [45.2%.] Optometrists also sell their practices at values including high levels of goodwill [33.2%.]

This does not compare well with such key medical specialties as cardiology [24.2%,] dermatology [25%,] internal medicine [20%] and family practice at 28.9%. In fact, goodwill has increased in the dental field while it has decreased in the other medical fields since 2007. It is possible that the difference is attributable to the fact that dentists generally do not have to deal with insurance carriers and thus can afford lighter overheads..

When it comes to control premium paid in public company acquisition of medical practices, the premium, in 2011, was lower than it was in 2007. This is based on MergerStat statistics collected on the premium offered by acquiring firms. Healthcare reform, anyone ?

### **New Data Offers Support for Appraisal Assumptions**

When I started in business valuation, there were a few databases of sold businesses, such as the IBA which in retrospect is not all that useable. Other databases were created such as the Prattsstats.com service which is more detailed, and occasionally can be used to support the value of a small business through a market approach to value. New contributions to the art focus not on the market approach but primarily on the income approach, helping supporting the discount rate by reference to specific market transactions. In particular, the Pepperdine Private Capital Market Survey and related Private Cost of Capital Model accesses the costs of financing and equity for firms and - assuming the subject company is comparable to underlying transactions in database, does provide strong evidence of value, particularly for capital intensive firm with heavy intangible assets.

On the other hand, some benchmarks such as RMA, based on bank borrowers' financial characteristics by industry, are losing their usefulness because so many transactions these days take place outside of the commercial banking system.

Then there are informal private company interest exchanges such as SecondMarket.com where the larger private companies can see their minority interests traded; this is typically of interest only to companies with good quality, public company-like financial information, and/or attempting to time a future IPO. Of course, comparisons between a trade on this type of exchange and a totally private company can also be made, particularly when the business model is "fashionable" e.g. anything connected with social media during the past year.

### **Happy New Year 2013 to our Clients & Friends !**

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**J.L. Pierson, ASA is an experienced business appraiser covering the tri-state area from his base in Darien, CT. His clients are closely-held businesses with revenues of up to \$250 million, as well as owners of family limited partnerships and professional corporations. He specializes in business valuation for estate/gift tax, succession planning, and litigation such as shareholder disputes and divorce, corporate development and other transactional support purposes.**

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