

Valuation Issues in the Coming Wave of Goodwill and Asset Impairments

By Bala G. Dharan, Ph.D., CPA

Widespread stock price declines and recessionary conditions will significantly affect corporate valuation and financial reporting of goodwill and long-term assets. The S&P 500 index, which represents a broad cross-section of the economy, declined by about 38.5 percent in 2008—its worst performance since 1937—and the stock market fell another 15 percent in the first two months of 2009. While the financial sector represented in the S&P 500 index declined the most in this period, all ten sectors represented registered significant double-digit declines.

Accounting standard FAS 144¹ requires companies to periodically assess the fair value of long-term assets and take impairment charges to the extent the fair value decline is considered other than temporary. In addition, FAS 142² requires that accounting goodwill be periodically assessed for impairment and written down to fair value. Since these standards require a fair value assessment, they are covered by the fair value disclosure standard FAS 157.³ FAS 157 defines fair value as the price at which an asset can be sold or a liability can be settled, and requires that the valuation process used by the company reflect market participants' views. This means that valuation model inputs, such as cash flow projections, cost of capital, and discount rates, should incorporate current market conditions and market participants' views.

Similarly, market-related data used for valuation procedures, such as the guideline public company method or guideline transaction method, should reflect current market conditions and market participants' views.

Given the widespread stock price declines and the deepening recession, it is not surprising

Continued to next page...

Fair Value Accounting & Litigation: The Next Wave of Valuation Risk

By Antonio Yanez Jr.

Some blame fair value accounting requirements for aggravating the economic downturn by requiring write-downs that exaggerate asset value declines. Others say that fair value accounting is the best method of recording asset values and that to blunt the effects of fair value accounting requirements would simply prolong the problem.

Continued to page 5...

INSIDE THIS ISSUE

Special Report.....7

Is Mergers & Acquisitions Deal-Making Dead, Dying, or Primed for Resuscitation?

There's no denying that the world of mergers and acquisitions (M&A) has changed dramatically, particularly in the months since year-end 2008.

In the News.....9

Fair Value: An Imperfect System Produces Flawed Results, Damodaran Says

When it comes to fair value, many business valuation experts are over a barrel.

Legal & Court Case Updates.....12

—*Estate of Litchfield v. Comm'r*

—*Mass. Eye and Ear Infirmary v. QLT Phototherapeutics, Inc.*

—*Gaskill v. Robbins*

—*Cannon v. Bertrand*

—*Negron v. U.S.*

—*Denny Construction Inc. v. City and Co. of Denver*

BVRConferences.....23

Calendar.....23

Cost of Capital24

Discount Metrics24

Executive Editor: Lisa Isom
 Legal Editor: Sherrye Henry Jr.
 Contributing Editors: Paul Heidt & Adam Manson
 Publisher: Doug Twitchell
 Production Manager: Laurie Morrissey
 President: Lucretia Lyons
 Customer Service: Stephanie Crader
 Sales: Linda Mendenhall
 Chair and CEO: David Foster

EDITORIAL ADVISORY BOARD

| | |
|--|---|
| NEIL J. BEATON, CPA/ABV, CFA, ASA Grant Thornton Seattle, Wash. | Z. CHRISTOPHER MERCER, ASA, CFA Mercer Capital Memphis, Tenn. |
| JOHN A. BOGDANSKI, Esq. Lewis & Clark Law School Portland, Ore. | JOHN W. PORTER Baker & Botts Houston, Texas |
| NANCY J. FANNON, ASA, CPA/ABV, MCBA Fannon Valuation Group Portland, Me. | JAMES S. RIGBY, ASA, CPA/ABV IN MEMORIAM (1946 – 2009) |
| JAY E. FISHMAN, FASA, CBA Financial Research Associates Bala Cynwyd, Pa. | RONALD L. SEIGNEUR, MBA CPA/ABV CVA Seigneur Gustafson Lakewood, Colo. |
| LYNNE Z. GOLD-BIKIN, Esq. Wolf, Block, Schorr & Solis-Cohen Norristown, Pa. | BRUCE SILVERSTEIN, Esq. Young, Conaway, Stargatt & Taylor Wilmington, Del. |
| LANCE S. HALL, ASA FMV Opinions Irvine, Calif. | JEFFREY S. TARBELL, ASA, CFA Houlihan Lokey San Francisco, Calif. |
| JAMES R. HITCHNER, CPA/ABV, ASA The Financial Valuation Group Atlanta, Ga. | GARY R. TRUGMAN, ASA, CPA/ABV, MCBA, MVS Trugman Valuation Associates Plantation, FL |
| JARED KAPLAN, Esq. McDermott, Will & Emery Chicago, Ill. | KEVIN R. YEANOPLOS, CPA/ABV/CFF, ASA Brueggeman & Johnson Yeanoplos, P.C. Tucson, AZ |
| GILBERT E. MATTHEWS, CFA Sutter Securities Incorporated San Francisco, Calif. | |

Business Valuation Update[™] (ISSN 1088-4882) is published monthly by Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035. Periodicals Postage Paid at Portland, OR, and at additional mailing offices. Postmaster: Send address changes to *Business Valuation Update*[™], Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035.

The annual subscription price for the *Business Valuation Update*[™] is \$339. Low cost site licenses are available for those wishing to distribute the *BVU* to their colleagues at the same address. Contact our sales department for details. Please feel free to contact us via email at customerservice@BVRresources.com, via phone at 503-291-7963, via fax at 503-291-7955 or visit our website at BVRresources.com. Editorial and subscription requests may be made via email, mail, fax or phone.

Please note that by submitting material to *BVU*, you are granting permission for the newsletter to republish your material in electronic form.

Although the information in this newsletter has been obtained from sources that BVR believes to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal, or consulting advice.

Copyright 2009, Business Valuation Resources, LLC, (BVR). All rights reserved. No part of this newsletter may be reproduced without express written consent from BVR.

Goodwill and Asset Impairments

that several companies have in recent weeks announced large write-downs of goodwill, intangible assets, and other assets. Recent corporate announcements of multi-billion dollar goodwill and asset write-offs include Time Warner (\$25 billion), ConocoPhillips (\$35 billion), Regions Financial (\$6 billion), and Royal Bank of Scotland (\$33 billion⁴). One should expect to see more such announcements of asset write-offs in the coming weeks and months. Goodwill is particularly vulnerable to large write-offs. Because of the wave of mergers and acquisitions that started in the late 1990s, goodwill is now a large percentage of the total assets of many corporations, so goodwill write-offs, when they occur, can be significant. In general, technology, media, energy, and consumer products companies tend to have large goodwill accounts due to industry consolidations and acquisition activities. For some technology companies, such as Cisco Systems, Inc., goodwill is the largest non-current asset on the balance sheet.

According to a research report cited by *The Economist*, goodwill in corporate balance sheets totals about \$2.6 trillion.⁵ A large portion of this goodwill undoubtedly resulted from mergers and acquisitions completed at the height of the stock market valuation in the 2004-2007 period. These transaction valuations have to be reassessed given the stock market decline and the recession's effect on projected cash flows. It is easy to see that the resulting goodwill write-off may add up to several hundreds of billions of dollars, rivaling in magnitude the initial wave of 2008 losses recognized from mortgage-related assets.

If history is any guide, we may also see several lawsuits against companies—and their advisors—following the asset impairment announcements related to the amount and the timing of these impairment charges as well as the alleged damages based on stock price declines. A late-2008 impairment announcement by CBS Corporation provides an illustration. During 2008, the stock price of CBS declined considerably, falling almost 50 percent by September 30, 2008.⁶ On October 10, 2008, the company announced that “as a result of adverse market conditions,” it conducted an impairment analysis of goodwill and intangible assets that resulted in a goodwill write-off of about \$9.6 billion and an additional write-off of about \$4.6 billion in other intangible assets. In December 2008, a purported class action lawsuit was filed against the company

Goodwill and Asset Impairments

alleging, among others, the “failure to timely write-down impaired intangible and goodwill assets.”

Goodwill write-offs and stock price declines. For goodwill and other non-financial assets, the purpose of periodic fair value evaluation is to determine whether “impairment” in the value of the asset has occurred, i.e., whether the fair value of the asset is less than the asset’s balance sheet “carrying value.” If the fair value evaluation suggests that an “other than temporary” impairment of fair value has occurred, then the company must write-down the carrying value of the asset on the balance sheet to the estimated fair value and recognize a corresponding impairment charge (loss) in its income statement. Factors considered for tests of impairment vary by the type of asset evaluated. In testing the goodwill asset for impairment, the market capitalization of the firm is often considered relevant. This is why the recent stock price declines are likely to lead to an increase in goodwill impairment tests, although a falling stock price is neither necessary nor sufficient for the recognition of impairment of goodwill or other assets.

To understand why stock price declines could precipitate a goodwill impairment test, it is useful to review the accounting basics for goodwill recognition and write-off. The goodwill account on the balance sheet is created when a firm acquires another firm or its assets and liabilities for a price that is in excess of the estimated fair values of the individual assets and liabilities acquired. FAS 142 requires that fair values are first determined at the so-called reporting unit level for all identifiable assets and liabilities acquired, including acquired intangible assets such as brands, royalties, and copyrights. Goodwill is then the excess of the price paid over the fair values of all identifiable assets less liabilities acquired.

Goodwill thus essentially represents unidentifiable intangible benefits from acquisition. For example, FAS 142 suggests that goodwill may be due to, among others, the “control premium” over fair values that a buyer would pay to get acquisition-related synergies. FAS 142 states: “Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity...An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed

its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit.”⁷

Impairment and consideration of stock prices. FAS 142, of course, requires that goodwill, once created, should be carried indefinitely at its original value without amortization unless an impairment analysis of the fair value of the reporting unit level indicates that goodwill has been impaired. Such a test for goodwill impairment must be done at least annually and also in the interim between annual tests “if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.”⁸

FAS 142 lists several examples of events or changed circumstances that might require an interim test for goodwill impairment. Although none of these examples specifically refers to a decline in the stock market value of the company as a trigger for goodwill impairment analysis, major accounting firms have stated that a significant stock price decline may be a potential event or changed circumstance requiring an impairment analysis for goodwill. For example, an Ernst & Young publication dated October 2008 states: “A significant decline in a company’s stock price may suggest that the fair value of one or more reporting units has fallen below their carrying amounts. Similarly, declines in the stock prices of other companies in a reporting unit’s industry may suggest that an interim test for goodwill impairment is required.”⁹ Similar comments on the potential for goodwill write-offs due to recent stock price declines have been included in recent publications by other major accounting firms.¹⁰

The SEC’s view on stock price decline and goodwill impairment. The Securities and Exchange Commission (SEC) has also said that it expects more goodwill impairment than usual due to the recent declines in stock prices. Robert Fox, III, a Professional Accounting Fellow at the SEC, said at a recent accounting conference that the need to test for goodwill impairment required judgment and that “this judgment may be more challenging in the current environment due to recent market declines that indicate that a potential impairment exists.”¹¹ He added that the SEC “would expect more goodwill impairment than in recent years...” in the upcoming financial filings.

At the same conference, Steven Jacobs, an Associate Chief Accountant at the SEC, indicated that a “decline in market capitalization below book

Goodwill and Asset Impairments

value,” including the “duration and severity of [the] difference,”¹² would be an impairment testing indicator for goodwill, assuming factors such as short-term volatility are ruled out as the causes. More interestingly, Mr. Jacobs noted that even in cases where a current impairment charge of goodwill is not taken, companies may be required to provide “early warning disclosures” of potential future goodwill impairment charges if there is a reasonable possibility of loss. These remarks by SEC staff members suggest that the SEC would be looking for an explanation from corporations on how they considered current stock price declines when analyzing goodwill impairment.

The SEC staff appears to have already made these kinds of inquiries during 2008 in some of its “comment letters” sent to companies requesting clarifications related to their 10-K and 10-Q filings. For example, in a comment letter to Regions Financial Corporation dated June 17, 2008, the SEC staff asked the company to explain, “How you determined that your goodwill balance is not impaired. Please specifically address how you took into consideration the fact that you have been trading at a market value that is below your book value.”¹³ The company, in its reply filed on July 1, 2008, responded that, “management could not conclude that [lower market value] was a long-term trend, particularly when our stock price was trading above book value in the fourth quarter of 2007. Further, given the relatively small difference between our stock price and our book value per share, we determined that a potential buyer would offer a control premium for our business franchise that would adequately cover these differences between trading prices and book values.”

As Regions Financial explained, a commonly claimed mitigating factor when the market value of a company is below its book value is whether the goodwill on the balance sheet represents (or may be justified by) the control premium that a current buyer would pay for the company. Clearly, there is judgment involved in determining the amount of control premium for a reporting unit. However, the SEC’s Fox, the speaker at the above-mentioned AICPA national conference, cautioned that companies should be prepared to justify the assumptions of control premiums that current buyers would pay given the significant fall in stock prices last year. Fox said, “I would also note that the amount of supporting evidence supporting your judgment would

likely be expected to increase as any control premium increases.”

Valuation and economic effects. Goodwill and asset impairment charges are generally considered “non-cash” in nature, i.e., they affect earnings but not cash flows from operations. Nevertheless, there may be stock price effects from goodwill announcements depending on the extent to which the information is a surprise to the market. In addition, stock price effects will also depend on whether the impairment charges could affect a company’s future operations and cash flows.

The effect on cash flows is hard to predict, and it would depend on how the impairments—and the resulting earnings decline—affect the company’s loan covenants, employment agreements, compensation plans, etc. Goodwill and asset impairment will also affect several financial ratios used in loan covenants and used by financial analysts to evaluate risk and returns. For example, large goodwill or other asset impairments would increase the debt-equity ratio and could cause violations of some ratio-based loan covenants. There could also be analyst rating changes and credit rating changes that could increase the cost of borrowing. Earn-out contracts and contingency payments related to mergers and acquisitions could be dependent on reported earnings, which could affect the cash flows related to these contracts. Valuation specialists and accountants need to consider these potential effects in evaluating the possible valuation consequences of goodwill and asset impairment.

About the author: Bala Dharan is a vice president in the financial accounting and valuation group at CRA International, Inc., a global business, financial and economic consulting firm. Dharan is also a visiting professor of accounting at Harvard Law School.

1. Statement of Financial Reporting Standard No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets,” Financial Accounting Standards Board, August 2001, as amended. The corresponding International Financial Reporting Standard (IFRS) 5, “Non-current Assets Held for Sale and Discontinued Operations,” International Accounting Standards Board, is similar to FAS 144.
2. Statement of Financial Accounting Standard No. 142, “Goodwill and Other Intangible Assets,” Financial Accounting Standards Board, June 2001, as amended. The corresponding international financial reporting standard is similar. See IAS 36, “Impairment of Assets,” International Accounting Standards Board.

Goodwill and Asset Impairments

3. Statement of Financial Accounting Standard No. 157, "Fair Value Measurements," Financial Accounting Standards Board, September 2006, as amended. The International Accounting Standards Board (IASB) has not yet issued a corresponding standard covering fair value definition, but it issued a discussion paper, "Fair Value Measurements," in November 2006 in which it has indicated its "preliminary view" that the FASB's fair value definition based on exit value "is an improvement on the disparate guidance in IFRS."
4. See "Goodwill Hunting: Balance Sheets' Latest Torment," Barron's, February 24, 2009, for examples of other recent goodwill writeoffs.
5. "Corporate Write-downs: The Goodwill, the Bad and the Ugly," The Economist, January 29, 2009.
6. The company only reported after-tax writeoff amounts, and before-tax amounts given here are estimates.
7. FAS 142, para. 23, as amended by FAS 157, para. E22 d.
8. FAS 142, para. 28.
9. "Recent Market Events: Accounting and Reporting Considerations," Ernst & Young, October 7, 2008.
10. See, for example, "Mergers & Acquisitions—A Snapshot," PricewaterhouseCoopers, December 2008.
11. Remarks by Robert G. Fox III before the 2008 AICPA National Conference on Current SEC and PCAOB Developments, December 8, 2008. Available at the SEC website.
12. Remarks in presentation slides of Steven Jacobs before the 2008 AICPA National Conference on Current SEC and PCAOB Developments, December 9, 2008. Available at the SEC website as part of the presentation by Chief Accountant Wayne Carnall.
13. Regions Financial Corp., Form CORRESP, filed July 1, 2008.

Fair Value Accounting & Litigation

...continued from front page

There is much to recommend fair value accounting. But, whatever the merits of the various positions, fair value accounting is having a significant impact in a number of areas, among them accounting-related litigation and securities class actions in particular. While the impact probably cannot be fully appreciated at this point, a number of implications for litigation are beginning to stand out:

Issued in late 2006, the "Statement of Financial Accounting Standards No. 157" or "FAS 157" took effect for fiscal years beginning after November 15, 2007 and interim periods within those years (though earlier application was encouraged).

In general terms, FAS 157 defines "fair value" and establishes a framework for measuring fair

value. The definition is that "[f]air value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The framework involves, among other things, reference to a "fair value hierarchy" of inputs considered in valuation. First are "Level 1 inputs," or "quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date." Second are "Level 2 inputs," which are inputs "other than quoted prices included within Level 1 that are observable for the asset or liability," for example, quoted prices for comparable assets. Third are "Level 3 inputs," which are "unobservable" and to be "developed based on the best information available in the circumstances," for example, where there is no active market for an asset. FAS 157 prioritizes inputs ranked higher in the hierarchy (Level 1) over those ranked lower in the hierarchy (Level 3).

With that context, three key implications for litigation of fair value accounting stand out:

1. Fair value accounting appears to be contributing to an increase in accounting-related litigation and securities class actions in particular. Before 2007, a downward trend in securities class action filings appeared to be emerging. Different explanations were offered for the trend. Some said that the Sarbanes-Oxley reforms had wrung manipulation out of the system. Others focused on improvements by the accounting profession. But perhaps the most commonly cited factor was the relative absence of stock price volatility.

Fair value accounting can be expected to increase stock price volatility which, in turn, will likely lead to more litigation. Quarter after quarter, investors get information about changes in the value of certain assets, and they will react to those changes. Stock prices will go down if asset values decrease. And, there will be investors who assert that the stock price dropped because the market was earlier misinformed. More than that, investors will have an economic incentive to make that assertion in litigation because the size of a stock price drop is a factor in the damages that potentially can be collected.

Indeed, an increase in litigation is already apparent. In 2008, 210 securities class actions were filed compared to 176 in 2007, according to *Securities Class Action Filings—2008: A Year in Review*, an annual report prepared by the Stanford Law

Fair Value Accounting & Litigation

School Securities Class Action Clearinghouse in cooperation with Cornerstone Research. A significant number of these cases were brought against financial institutions, almost all featuring fair value-related allegations.

None of this is to suggest that the benefits intended to be achieved through fair value accounting are outweighed by the costs of increased litigation. Proponents point out that fair value accounting provides the most transparent information—which is of immeasurable value to investors, counterparties, potential merger partners, and others. Nor does an increase in securities litigation necessarily mean that the defendants in those cases (financial statement preparers, auditors, and others) are more likely to lose. However, an increase in litigation is likely and, in fact, already appears to have begun.

2. Fair value accounting litigation will focus on judgment. The judgment of financial statement preparers and auditors will likely be a focus in fair value litigation. There may not be much judgment involved in selecting a Level 1 input. A market price for an identical asset is what it is. But there is judgment in valuations involving Level 2 and Level 3 inputs. For example, there is judgment in determining whether assets are sufficiently analogous to permit Level 2-type comparisons and in selecting and using Level 3 inputs.

Those judgments are being second-guessed aggressively in litigation, and likely will be in the future. The types of allegations being made—and which can be expected to resonate—include claims that valuation models failed to appropriately consider factors reflecting deterioration in asset values, and that write-downs should have been made earlier than they were (both matters of judgment). There are allegations suggesting a failure to properly expose to whatever it was that was written down—put differently, that judgments about the content of disclosure were improper. There are allegations that warnings about write-downs should have been issued before the write-downs themselves were taken (also a matter of judgment). And there are allegations suggesting a failure to maintain systems that would have limited exposure in the first place to what was written down (again, a judgment call).

Recent U.S. Supreme Court precedent also ensures that this focus on judgment will begin from the early stages of securities litigation. In 2007, the Supreme Court issued a landmark decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, which held that

before a securities case can get to discovery, a court must weigh the allegations in the complaint and decide whether they suggest fraud or the absence of fraud. Where the suggestion of fraud is at least as strong as the absence of fraud, the case goes forward; otherwise, it does not. What that means in fair value lawsuits is that courts will have to concentrate right from the outset on the allegations about the accounting judgments—that is, the selection of inputs, the decisions about disclosure, the design of internal systems, and everything else—and decide whether they appear to be tainted by fraud or were made in good faith. And the focus on judgment will continue throughout the lawsuit.

This focus on judgment, too, is not necessarily a negative development even for the defendants. Pointing to good judgment exercised in good faith can be very effective with juries. But judgments are going to be questioned.

3. Fair value accounting brings to a head a conflict between the evolution of financial reporting on the one hand, and our system of litigation on the other. Fair value accounting is one aspect of an evolution in financial reporting that seeks to give users of financial statements more timely and more useful information even though that information may be more judgment-driven. For example, measuring value based on historical cost would involve significantly less judgment but also could be significantly less useful. At the same time, our system of litigation permits those judgments to be second-guessed. And while more litigation and an increased focus on judgment is not necessarily a negative development for financial statement preparers, the fact remains that the process of litigating is expensive and disruptive even if one prevails at the end of the day.

So, there is the conflict. On the one hand, there is an evolution in financial reporting intended to benefit the users of financial information. On the other, given our system of litigation, that evolution will likely subject those that prepare financial statements to the expense and disruption of increased litigation. And the question is whether anything is going to be done about that. There have obviously been calls for reform for some time, but fair value accounting brings the need for reform into focus like never before.

About the author: Antonio Yanez Jr. is a litigation partner with Willkie Farr & Gallagher LLP and a member of the law firm's Securities Litigation & Enforcement practice group.

SPECIAL REPORT

Is Mergers & Acquisitions Deal-Making Dead, Dying, or Primed for Resuscitation?

By Steven M. Levitt and Jaime Carvallo

There's no denying that the world of mergers and acquisitions (M&A) has changed dramatically, particularly in the months since year-end 2008. Data from the latest twice-yearly survey of middle market merger professionals conducted by Thomson Reuters and the Association for Corporate Growth (ACG) show that the volume of all worldwide mergers and acquisitions totaled \$2.4 trillion in announced deals during the first three quarters of 2008, a decrease of 28% over the record-breaking first three quarters of 2007.

Interestingly, of this total, M&A deals in the mid-market, defined by Thomson Reuters as transactions under \$500 million, fared better. Less reliant on the global credit markets, they declined only 16%, with a total value of \$569.6 billion.

Will 2009 be any better? Remember, however, history is on the side of companies that buy at the bottom. Attractive valuations, the drive toward consolidation within certain industries, and the need for capital by many organizations will spur a series of deals—echoing the experience of previous crises of the 1930s, 1970s, and late 1980s. This article focuses on likely deal activity in the asset & wealth management industry. Some of the industry challenges likely to contribute toward consolidation include:

1. Accelerated market declines. We have just closed the year that appears to be the worst for U.S. equity market performance since the Great Depression. While asset managers do have recent experience with an equity market decline in excess of 40% (which is around what most equity markets dropped during 2008), this decline occurred over a multi-year period between 2000 and 2002 upon the burst of the Internet bubble. At that time, the dividend-adjusted S&P 500 index declined about 9%, 12%, and 22% for those three calendar years, respectively.

This time around, however, the speed of the plunge has been sudden and shocking, and will make it difficult for some managers to right size their businesses and restore profitability quickly enough. In addition, today's markets are atypically experiencing declines across virtually all as-

set classes, as seen in the public debt and bank loan markets, where securities currently trade well below par, even for many investment grade companies.

2. Market effects on assets under management (AUM). Market performance and net asset flows are the two primary drivers of AUM. The effects of the market during 2008 on managers' assets were drastic. Data provided by Moody's indicates that the AUM levels for 11 publicly-traded asset managers between September 2007 and September 2008, a period when the S&P 500 declined 26%, dropped over this period by 15% for 7 of the 11 firms studied. Even those with a relatively high percentage of fixed income AUM suffered casualties. To add to the severity of this situation, by the end of December 2008 some firms, mostly equity-focused, experienced AUM declines in the 40% - 50% range. Even firms with a sizable fixed income presence in some cases experienced AUM declines of between 20%-30% for the 2008 calendar year.

3. Flow effects on AUM. Data from The Investment Company Institute and Lipper indicate that the impact of market weakness on long-term fund flows is dramatically worse today than that experienced from 2000-2002. Investors withdrew \$320 billion from mutual funds during 2008. Much of the cash withdrawn was allocated to money market funds that saw inflows of over \$420 billion during the year. Since revenues and earnings before interest, taxes, depreciation, and amortization (EBIDTA) margins in the asset and wealth management industry are directly tied to AUM, it is clear that the above effects have placed significant pressure on the profitability of many industry participants. Such firms generally benefit from operating leverage during up-markets.

In turn, the impact is magnified during down-markets as the decline in revenues is not matched by an equivalent decline in fixed expenses. Quickly implementing expense cuts—including reductions in headcount, performance-based compensation, and general and administrative costs—can be challenging, particularly when groups need to ensure retention of their best and brightest now more than ever.

Is M & A Deal-Making Dead?

4. Valuation adjustments and other challenges. Pressure on AUM has ultimately placed pressure on firms' valuations: when AUM drops, profitability drops thereby, translating to a decline in a firm's value. Firms are affected irrespective of their strong or weak (relative) investment performance. The number of firms at risk of failing has clearly increased, and some bottom-fishers, including numerous private equity groups, are on the prowl for bargain basement prices. At the same time, many successful firms that otherwise might have entertained transaction discussions are electing to hold off for fear of selling at the bottom of the market.

Valuation discussions are particularly difficult in the context of firms who are in the late stages of transaction discussions. Several months ago, some groups thought they had pricing and deal structures agreed; such presumptions soon proved to be false. To the extent a deal price was fixed, in many cases the buyer now no longer wishes to honor the price. To the extent a multiple was agreed, with the AUM of some firms down 20-50%, firms' valuations are drastically lower since September 2008, thereby deterring some sellers from completing transactions. One buyer of wealth management firms, who consummated four transactions during the first three quarters of 2008, reports a decision to hold off on deal-making for the foreseeable future given the expectation of a challenging 2009.

Does this mean that deal making in the asset & wealth management industry is dead or should be dead? In many instances, a strong rationale to transact will continue to exist:

- Many firms face succession-planning issues that need to be addressed and which are independent from short- or medium- term market moves.
- A major reason firms transact is to achieve access to marketing and distribution. Deals can provide firms with access to new markets that would be otherwise too costly or too difficult for them to tap independently.
- A desire for liquidity, which means taking some money and risk off the table.
- The need and desire to gain access to centralized administrative and operational services—thereby allowing professionals to focus on wealth management, investment management, and research.

- A transaction may position two entities to better “weather the storm” of 2009 and achieve a more promising combined future.

Successful deals happen when each side reflects hard on their deal must-haves and non-starters, and are not frustrated when the pricing and deal structure require extended negotiation or re-negotiation. An important aspect of flexibility involves both sides being open to considering price adjustment mechanisms. For instance, buyers often consider agreeing to a fixed price so that sellers need not deal with the anxiety of witnessing their firms' values substantially move daily prior to signing. Additionally, sellers are now more open to price adjustment mechanisms that involve reduced amounts paid at closing with greater amounts earned at later points should the market recover to certain levels.

One example of a deal undeterred by a challenging market environment is the recent sale of a wealth manager in the Midwest to a larger wealth management organization. To keep the deal alive, terms were re-negotiated. The new terms included a reduced valuation at closing, and thus a lower closing payment. After jointly exploring multiple options with the buyer multiple options, the seller agreed to a revised deal structure that included easier earn-out tests that could potentially allow for larger future contingent payments. Such a structure was intended to potentially allow the seller to recover a meaningful portion of the value lost at closing.

About the authors: Steven M. Levitt leads and co-founded Park Sutton Advisors, a New York City-based boutique investment bank and wealth management firm. Levitt has focused on middle-market M&A and strategic advisory work in the financial services sector for the past 12 years working with asset and wealth managers, broker-dealers, and fund administrators globally. Levitt can be reached at Steven.Levitt@ParkSuttonAdvisors.com. Jaime Carvallo co-founded Park Sutton Advisors. Prior to Park Sutton, Jaime spent eight years advising Latin American high-net-worth individuals representing over \$500 million in assets. Most recently, he was a Private Banker with Deutsche Bank, actively involved in developing the Andean Region client base for the bank's New York office. Carvallo can be reached at Jaime.Carvallo@ParkSuttonAdvisors.com.

IN THE NEWS

Fair Value: An Imperfect System Produces Flawed Results, Damodaran Says

When it comes to fair value for financial reporting, many business valuation experts are over a barrel. There is a reason for the conundrum: “If you put good people into a flawed system, you will get bad results,” Aswath Damodaran, professor of finance and David Margolis Teaching Fellow at the Stern School of Business at New York University, told some 200-plus attendees at the *BVR*’s recent 2nd Annual Fair Value for Financial Reporting Summit in New York City. “I think fair value [for financial reporting] is a flawed system and it gives bad results,” the always-candid professor explained.

To get a better handle on fair value’s shortcomings—and possible solutions—Damodaran says it helps to “think like an accountant.” In doing so, he developed three perspectives on why the current system came to be:

1. The Dreamer. These fair value proponents “actually see a day when accounting balance sheets will replace the market,” Damodaran said. In their vision, investors would not look to the market to assess a company’s fair value—but at its accounting statements.

2. The Pragmatist. Pragmatists believe that if we can mark up assets to fair value, then investors will have a better idea of a firm’s “true value,” which will lower uncertainty and the variance in values. “This story has resonance,” Damodaran said.

3. The Marginalist. Fair value accounting, even if imperfect and “noisy,” will give investors additional, useful information by which to estimate a company’s value and risk.

Each of the three approaches is fundamentally flawed, Damodaran contends. *For example:* The dreamer may be reacting in part to a financial world in which accounting numbers such as earnings, book value, etc., seem to matter less and less. This is upsetting, and understandably, accountants want to develop numbers that companies and investors will “care about again,” he said. So they took apart the traditional balance sheet, trying to compensate for its faults and weaknesses, and came up with the “intrinsic value” balance sheet that records assets not at their original cost but at their expected

growth, cash flows, and risk. Similarly, fair valuing liabilities reflect their fixed claims on cash flows (debt) and residual claims (equity).

Such efforts were more like embarking on the “impossible dream,” he told attendees. “Even in a well functioning market, if you succeed in writing up every asset at fair value, you will never be able to fully capture growth assets.” As an initial proposition, you will need to decide on which balance to converge the accounts, intrinsic or market value. When there are no significant growth assets, the balance sheets will end up looking close to market value—i.e., the assets recorded at what investors would be willing to pay today, rather than their original cost or intrinsic value.

If there are significant growth assets, however, “you’ll never be able to get your arms around them and... that pathway will be filled with disappointments.” Growth assets will either be impossible to value (since they do not exist and may not even be identified yet), or valued haphazardly. *Bottom line:* Fair value accounting, even if done precisely, “will create a two-tier system,” Damodaran said, “providing accounting values that are close to true value for mature businesses and divergent values for growth businesses.”

Testing the pragmatic approach. Fair value accounting has its deepest roots in the financial services sector, where mark-to-market “has been the rule for twenty years now,” Damodaran said. If the premise of fair value is correct, then variance in these firms’ stock prices should be lower than those for industrial firms of similar size and maturity. Additionally, some countries with inflationary currencies have been quick to switch to fair value, to allow local companies to revalue assets to their current replacement cost. If the “pragmatist’s” hypothesis is correct, then securities in these countries should be less volatile than those in countries with low inflation.

The evidence does not back this up. “While it may be unfair to use the current crisis to make any long-standing arguments,” Damodaran explained, “the securities with the most volatility have been,

Fair Value: An Imperfect System

in fact, those in financial service companies that marked-to-market.” In addition, stock volatility has increased in inflationary countries where fair value has been in effect. *Bottom line:* The acceptance of fair value accounting is going to do little to dampen stock price volatility. “It may even increase it,” he observed.

Finally, what about the marginalist’s view?

Under this approach, the purpose of fair value is to 1) provide investors with more information, to better assess a firm’s value; and 2) to protect them, by warning of the firm’s potential dangers. The accounting rules have been in place since 2002; thus, one would expect more significant investor reactions to market information during the past seven years. Nevertheless, a study of stock prices during the second half of 2002 and all of 2003 revealed that on average, stock prices dropped only 1.2% following a firm’s announcement of goodwill impairment. By contrast, the same study found that from 1996 to 2002, stock prices dropped an average of 3% after news of impairment. “There was a bigger effect under the prior regime,” Damodaran said.

“So why are we going forward with fair value and goodwill impairment if the market does not care?” he asked. “A big chunk of what accountants spend their time on has very little impact” on investor behavior, he said. “By the time you tell me something, it’s already too late.” Accountants (and analysts) also spend as much time on the small stuff as the large. The result is an “information dump” that does not really permit investors to separate the minutiae from what matters. “Your time should be proportioned to the term’s effect on value,” Damodaran said. However, that is hard to do. The different ‘visions’ of fair value accounting are pushing different rules and they are fighting each other.” Accounting rules should also be structured to prevent their abuse by “the unethical 10 percent,” he said.

An example illustrates the variability of fair value. Fair value accounting can produce a wide range of values, depending on *how* you value (intrinsic versus relative valuations); *who* you value it for, a passive or active investor; and the *purpose* of the valuation, for a transaction or an asset (cash flow) appraisal.

As an example, consider the intrinsic value of a company with \$400 million in expected revenues, \$250 million in operating expenses, \$30 million de-

preciation, and \$40 million in taxes (on \$120 million of operating income), leaving \$80 million net income. For simplicity, assume the company plans zero growth in perpetuity, there are no working capital assets and capital expenditures offset depreciation. The firm is all equity funded and has a 10% cost of equity. The intrinsic value of the firm is just as easy to conclude: \$800 million.

But what if different—and optimal management takes over? Under this scenario, the firm increases its after-tax operating margins from 20% to 25%, boosting its operating income to \$100 million. The firm also lowers the cost of capital to 8%, and its intrinsic value is now equal to \$1,250 million.

Assume a third scenario—that there is only a 60% probability that the optimal managers will stay on. In an efficient market, this reduces the “expected” intrinsic value of the firm to \$980 million. Should the firm acquire a midsize company that trades at five times EBITDA of \$150 million, however, the “relative” value of the acquiring firm now becomes \$750 million. Add a final assumption: the firm is for sale, but in an illiquid market. If the illiquidity discount is 20% of estimated value, then the business should only sell for \$600 million.

“Let’s take each of these [scenarios] and see what your vision of a market participant would have to do to support these numbers,” Damodaran suggested. The whole notion of a market participant is “slippery,” he added. “Who is it? A rational guy? A strategic buyer?” If a long-term investor were looking at the example firm, for instance, he would value it at \$800 million; he does not care about the differences in value that shifting management control would make. But an all-knowing acquirer would value the firm at \$1,250; a rational investor in an efficient market would choose \$750 million, and a pure asset buyer would price the firm at \$600 million. Synergies do not really enter into the determination, Damodaran said. “Why open this box? How do you differentiate between a control premium for synergy—and one for stupidity?”

So what is the FASB’s vision? Throughout the entire FAS 157, “homage is paid to the ubiquitous market participants and what they think about risk and [what] they would be willing to pay for an asset,” Damodaran noted. “In effect, accountants are asked to attach values to assets/liabilities that mar-

Fair Value: An Imperfect System

ket participants would have been willing to receive/pay.”

But there is a tilt toward relative value, as the example illustrates. The FAS 157 definition of fair value focuses on the exit price; its valuation hierarchy prioritizes observable “market prices” and accepts intrinsic value only when observable inputs are unavailable. Further, accountants are asked to consider specific restrictions on an asset’s use or sale and apply discounts related to illiquidity. “This is why the notion of fair value is a very deceptive notion,” Damodaran said. Not only because it is relative, but also because FAS 157 doesn’t tell analysts which of the five illustrative values to use, and it provides no particular description of a market participant. “It says that you should consider liquidity but not too much. No wonder you spend so much time reading this document,” he added, “it changes every time.”

A roadmap for users of fair value accounting.

Damodaran maintained that if he were accounting czar for a day—and he lived through the day—then he would support accounting’s ultimate role to provide investors with enough information to estimate a company’s value and measure its performance. Done right, fair value should make it easier for investors to assess this information, he told attendees. *Done wrong, the rules:*

1. **Replace existing book values of assets** (which measure capital invested) with the fair or market value of those assets. This process replaces a useful piece of information with one that can be redundant, misleading, or confusing.
2. **Adjust earnings for past mistakes in fair value assessment**, which makes earnings less informative.
3. **Try to include potential, possible, and imagined liabilities in balance sheets.** This dilutes the meaning of risk.

Accordingly, as “accounting czar,” Damodaran would implement the following principles and practices:

- **First, do no harm.** “Don’t mess up what you already provide me as an investor,” he said. We live in a world of information overload, and we don’t need more. In fact, “less is more” in the financial reporting world. Financial state-

ments are increasingly becoming “information dumps.” (Damodaran cited the 1,024-page 10K filed by Citigroup last year—which of course gave no indication of what would happen this year.)

- **Do not over-reach.** Fair value accounting should be clear about what it wants to accomplish. “Rather than reach for the ultimate, settle for the incremental, or you’ll get into trouble.” Accept that the accounting statement cannot be all things to all investors. “It will always reflect the past and lag both intrinsic and market value.”
- **Keep it simple.** “Life is complex enough,” Damodaran said. Accounting statements will never replace or even compete with market values, and book values are poor replacements for market values. They should stick with the easy assets and “let someone else worry about the complex ones. You’re so busy looking at the trade name,” he told attendees, “you forgot to tell me what the cash balance is.” Overall, financial statements should answer three fundamental questions: 1) How much did you earn last year? 2) What do you own and how much did you invest to get what you own? 3) What do you owe?
- **Go back to principles.** “This goes against everything in the fair value philosophy,” he said, but he wants to see a return to principle-based standards. Rules have never stopped the unscrupulous, he noted. “Treat accountants like grown ups.” Don’t give them thousands of rules; just the fundamental principles—and let them do their jobs. This will lead to better valuations.

Damodaran, unfortunately, is not hopeful that his rules and roadmap will ever be an accounting reality. “I think what’s [happening] with fair value is dangerous,” he concluded. “The Pandora’s boxes keep opening.”

New Tax Court Decision on Discounts and Embedded Taxes Hinges on Experts

Estate of Litchfield v. Comm’r, 2009 WL 211421 (U.S. Tax Court)(Jan. 29, 2009)

With about \$26.4 million in assets, the Litchfield estate consisted primarily of minority stock interests in two closely held, family owned companies, Litchfield Realty Co. (LRC) and Litchfield Securities Co. (LSC). The Internal Revenue Service (IRS) and the estate agreed on the net asset values (NAV) of the estate’s interests. However, they aggressively disputed the discounts related to built-in capital gains taxes, lack of control, and lack of marketability.

Marjorie Litchfield died in 2001. At that time, her estate owned a 43.1% interest in LRC, which held Iowa farmland and marketable securities along with a farming subsidiary. LRC earned a marginal profit, but the company was not performing up to management expectations. Its farm holdings, for example, yielded less than 1% net annual income compared to Midwestern farmland generally, which yielded about 4% of NAV annually. Historically, the company had sold portions of its farm holdings to raise cash.

To increase profitability and shareholder returns, LRC converted from a C corporation to an S corporation in January 2000. However, for the 10 years following conversion, if the company sold any of its former C Corp assets then it would incur corporate-level tax on the sale (per IRC Sec. 1374). The company also postponed switching from share-lease agreements with its farmers to straight cash leases, which would have been more profitable and produced more taxable corporate income. As of the valuation date, LRC’s total NAV of \$33.174 million included \$28.762 million in built-in capital gains—or 86.7% of NAV. Just over \$19.789 million of the built-in capital gains taxes related to its farm holdings and \$8.972 million to its marketable securities.

To prepare the estate’s tax return in connection with LRC, its expert appraised the estate’s 43.1% interest in the company at a fair market value of \$6.475 million—after application of discounts for the built-in capital gains taxes, lack of control, and lack of marketability. On audit, however, the IRS valued the estate’s interest in LRC at just over \$10

million and assessed a deficiency of approximately \$3.825 million. *The chart below shows the breakdown of the parties’ respective valuations for LRC:*

| | Estate expert | IRS expert |
|--------------------------------|------------------|------------------|
| NAV (estate’s 43.1% interest) | \$14.298 million | \$14.298 million |
| Discount for capital gains tax | 17.4% | 2.0% |
| Discount for lack of control | 14.8% | 10.0% |
| Marketability discount | 36.0% | 18.0% |
| Ultimate fair market value | \$6.475 million | \$10.069 million |

The estate also owned some 23% of Litchfield Securities Co. (LSC), a C corporation that held “blue chip” marketable securities as well as partnership and other equity investments for a combined NAV of \$52.824 million. Like LRC, none of the LSC stock had ever been publicly traded, and its stock transfer policies generally restricted redemptions or sales outside of the Litchfield family. Its investment strategy focused on maximizing cash dividends to its shareholders, and these had increased consistently over the years.

In the late 1990s, however, the directors became concerned that elderly shareholders in both LRC and LSC would not have adequate cash reserves to pay for estate taxes and other obligations on their deaths. Consequently, management contemplated sales of LRC and LSC corporate assets to finance stock redemptions for those shareholders. After the death of Mrs. Litchfield, LRC sold its farm services subsidiary and, due to mergers and acquisitions of the public companies in its portfolio, LSC realized a significant appreciation of its holdings.

As of the valuation date, LSC’s NAV included \$38.984 million in built-in capital gains, or 73.8% of its total NAV. *Note:* The capital gains tax applicable to both companies ranged from 35.5% to 39.1%. The estate’s expert discounted its 22.96% stock interest in LSC by capital gains tax as well as lack of marketability and control, but on audit, the IRS de-

Discounts and Embedded Taxes

terminated a deficiency of over \$3.014 million. *Their respective valuations broke down as follows:*

| | Estate expert | IRS expert |
|--------------------------------|------------------|------------------|
| NAV (estate's 22.96% interest) | \$12.133 million | \$12.133 million |
| Discount for capital gains tax | 23.6% | 8.0% |
| Discount for lack of control | 11.9% | 5.0% |
| Marketability discount | 29.7% | 10.0% |
| Ultimate fair market value | \$5.748 million | \$9.565 million |

The court considered discounts for capital gains first. At trial, U.S. Tax Court Judge Swift found that the built-in capital gains associated with the total assets of both companies were “substantial.” *In particular:*

A hypothetical buyer would be willing to pay fair market value for the LRC and LSC stock, which would take into account and...reflect the millions of dollars in untaxed appreciation over the years in the values of LRC's and LSC's underlying assets. Knowledgeable buyers, however, also would negotiate discounts in the price of the stock to estimate, on the basis of current tax laws, the corporate capital gains tax liabilities due on that very same appreciation when the assets are sold or otherwise disposed of by the corporation. In other words, if a valuation of...corporate stock in a hypothetical sale is significantly affected by the untaxed appreciated value of the underlying corporate assets, the stock valuation ...should reflect the corporate capital gains tax liabilities that the appreciated assets carry with them and that will be paid by the corporation upon sale or other disposition of the assets.

In this context, the court considered the two experts' valuations in turn:

1. Built-in capital gains taxes. In calculating his discount for built-in capital gains tax related to both entities, the estate's expert not only reviewed historic asset sales but also board meeting minutes. He also spoke with current management about their plans for future sales. He then estimated asset turnover rates, projecting a 5-year holding period for LRC and 8 years for LSC. After estimating appreciation and applying capital gains tax at the projected sale dates, discounted back to pres-

ent values, he reached his discounts of 17.4% and 23.6%, respectively.

By contrast, the IRS expert did not talk to management, and he used turnover rates based solely on historical asset sales. For LRC, he used a 1.86% turnover rate to project an asset-holding period of over 53 years. Because LRC had elected S Corp status, the expert did not include any capital gains tax liability beyond 2009 (ten years following conversion). For LSC, he used a 3.45% asset turnover rate, resulting in a 29-year holding period. By applying similar calculations to each entity (multiplying capital gains tax by gains on asset sales as of the valuation date, discounted by a ratable portion over the relevant holding periods), he reached his 2% discount for LRC's NAV and 8% for LSC.

The court's findings: Given the “highly appreciating non-operating investment assets” that both companies held, the court considered it likely that a hypothetical buyer and seller would negotiate “significant” discounts related to the built-in capital gains tax liability. Further, the assumptions by the estate's expert related to asset turnover rates were based on more accurate data, especially his conversations with management and review of current sales. The IRS expert, on the other hand, did not account for appreciation during the holding periods and looked only at historic data. For these reasons, the court accepted the estate's expert's discounts for built-in capital gains tax, without adjustment.

2. Lack of control. To determine the discount for lack of control (DLOC) for LRC's securities holdings, the estate's expert used closed-end funds, observing a median 7.16% discount among the data. He used REITs (real estate investment trusts) and RELPs (real estate limited partnerships) in relation to the firm's farm holdings and found an average 25.5% discount.

The estate's expert then looked at factors particular to LRC and assigned each a value between -1 (poor investor rights) and 1 (excellent rights). For instance, a 43.1% stakeholder in LRC would have some ability to force liquidation and change operating policies, and these factors received a zero (neutral) value. The company's historical returns were substantially below those of similar investments, and this received a -1 value. Using these factors, weighted for LRC's combined asset classes, he calculated a 14.8% DLOC for the estate's interest.

Discounts and Embedded Taxes

For its interest in LSC, the estate's expert used closed end funds and observed the mean, median, and standard deviation of the discounts. He then assigned values from -1 to 1 to each of the factors that he also used to assess LRC; for example, because a 22.96% stakeholder would have little influence on operations or liquidation, this factor received a -0.5, but the company's financial efficiency and historical returns received a 0 value. After determining a DLOC of 12.23%, unweighted by asset class, the expert reduced this to account for LSC's small percentage of cash and short-term investments, resulting in an 11.9% DLOC.

According to the IRS expert, a DLOC is generally required "only if" the buyer intends to change the entity's operations. Because LRC's assets were performing well, a buyer would not expect a large discount for lack of control. Notably, in considering the entity's securities holdings, the IRS expert did not break down his analysis by asset class, but looked at closed end funds to find an average 3.4% discount. Since the standard deviation was 17%, he "trimmed the mean" (removed the top and bottom 10%), resulting in a "trimmed" 5.2% average discount. Given the estate's sizeable 43.1% interest in LRC, the IRS expert believed that a DLOC below 5% was appropriate for its marketable securities.

When considering the entity's farmland holdings in LRC, the IRS expert reviewed a variety of data, including Mergerstat™, and noted a range of 17% to 20% DLOC. Nevertheless, because discounts for public takeovers are generally higher than those for "normal" sales activity, LRC's farming assets merited a DLOC lower than the Mergerstat range, or 15%. Even though the farmland comprised the bulk of the firm's NAV, he averaged the two findings (5% and 15%) to conclude an overall DLOC for the estate's 43.1% interest in LRC of 10%.

For LSC, the IRS expert once again used the 5.2% "trimmed mean" from the closed-end funds. Because the estate's 22.96% interest was the single largest block of stock, its returns were good—and a purchaser would not want to change operations, a hypothetical buyer "would place no value on control," he believed and a "nominal" DLOC of 5% was appropriate.

The court's findings: The court noted that both experts calculated similar DLOC for LRC's farming assets (15.7% vs. 15%), and both used lower-

than-average discounts for its securities; and both averaged the respective discounts in their overall determination of DLOC. But only the taxpayer's expert used a weighted average to account for LRC's more significant holdings of farm property, while the IRS expert used a straight average. "A straight average would have been appropriate if LRC's farmland and securities holdings were roughly equivalent," the court said, in determining that the estate's expert's 14.8% DLOC was more appropriate.

With regard to the DLOC for the estate's LSC stock interest, the IRS expert used the same 5% discount as he did for LRC's marketable securities, without accounting for the estate's much smaller interest in LSC. The estate's expert accounted for the size difference, and once again, the court adopted his 11.9% DLOC for the 22.96% interest in LSC.

3. Marketability discount. To calculate LRC's discount for lack of marketability (DLOM), the estate's expert looked at restricted stock studies and observed a range from 10% to 30% for larger, profitable companies and a 30% to 50% range for smaller, riskier companies. Once again, he assigned average investor values of -1 to 1 to each class of LRC's assets (e.g., its farmland was -0.5 and its marketable securities -0.125) to reach a DLOM for the estate's 43.1% interest of 36%.

He also used the same restricted stock studies for the LSC interest. After assigning average values to its assets classes, such as cash and short term investments (-0.5) and marketable securities (0), he concluded a DLOM for the estate's 22.96% interest in LSC of 29.7%

The IRS expert looked at restricted stock studies, including three from the 1990s that the estate's expert did not consider, and observed an average 25% DLOM. Because he believed the data did not account for liquidity and "corporate distress," he also looked at private placement studies (more indicative of a "true" discount, he said), and observed discounts ranging from 7.23% to 17.6%. He then adjusted for entity-specific factors, such as LRC's dividend-paying policy, the estate's sizeable interest, and stock transfer restrictions, to determine an 18% DLOM for the estate's 43.1% interest.

He reviewed the same studies with reference to LSC, and because these assets were more readily ascertainable and saleable, its earning history was consistent and its management competent, he de-

Discounts and Embedded Taxes

terminated a lower than average discount of 10% for the estate's 22.96% interest.

The court's findings: The court considered it appropriate to weigh the assets of both entities by class, but believed that both of the estate's expert's DLOMs were too high, particularly when combined with his discounts for lack of control. Some of the restricted stock data the estate's expert used were aged, and his discounts were higher than the average benchmark studies that included "all components of a lack of marketability discount," according to the court. Finally, the estate's expert had performed a valuation for the same entities in connection with a 2000 gift estate tax return, in which he determined a "significantly lower" discount for the estate's interest in LSC (21.4% in 2000 vs. 29.7% in 2001). As a result, and without further discussion, the court concluded DLOM for the estate's respective interests in LRC and LSC of 25% and 20%.

Overall, the court found that the fair market value of the estate's 43.1% interest in LRC was \$7.546 million, and its 22.96% interest in LSC was worth \$6.530 million.

LEGAL & COURT CASE UPDATE

Financial Expert Ensures Proof of Reasonable Royalty In Unjust Enrichment Case

***Mass. Eye and Ear Infirmary v. QLT Phototherapeutics, Inc.*, 2009 WL 78064 (C.A. 1 (Mass.)) (Jan. 12, 2009)**

After a "spirited" trial on the merits, a jury found QLT Phototherapeutics (the defendant) liable for misusing the plaintiff's confidential research and other proprietary materials in the development of a "blockbuster" pharmaceutical to treat age-related macular degeneration. The jury awarded the plaintiff a running royalty rate of 3.01% of the defendant's gross sales of the pharmaceutical. The court further awarding some \$14.1 million in attorneys' fees to the plaintiff, plus interest. The defendant appealed all aspects of the judgment.

The U. S. Court of Appeals for the First Circuit initially reviewed the jury's verdict in favor of unjust

enrichment. The court found that it met the standards under applicable (Massachusetts) law; i.e., the plaintiff conferred a benefit on the defendant, which in this case included the unauthorized use of confidential information, which the defendant knowingly accepted without paying for its value. Having lost the issue of liability, the defendant agreed that the appropriate remedy for unjust enrichment would be some royalty rate based on its net sales of the pharmaceutical. "Unfortunately," the court commented, "the parties agree on little else."

The financial expert proved indispensable.

Under Massachusetts law, the appropriate measure of damages in this case was "an approximation of the value of the benefit" that the plaintiff's confidential information conferred on the defendant, the court held. Further, in situations where the parties had no formal agreement, the plaintiff's recovery should be measured solely by the value of the benefit to the defendant, and "may not be based only upon [the plaintiff's] lost profits." In patent and related disputes, such recovery may include the disgorgement of the defendant's profits, the court continued. When the jury cannot estimate the value of a conferred benefit from "common knowledge," the plaintiff "must present evidence of the reasonable value of the benefit...to receive anything more than nominal damages."

With these standards in mind, the court reviewed the jury's damages award in relation to the evidence at trial. Both parties presented financial experts "to help the jury understand how to express the benefits conferred as an ongoing royalty," the court explained. The plaintiff's expert provided "important background evidence showing reasonable royalties in the pharmaceutical industry" in general as well as particular licenses that the defendant negotiated with other parties. In addition, plaintiff's damages expert testified that a reasonable royalty could be as high as 13.5%, which would constitute approximately 50% of the defendant's net profits from its sale of the pharmaceutical.

In reaching this conclusion, the expert explained that he discounted the defendant's negotiations with a third party for a royalty agreement of 0.5%, because it conferred that party a "most favored nation clause" (obligating the defendant to make any more advantageous license terms it negotiated with the plaintiff available to this third party as well) without conferring any larger benefit to the defendant.

Unjust Enrichment Case

The defendant presented its own damages expert, primarily to discredit the plaintiff's. This expert criticized the reasonable royalty surveys on which the plaintiff's expert relied (the court opinion does not name the surveys' sources). Similarly, the defendant's expert argued that a fair royalty could not exceed the 0.2% royalty that the defendant paid for sales in jurisdictions covered by other patents. Moreover, because there was evidence of a co-inventor who could sell the pharmaceutical independently, the expert claimed that the defendant did not have to pay any royalties, and thus the 0.5% that it presented to the jury "was not only fair, but munificent."

"From this competing evidence," the court said, "the jury had enough information to establish an approximate valuation of the benefit [plaintiff] conferred on [defendant]." The jury's unjust enrichment award "need not be susceptible of calculation with mathematical exactness, provided there is a sufficient foundation for a rational conclusion," it added. "In a case where the jury cannot estimate the value of a benefit from common knowledge, the plaintiff must present evidence of the reasonable value of the benefit in order to receive anything more than nominal damages." Importantly, "the damages experts ensured that the jury engaged in an effort to determine a reasonable approximation of the value of the benefits [the plaintiff] conferred on [the defendant]."

That at one point during his testimony, plaintiff's expert referred to the defendant's *profits* on the sale of the pharmaceutical did not conflict with the requirement that a reasonable royalty rate based on defendant's *sales* was the preferred measure of damages in this case. "After all, [the defendant's] profits served as a reasonable approximation of the value of the benefit conferred at a particularly critical time in the life cycle" of the defendant, which was a start-up biotechnology company with a product (the plaintiff's pharmaceutical) in search of an application.

"Given these considerations," the court held, "we cannot conclude that the damages evidence was insufficient as a matter of law to permit a reasonable approximation of the value of the benefit conferred on" the defendant. Moreover, the jury "grappled with highly complex, voluminous evidence to reach a reasonable conclusion," the court said. The jury rejected the plaintiff's "out-sized valuation of its own contributions" to developing the

pharmaceutical, while simultaneously rejecting the defendant's "cramped" view. "We see no reason to disturb the jury's finding," the court said, in upholding the amount of the damages award as well—although it did remand the trial court's award of attorneys' fees for more specific findings of fact.

LEGAL & COURT CASE UPDATE

Kentucky Adopts Majority Rule in Distinguishing Enterprise vs. Goodwill

***Gaskill v. Robbins*, 2009 WL 425619 (Ky.)(Feb. 19, 2009)**

"The valuation of a business is complicated, often speculative or assumptive, and at best subjective," the Kentucky Supreme Court observed, in addressing a question of first impression in that state: whether the goodwill of a closely held or sole proprietorship business can have both personal and enterprise values for purposes of marital dissolution proceedings.

This is particularly true in a divorce case where the business is a professional practice with only one practitioner, clients or patients come to the business to receive that particular person's direct services, the business is not actually being sold, and the success of the business depends upon the personal skill, work ethic, reputation, and habits of the practitioner.

During a "protracted, contested" divorce trial, the wife in this case—a well-established oral surgeon in Bowling Green, Kentucky, with a successful practice and staff—asked her CPA to value her business. He collected data from business records, spoke with her personnel during a site visit, and prepared a detailed report that laid out all of the pertinent financial information and accounting methods. After explaining why certain valuation approaches did not apply to a sole profession practice (no prior sales or sales of similar business, and no plans to liquidate) he applied an asset-based analysis to value the practice at \$221,610. He also assigned a zero value to goodwill, because the wife's role in the business amounted to a "non-marketable controlling interest." To illustrate, he asked the revealing question: "Why would a purchaser pay more than fair market value of the tangibles if [the doctor]

Distinguishing Enterprise vs. Goodwill

can take her patients, go down the hall, and set up a practice?”

The husband’s expert did not conduct a site visit or collect data independently. Instead, he used the detailed data from the wife’s expert and then applied four different valuation methodologies: excess earnings, capitalized earnings, market approach, and adjusted balance sheet. He calculated a value under each and, finding all reliable but none determinative, he averaged the four numbers to arrive at a value of just under \$670,000, which included an assumed non-compete agreement and goodwill. He also objected to one calculation by the wife’s expert, which involved doubling employee wages to allow for the hiring of similarly trained personnel, claiming that a willing buyer could use existing employees. (This one calculation reduced the practice’s value by over \$315,000.)

The trial court found the husband’s expert to be more credible—in particular his claims about employee wages, and adopted the \$670,000 valuation. The court based its determination in large part that there was no direct legal authority in Kentucky for distinguishing between personal and enterprise goodwill when valuing a professional practice. The wife appealed—and the Court of Appeals, after reversing the trial court on goodwill, finding that it erred in assuming that goodwill in a business must be assigned a value greater than zero—sought discretionary review of the issue by the state Supreme Court. (The abstract of the appellate court’s decision appears in the Feb. 2007 *BVU*, and the full-text of the court’s opinion is available at *BV-Law*TM.)

After observing the general complexity involved in valuing professional practices, the highest Kentucky court noted that there are additional questions that any court must answer when determining the fair market value of the business in divorce:

1. What is the value of the hard assets? This can include real estate, equipment, client lists, and cash accounts.
2. What can be earned from the business over a reasonable time? This could include transferable goodwill.
3. What about the value of accounts receivable? Personnel who will remain with the business (or the cost to replace)? What liabilities will remain?

Of these, the question of valuing the goodwill of a professional practice has been “a source of contention for many years,” the court said. Prior state precedent generally accepted that goodwill was a factor for the trial court to consider—but the cases had never considered whether goodwill could be allocated between the practice and the professional.

Clearly, the practice is, in general, marital property, and therefore subject to division, but how are we to divide a person’s reputation, skill, and relationships? To what extent can a buyer of a business assume that his performance will equal that of the present owner? To what extent can he take on the seller’s reputation in the community?

To some extent, the court observed, some businesses may be able to establish value beyond fixtures and accounts receivables. Nevertheless, in most professional practices, goodwill—like the practitioner’s advanced degree—will not have any “objective transferable value on the open market.” These two concepts have led courts in several jurisdictions to recognize a distinction between *personal* and *enterprise* goodwill. In particular, the court discussed *May v. May* (W.Va. 2003) and *Yoon v. Yoon* (Ind. 1999) for their summary of the now-majority rule that while personal goodwill is non-marketable and non-divisible, enterprise goodwill belongs to the business and is allocable in divorce.

The court found the *May* and *Yoon* cases “compelling.” “The distinction between enterprise and personal goodwill has a rational basis that accepts the reality of specific business situations.” In cases such as this one, there was little doubt that the skill, personality, work ethic, reputation, and relationships of the doctor were “hers alone,” the court said, and could not be sold to a subsequent practitioner. “To consider this highly personal value as marital would effectively attach her future earnings, to which [the husband] has no claim.” Moreover, if he or someone similarly situated were awarded maintenance in addition to a portion of the practice’s value, then this would amount to “‘double dipping,’ and cause a duel inequity to [the wife].”

Finally, the distinction between enterprise and personal goodwill is just as susceptible to expert valuation as goodwill on the whole is, the court ruled, and held as a matter of law that the distinction should be considered by trial courts in divorce.

More on valuation methods and non-competes. Although both experts testified to multiple valuation methods, only the wife's expert chose a specific method, gave his reasons for choosing it, and explained his supporting data. By contrast, the husband's expert did not collect his own data and calculated four different values for the wife's practice. Unable to choose one among the four, he averaged them all to conclude an ultimate value.

However, "using an average to obtain a value, without some basis other than an inability to choose [among] competing and conflicting valuation methods, is nothing more than making up a number," the court said. It was "tantamount to no method at all." A trial court must have credible evidentiary support for a *specific* number, the court added (with emphasis). "While an average may present the easiest route, it lacks the proper indicia of reliability." Thus the trial court erred by relying on the husband's expert's valuation.

A further complication: the trial court also relied on the expert's assumption that a non-compete agreement would be an element of the valuation. "While fair market value of [the doctor's] practice anticipates what a willing buyer would give a willing seller, the fictional sale must be viewed as a 'fire sale'," the court said, "meaning that it must be valued in its present state." This precluded factoring in a non-existent non-compete clause, as there was no requirement that the wife enter into one other than as a possible negotiated term of a hypothetical sale. "It was improper to include such a speculative item to enhance the value of the practice."

A couple of dissents take on the more controversial aspects of the ruling. While all six sitting judges on the Supreme Court panel concurred with the "well-reasoned" decision on distinguishing goodwill, one justice "strongly disagreed" with the majority's criticism of all expert valuations based on an average of various valuation methods. A second disagreed with its prohibition against considering covenants not to compete. "If expert testimony establishes that such covenants are an integral part of a sale of a professional practice (as they typically are, in my opinion) the expert should be able to take into account the [non-compete] in valuing the practice." Surely, these two more controversial aspects of the majority's opinion will be the subject of further debate among the wider legal and valuation communities.

Statutory Appraisals: La. Supreme Court Says Use Discounts 'Sparingly'

Cannon v. Bertrand, 2009 WL 130341 (La.)(Jan. 21, 2009)

Three partners created a limited liability partnership a dozen years ago to develop Louisiana timberland. Per their agreement, each partner received an equal one-third share, but importantly, it did provide buy-out terms. When one of the partners withdrew in 2006, they were unable to agree upon payment and the withdrawing partner sought judicial determination of his interest.

At trial, the former partner presented an expert who valued the partnership at \$1,324,203 and his one-third share at \$457,401, without discounts. The expert for the remaining partners, however, appraised the partnership at \$955,000 and then applied a 75% minority discount, valuing the withdrawing partner's interest at \$80,000. The court found the underlying assets were worth just over \$1 million and, after discounting the partner's interest by 35% (or nearly halfway between the parties' positions), arrived at a buy-out price of \$228,000.

Fair market value applies in statutory appraisals. On review, the Louisiana Court of Appeals confirmed the trial court's valuation, citing a 1989 state Supreme Court case, *Schopf v. Marina Del Ray Partnership*, for the proposition that the higher court had "ratified" the use of minority discounts in statutory buy-outs. (See the June 2008 issue of *BVU* for an abstract of the appellate opinion.)

This time the withdrawing partner appealed to the Supreme Court, which began by discussing the Louisiana statute governing the rights of withdrawing partners. In particular, the buy-out provision entitles a former partner to "an amount equal to the value that the share of the former partner had at the time membership ceased." Importantly, the statute does not define "value," and so the court turned to its 1989 *Schopf* decision that valued a withdrawing partner's shares.

In *Schopf*, the trial court placed a zero value on a minority partner's shares in a real estate venture, because it posted a negative book value at the time of withdrawal. The state Supreme Court reversed, finding that:

Statutory Appraisals

...a proper value of a withdrawing partner's shares could be based on fair market value, or 'the price that a willing buyer would pay to a willing seller for a certain piece of property in an arm's length transaction, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.'

The *Schopf* court then looked for evidence of fair market value (FMV), including the amounts that the majority partner had paid to another withdrawing partner in an earlier deal and the amount that he had offered the withdrawing partner in this case. The court decided that the parties were willing but the transaction was not "arm's length" due to the forced buy-out. Thus, the fair market value for the shares "must be adjusted to account for other considerations," the *Schopf* court held, the "most significant" of which would recognize the withdrawing partner's minority interest. Although there was no testimony on the record regarding a discount, the court ultimately decided "some reduction" was warranted, and discounted the partner's shares by a third of their appraised value.

The Cannon court stretches to preserve precedent. After its discussion of *Schopf*, the Supreme Court went to great lengths to decide the discounts in the present case while at the same time preserving its own precedent and the trial court's broad discretion to determine fair market value in judicial appraisal cases. The rationale may have been a bit of a stretch.

First, the court confirmed that *Schopf* permits the fair market value standard in statutory appraisal cases. Next, it determined that because the *Schopf* court could not find evidence of fair market value on the record, it had to discount what evidence it had (the prior buy-out offers by the majority partner) to determine FMV of the withdrawing partner's shares. However, this discount "was not a 'minority discount,' ... which is applied to the pro rata share of the assets of a partnership due to lack of control in order to find fair market value," the *Cannon* court explained. "[R]ather, it might best be termed a kind of 'majority discount;' a discount applied to the 'unique' value placed on property by majority owners...to reach fair market value."

As such, because no minority discount was applied by the *Schopf* court, any mention of a

minority discount by that court was merely dicta [non-binding], and cannot be relied upon as precedent.

Further, the *Cannon* court found that fair market value was not the "only means of establishing 'value'" per the Louisiana statute. Although it did not use the term "fair value," the court's ultimate determination more or less accords with the statutory fair value standard. In fact, although "[m]inority and other discounts, such as for lack of marketability, may have a place in our law," the court held, "such discounts must be used sparingly, and only when the facts support their use."

In this case, the buyers of the partnership were in fact the two remaining partners, who would not be subject to the same lack of control as a third party buyer. Moreover, because these partners decided to continue the partnership rather than liquidate, lack of marketability was not a factor. Finally, "discounting the market value of the partnership's property would be inequitable," the court said. "The withdrawing partner should not be penalized for doing something the law allows him to do, and the remaining partners should not thereby realize a windfall profit at his expense." In sum, the court declined to limit the term "value" in the Louisiana statute to any standard but the broader, more equitable FMV standard:

[W]e hold that the 'value' of the partnership share of a withdrawing partner may be determined in any of several manners—book value, market value of the underlying partnership assets, fair market value of the partnership share, or other means—depending on the circumstances requiring the valuation. Because the circumstances surrounding a partnership withdrawal can vary so greatly, this court cannot fashion a 'one size fits all' method of valuation which would be fair in all cases.

When the remaining partners are the buyers of a withdrawing partner's share, the court concluded, the market value of the underlying partnership assets is the most equitable manner to value the shares at issue. Thus it adopted the trial court's valuation of the entire partnership (just over \$1 million), and awarded the withdrawing partner one-third of that amount, without applying any discounts.

Lottery Case & Effect of Transfer Restrictions on Valuing Annuities

Negron v. U.S., 2009 WL 186195 (C. A. 6)(Jan. 28, 2009)

Two women shared a \$20 million lottery jackpot along with an unidentified third party in 1991. Each woman was entitled to 26 annual payments of just over \$256,000. The women collected payments for ten years until their deaths, which occurred less than one month apart, in 2001. Their estates shared the same executrix, who elected to receive the remaining payments as a lump sum and reported \$2.28 million on the respective tax returns. This amount was based on calculations by the state lottery commission, which used a 9% discount rate to present value the final distribution.

The IRS, however, used discount rates from its annuity tables (IRC Sec. 7520 and related Treasury Regulations) in effect on the dates of the lottery winners' deaths, applying 5.0% for one and 5.6% for the other. This increased the present values of their estates' distributions by \$500,000 and \$400,000, respectively. After paying additional tax and unsuccessfully seeking refunds, the estates consolidated their claims against the government.

The federal court takes a first look. When the case first came on for consideration in June 2007, the federal district court (Ohio) noted a split among U.S. Circuit Courts as to whether the IRS annuity tables accurately reflected the fair market value of a lottery winner's non-transferable right to receive future payments. The Second and Ninth Circuits have held that they do not, and that discounts are appropriate to reflect the sale restrictions to a hypothetical buyer. The Fifth Circuit, however, has held that the IRS annuity tables already account for lack of marketability and thus are appropriate to value future lottery payments for estate tax purposes.

The federal district court found the former more persuasive. A departure from the IRS annuity tables was warranted when the plaintiff could show that: 1) the value ascribed is unrealistic and unreasonable; and 2) there is a more reasonable means by which to determine the fair market value of the annuity. After concluding that transferability would affect an annuity's fair market value, the court ordered further proceedings for the taxpayer to show a more

realistic valuation method to justify departure from the IRS tables. (See the August 2007 *BVU* for the abstract of this first phase of *Negron*.)

The IRS sought an intermediary appeal in the U.S. Court of Appeals for the Sixth Circuit. "This appeal boils down to whether the IRS used an appropriate discount rate when calculating the present value of the remaining lottery payments," the court observed. The estates argued that it was unreasonable to tax the distribution in excess of the amount they actually received. This concern "translated into allegations that the IRS annuity tables did not properly take into account marketability restrictions on the lottery annuity," the court said, and thus did not reasonably assess fair market value.

However, the difference in the amount received and the taxable value resulted from the two different discount rates, one used by the state lottery commission to approximate the value of the lump sum distribution, the other by the IRS to value the annuity as a stream of continuing payments. The former is simply an alternative to the latter, the court ruled, and does not make the IRS method unreasonable.

In fact, if the estates had chosen to continue the payments rather than take a lump sum, the state's discount rate might have been relevant. Nevertheless, it was the estate's choice that made the IRS assessment "particularly unpleasant," according to the court, "and it is not entirely clear how the non-marketability discount can properly address such an equitable concern, beyond simply reducing the scale of the liability." Equity arguments are insufficient to invalidate appropriate tax regulations, such as those requiring the use of the IRS annuity tables. "Despite the differences in discount rates and resulting present value calculations," the court held, the IRS annuity tables "provide a reasonable and proper framework for calculating federal tax liability."

Deciding among federal precedent. The Sixth Circuit also revisited the apparent split among federal jurisdictions regarding the appropriateness of using the IRS annuity tables to value lottery and other annuities subject to transfer restrictions. The Second and Ninth Circuits reasoned that the "right to transfer is one of the most essential sticks in the bundle" of property rights, and the IRS annuity tables did not accurately reflect this right.

Lottery Case

The Fifth Circuit, however, found that the IRS annuity tables assumed the non-marketability of a private annuity payment in its calculations. It was also unreasonable to apply a marketability discount “when the asset to be valued is a right, independent of market forces, to receive a certain amount of money annually for a certain time.” Marketability is only important when capital appreciation is an element of the valuation, or when the value is otherwise difficult to ascertain.

Moreover, “every court” that has considered this issue since the 1995 effective date of the current, controlling Treasury Regulations has used the same “unreasonable and unrealistic” test to determine that departure from the IRS tables was *not* warranted, the court pointed out. More recently, in *Davis v. U.S.* (D.N.H. 2007), the federal district court held that a non-marketable right to lottery payments was “likely less valuable” than a freely transferable right, but the proper question was how much a willing buyer would pay for a “legally enforceable, virtually risk-free right to receive” annual payments that cannot be assigned to a third party. Such a hypothetical purchaser would be willing to pay something very close to present value of the remaining payments, the *Davis* court reasoned, because for tax purposes, this buyer would have to share the same property rights as the estate. (The *Davis* abstract also appears in the August 2007 *BVU*.) Or as the Sixth Circuit held in this case, “to provide a proper value for estate tax purposes, the hypothetical buyer must hold the same property rights as the estate.”

Finally, the court considered a Massachusetts decision that required using the IRS annuity tables when valuing an annuity unless they produce unrealistic and unreasonable results. (*Estate of Donovan v. U.S.*, 2005 WL 958403 (D. Mass. 2005); copy available at *BVLaw™*.) This case also found that the IRS tables assume non-marketability and that an annuity’s proper value refers to the decedent’s estate, “not the value to a hypothetical buyer holding a very different property interest with substantially greater risks.”

Given the weight of this law, the Sixth Circuit held that the IRS properly used the IRS annuity tables to value the remaining lottery payments for estate tax purposes in this case. The only exceptions (causing “unrealistic or unreasonable” results) might occur when the annuity exhausts before the final payment or when a measuring life is terminally ill.

“Marketability or transferability is not one of these restrictions,” the court held.

Thus, the Sixth Circuit joined the federal courts that have adopted only the narrow exception to applying the IRS tables when valuing non-assignable lottery payments or similar annuities/structured payments. The lower court was incorrect when it held that transfer restrictions affected fair market value. This assumption is built into the IRS tables, and a “marketability factor” is not necessary to value a guaranteed income stream, which is “readily ascertainable” by the present value of remaining payments under the tables.

LEGAL & COURT CASE UPDATE

Contractor May Never Recover Lost Profits for Lost Bonding Capacity?

***Denny Construction Inc. v. City and Co. of Denver*, 2009 WL 60507 (Colo.)(Jan. 12, 2009)**

After soliciting bids, the Board of Water Commissioners for the City and County of Denver (the “Board”) awarded a \$3.5 million contract to build its new headquarters to Denny Construction Company (“Denny”). The contract called for completion in July 2003. Due to weather delays, the parties extended the deadline to October 2003. After that, the Board refused to grant any additional weather-related extensions. When it took occupancy a month later the facility was still not completed.

The Board withheld the remainder of the contract price and in April 2004 declared Denny in default. It also filed a claim against Denny’s surety, which ultimately stopped underwriting the contractor, and both parties sued for breach of contract. At trial, Denny claimed that the contract permitted extensions due to bad weather, and that because of all of the Board’s actions, it could no longer secure the bonds necessary to bid on public works projects. Its owner testified that from 1995 through 2003, the company had gradually increased its public projects until they accounted for half of its revenues. After the Board declared Denny in default and filed its bond claim, the company’s profits suffered a significant drop.

Lost Bonding Capacity?

Denny also presented a damages expert, who analyzed data from 2000 through 2005, including company, industry, and market conditions. In particular, he reviewed Denny's financial statements and bidding history, the number of public works projects that it typically won, and the profits from those contracts. The expert calculated that Denny incurred pre-trial lost profits of just over \$537,000 and post-trial lost profits of \$1.025 million. The Board presented no opposing expert, but cross-examined Denny's.

The jury concluded that the Board breached the contract and awarded Denny a total of \$1.063 million, including \$380,000 for pre-trial lost profits and \$465,000 post-trial. The Board appealed.

The theory of lost profits piles 'inference upon inference.' In reviewing Denny's damages claims, the Colorado Court of Appeals found that a "host of factors" could determine a party's success in bidding on a public works contract, including "unpredictable future events" such as weather and changes in labor, material costs, and management. Denny's theory of lost profits damages was therefore based "on inferences piled on inferences," it held. Moreover, *any* claim for lost profits from future public works projects due to impaired bonding capacity is speculative as a matter of law.

Further, there was no evidence that the Board actually knew that Denny could lose profits if it lost its bonding capacity. The court cited a California decision in which a contractor failed to establish that lost profits due to impaired bonding capacity were reasonably foreseeable from a school district's breach of the contract. In that case, the school district had no actual knowledge of the contractor's balance sheet or what criteria a surety would require to underwrite its bonds. Similarly, in this case:

There is no evidence in the record that the parties contemplated a loss of bonding capacity when they entered into the contract, that [the Board] *knew* the extent of Denny's bonding capacity, that [the Board] *knew* Denny's overall financial condition, or that [the Board] *knew* what effect declaring Denny in default would have on Denny's bonding capacity and future business prospects. (emphasis in original)

The court denied the entire damages award, and this time Denny appealed.

Bonding capacity is a critical element to consider. "First, lost profits are recoverable only if they can be proven with reasonable certainty," the Colorado Supreme Court held, stating the general rule. State precedent provides that a contractor may establish a reasonable basis for computing a lost profits claim by presenting evidence of both its prior experience and profitability. To be sure, there are "uncertainties inherent in any estimation of future damages," the court said. However, this should not prevent a plaintiff from presenting such an estimate based on competent evidence and reasonable inferences from the same.


Undoubtedly, a plaintiff's bonding capacity is just one factor that could determine its success in bidding on public projects. "However...it is an extremely important one," the court held. Even the Board's witnesses agreed that bonding capacity was a critical element to consider in awarding a public works contract. The court of appeals' diminishment of this factor "fails to recognize the purpose of the bonding system" to minimize construction costs and delays by awarding public contracts to the lowest and most responsible bidder. "At bottom, then, a reduction in bonding capacity indicated a reduction in responsibility, which in turn will impair a contractor's ability to obtain public works contracts," the court said. "This is not speculation," and it rejected the rule that lost profits claims due to impaired bonding capacity are disallowed in all cases.

As to the second issue, the court agreed that lost profits for breach of contract must be foreseeable at the time the parties made their agreement. The test of foreseeability is objective, however, and includes actual knowledge as well as situations in which the defendant "knew or should have known" that damages would probably result.


In this case, the appellate court's reliance on the California case was mistaken, because that considered only the plaintiff's subjective or actual knowledge. Instead, the court should have considered whether—in spite of lacking actual knowledge, the Board "*should have known*" that its breach would cause the contractor's damages. (emphasis in the original) Rather than reaching any decision on that question, the Colorado Supreme Court remanded the entire case for further proceedings consistent with its rulings.


BVR AUDIO & LIVE CONFERENCES


To register for any of our conferences, or for more information, visit our website at BVRResources.com/conferences (teleconferences), BVRResources.com/training (live events) or call (503) 291-7963.


 April 2, 2009, 10:00am - 11:40am PDT
Valuing Professional Practices
 Featuring: **Kevin Yeanoplos Ron Seigneur**, and **Stuart Weiss**


 April 30, 2009, 10:00am - 11:40am PDT
Developing Capitalization and Discount Rates in a Troubled Economy: New and Emerging Views on Old Issues
 Featuring: **Ron Seigneur**, **Don DeGrazia**, and **Stacy Collins**

 May 14, 2009, 10:00am - 11:40am PDT
Valuing Dental Practices
 Featuring: **Jim Andersen**, **Ron Seigneur**, and **Dr. Stephen Persichetti**, DDS

 May 18 – 19, 2009, New York, NY
 New York Marriott Marquis Times Square
11th Annual FAE/BVR Business Valuation Conference
 Featuring: **Aswath Damadoran**, **Jim Hitchner**, **Mel Abraham**, **Darrell Dorrell**, **Ashok Abbott**, and **Vincent Love**

 June 23, 2009, 10:00am - 11:40am PDT
BVR's Teleconference Series on Healthcare Valuation (Part 2 of 3)
 Featuring: **Carol Carden**, **Mark Dietrich**, **Douglas Smith**, and **Timothy Smith**

 September 24-25, 2009, Chicago, IL
Divorce: A Hands-On Workshop for BV Practitioners
 Featuring: **Jay Fishman**, FASA, CBA, and **William Morrison**, CPA/ABV

 October 9, 2009, San Diego, CA
University of San Diego School of Law 2nd Business Valuation and Tax Conference
 Featuring: **Aswath Damadoran**, **Jim Hitchner**, **Mel Abraham**, **Darrell Doyle**, **Ashok Abbott**, and **Vincent Love**

=Telephone Conference =Live Event =Webinar

CALENDAR

Ne_w New item added or changed this issue

April 26 – 29
 CFA Institutes' Annual Conference
 Orlando, FL—Disney's Contemporary Resort
 (434) 951-5500
www.cfainstitute.org

May 6 – 7, 2009
 ESOP Association's 32nd Annual Conference
 Washington, DC—Renaissance Washington Hotel
 (202) 293-2971
www.esopassociation.org

May 12 – 14
 ACG InterGrowth Conference
 Las Vegas, NV
 (877) 358-2220
www.acg.org

May 27 – 30
 NACVA's 2009 16th Annual Consultants' Conference
 Boston, MA—The Westin Boston Waterfront
 (800) 677-2009
www.nacva.com

May 27 – 30
 IBA's 2009 Business Valuation Conference
 Boston, MA—The Westin Boston Waterfront
 (954) 584-1144
www.go-iba.org

June 7 – 13
 IBBA Conference for Professional Development
 Atlanta, GA
 (888) 686-4222
www.ibba.org

June 18 – 19
 CICBV Eastern Regional Conference
 Niagara Falls, Ontario
 (416) 204-3461

Ne_w July 28 – 30, 2009
 AM&AA Summer Conference
 Chicago, IL—Fairmont Hotel
 (877) 844-2535
www.amaaonline.com

July 12 – 15
 ASA International Appraisal Conference
 Orlando, FL—Renaissance Orlando Resort at SeaWorld
 (703) 478-2228
www.appraisers.org

Ne_w September 23-25, 2009
 AICPA National Forensic Accounting Conference on Fraud and Litigation Services
 Lake Buena Vista, FL—Walt Disney World Swan
 (888) 777-7077
<http://www.cpa2biz.com>

October 1 - 2
 CICBV Western Regional Conference
 Kelowna, British Columbia
 (416) 204-3461
www.cicbv.ca

October 19 – 21
 ASA Advanced BV Conference
 Boston, MA—Marriott Copley Place
 (800) 272-8258
www.appraisers.org

November 14 – 20
 IBBA Conference for Professional Development
 Reno, NV
 (888) 686-4222
www.ibba.org

November 15 – 17
 AICPA National Business Valuation Conference
 San Francisco, CA—Marriott San Francisco
 (888) 777-7077
www.aicpa.org

For an all-inclusive list of valuation-related Seminars and Conferences, BV Education classes and credentialing programs—plus BVR Conferences, go to BVRResources.com, and click on the "Calendar" menu.

COST OF CAPITAL

Treasury yields¹

30-day: 0.17% 5-year: 1.86% 20-year: 3.89%

Duff & Phelps' 2009 Premiums Over Long-Term Risk-free Rate²

Historical Equity Risk Premiums: Averages Since 1963

Data for Year Ending December 31, 2008

| Measure Used for Size ³ | 1st | 13th | 25th |
|------------------------------------|------|------|-------|
| 5-Year Average EBITDA | 3.5% | 7.8% | 11.4% |
| 5-Year Average Net Income | 3.1% | 7.8% | 11.7% |
| Sales | 4.7% | 7.8% | 10.5% |
| Total Assets | 3.3% | 7.6% | 11.2% |

IBBOTSON'S 2008 Arithmetic mean equity risk premium⁴

| | |
|--|--------------------|
| Historical equity risk premium (S&P 500) for 30-day horizon, 1926-2007 | 8.48% |
| Historical equity risk premium (S&P 500) for 5-year horizon, 1926-2007 | 7.51% |
| Historical equity risk premium (S&P 500) for 20-year horizon, 1926-2007 | 7.05% |
| Micro-cap size premium (S&P 500), 1926-2007 | 3.65% |
| 10th decile size premium (S&P 500), 1926-2007 | 5.82% |
| Supply side equity risk premium (S&P 500) for 20-year horizon, 1926-2007 | 6.23% ⁵ |

Prime lending rate:¹ **3.25%**

Dow Jones 20-bond yield:⁶ **6.87%**

Barron's intermediate-grade bonds:⁶ **13.51%**

High yield estimate:⁶

Mean 23.99% Median 16.51%

Dow Jones Industrials P/E ratios:⁶

On current earnings: 23.42

On '08 operating earnings est.: 13.10

On '09 operating earnings est.: 15.10

Long-term inflation estimate:⁷ **2.50%**

Long-term rate of growth GDP:⁷ **2.60%**

¹ Source: The Federal Reserve Board as reported by the BVR Risk-Free Rate Tool™, located in the Free Downloads section at BVResources.com, March 2, 2009.

² Source: *Risk Premium Report 2009* © Duff & Phelps LLC. All rights reserved. *Report* includes premiums where size is measured by market value of equity, market value of invested capital, book value of equity, and number of employees. We highly recommend that analysts using Duff & Phelps data for cost of capital have the current year's *Report* and thoroughly understand the derivation of the numbers used. Complete current and historical Duff & Phelps cost of capital data available at BVResources.com.

³ Each measure for size is organized by Duff & Phelps, LLC into 25 portfolio ranks, with portfolio rank 1 being the largest and portfolio rank 25 being the smallest. Smoothed average premiums are presented here because they are considered a better indicator than the actual historical observation for most of the portfolio groups.

⁴ Source: 2008 Ibbotson *Stocks, Bonds, Bills and Inflation*® (SBI®) *Valuation Yearbook*, ©2008 Morningstar. All Rights Reserved. Used with permission. We highly recommend the use of SBI valuation data for cost of capital and related fundamental analysis work. Copies of the *Yearbook* may be acquired directly from Morningstar. While Morningstar makes every effort to provide high quality data, Morningstar does not guarantee the accuracy, timeliness or completeness of these data.

⁵ Represents the historical equity risk premium adjusted downward to remove historical price to earnings growth.

⁶ *Barron's*, March 2, 2009.

⁷ 10-year forecast; Federal Reserve Bank of Philadelphia, *Livingston Survey*, December 9, 2008.



What It's Worth

Business Valuation Resources, LLC

1000 SW Broadway, Suite 1200

Portland, OR, 97205-3035

DISCOUNT METRICS

ABBOTT LIQUIDITY FACTOR™

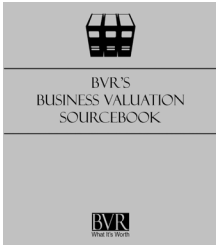
The Discount for Lack of Liquidity (DLOL) database compiled by Dr. Ashok Abbott, from which the Abbott Liquidity Factor™ is derived, provides the first complete tool for quantifying discounts for lack of liquidity specific to size of the block and the valuation period. It is based on directly observable, publicly available data. The reported results are representative of the small firm, publicly traded stock pool with an average market capitalization between \$14 and \$21 million during 2006-2007. The data represent the mean DLOL for the last month of the quarter and ignore SEC Rule 144 restrictions. If you are interested in using Abbott Liquidity Factor™ consulting services for a specific DLOL assignment, please contact Linda Mendenhall at lindam@bvresources.com.

| Block size | Discount for Lack of Liquidity | | | |
|------------|--------------------------------|--------|--------|--------|
| | 2006 | | 2007 | |
| | Q2 | Q4 | Q2 | Q4 |
| 10% | 18.83% | 12.59% | 14.63% | 19.69% |
| 20% | 22.86% | 15.74% | 19.79% | 25.83% |

The information contained in this Liquidity Factor is current as of December 31, 2007, and subject to change without notice. Ashok Abbott and BVR are not responsible for any damages, direct or indirect, caused by any error or omission in this Liquidity Factor.



BVR
What It's Worth



Special Offer
Save \$40.00!
\$199 + S&H

BVR's Annual Business Valuation Sourcebook

Bill Sipes, CPA/ABV, PFS, CFF, ASA, CBA, BVA, Editor

Your time is valuable. Don't waste it hunting for hard-to-find documents!

BVR's Business Valuation Sourcebook is the essential, go-to reference for the appraisal profession. The *Sourcebook* compiles first generation content—including IRS code, regulations, and standards—as well as summaries and commentary on landmark BV cases—including *Jelke* and *McCord*. Save time and spare yourself the frustration of mining the Internet or thumbing through print sources for these key materials. The *BV Sourcebook* puts everything you need in one place!

This essential annual reference features:

- Recent noteworthy changes to BV standards
- Summary of FAS 157, Fair Value Measurements
- IRS Code, Revenue Rulings and Procedures, and Treasury Regulations related to the Business Valuation Profession
- State-by-state summary of the leading U.S. court cases deciding the disposition of goodwill in marital dissolution
- Business Valuation Standards from key organizations, including NACVA, ASA, AICPA, and IBA
- Additional court case abstracts and articles across the entire BV spectrum
- The Federal and Regional Reporter's List
- BVR's Professional Association Directory

Bonus Searchable CD Also Included!

The CD contains all of the content from the book, PLUS the full text opinions of all cases covered in the Guide—as well as the transcript from the Defending the Business Valuation in Court teleconference!

Order Online Today at: www.BVResources.com/Sourcebook

If you prefer, fax this form to: (503) 291-7955 or call (503) 291-7963

- Yes!** Please send me *BVR's Business Valuation Sourcebook* for \$199.00 — **a \$40.00 savings!**
(Please add \$9.95 S&H for the first copy and \$5.95 for each additional copy - Priority code: PRIOR9730)

Name: _____ Firm: _____
Address: _____ City, State, Zip: _____
Phone: _____ Fax: _____ E-mail: _____

Billing Information:

Visa MasterCard AMEX Check payable to: Business Valuation Resources, LLC (please include \$9.95 S&H)
Credit Card #: _____ Exp. Date: _____ Sec. Code: _____
Cardholder Name & Address (if different): _____