

Firm Values

A Business Appraisal Publication

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I offer this newsletter to provide insight into current information and trends in business and the appraisal industry. I hope you find it enriching and welcome any questions or comments you may have.

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Greg Weichbrodt - Principal

This writing presents summaries of court rulings about issues that have come into focus in my practice of late including: characterization of property in divorce, limitations on use of appraisal reports, difficulties in performing ESOP appraisals, and differences in value opinions between expert appraisers. It appears I am not alone in facing such challenges.

Arkansas KOs active appreciation in divorce

In a dramatic about-face, a divided Arkansas Supreme Court recently decided to get rid of the active appreciation rule-a rule the court had introduced almost 30 years ago when it interpreted a state statutory provision on nonmarital property. What adds to the controversy is that the court decided to overrule its earlier decisions of its own volition. Neither of the parties had advocated for a change in case law.

The case reached the state Supreme Court after the husband contested a trial court's decision to award the wife half of the appreciation in value of his company, which was separate property. The appreciation was over \$556,000. Performing an active appreciation analysis, the trial court found that the appreciation was the result of the husband's efforts during the marriage as well as the wife's contributions to the company.

In contesting the trial court's analysis, the husband argued that, under the applicable state statute, the increase in value of the nonmarital business remained nonmarital property. But he also acknowledged that in a line of cases the state Supreme Court had used the active appreciation doctrine to carve out an exception to the statutory law. Instead of claiming the controlling case law was wrong on the issue, the husband argued the exception was inapplicable to the facts of the instant case. Therefore, the trial court in this case erred when it awarded the wife part of the appreciation.

The High Court overruled the decision. A majority of the state Supreme Court performed a different analysis altogether. It began by noting that the applicable statutory provision defines marital property as "all property acquired by either spouse subsequent to the marriage except ... the increase in value of property acquired prior to marriage." Therefore, the court said, "the increase in value of property during a marriage is nonmarital, without exception, and should be returned to the owning party."

The majority then went on to "expressly overrule" all prior cases in which the court once had "redefined marital property through the 'active appreciation' rule." These cases, and the active appreciation rule, "clearly conflict with the statutory scheme," the court's majority said. How to define marital property and how to divide property at divorce is "a matter of policy with which the legislature, not this court, is almost exclusively tasked."

The majority observed that, over time, some trial courts confused the issue even more by weighing the efforts of both the owner and nonowner spouse in determining whether or not to reclassify nonmarital property as marital property. This happened in the instant case.

In creating the active appreciation doctrine, the judiciary moved the law "too far from the statute," the high court decided. The only way to correct this "palpable error" was to overturn the prior case law, notwithstanding the legal doctrine of stare decisis, which cautions against overruling precedent.

Takeaway: The Arkansas Supreme Court invalidates the active appreciation doctrine; under the applicable statute, the appreciation in nonmarital property is nonmarital.

A digest of *Moore v. Moore*, 2016 Ark. LEXIS 82 (March 10, 2016)

Excerpts from BV Wire - April 27, 2016

Bankruptcy Court balks at repurposing divorce valuation

Is a valuation that prevailed in one type of case applicable in another context? This question was at the heart of an unusual case that combined bankruptcy and divorce-related issues.

From divorce to Chapter 13: The husband owned a 25% interest in a dental practice. Under the controlling shareholder agreement, if a shareholder wanted to dispose of his interest, the other shareholders were obligated to buy it back. The agreement included a formula for determining the purchase price for the shares.

At divorce, the wife's expert valued the husband's interest based on the going concern of the dental practice as a whole, taking 25% of it. He concluded it was worth \$212,000. He also valued the interest based on the formula, which he said was "an absolute floor" in terms of the amount the husband could get from the other shareholders.

The husband's expert said the interest was worth \$15,800. He assigned no value to patient records or the practice's goodwill. The trial court adopted the value the wife's expert proposed - \$212,000. It noted the applicable standard of value in divorce proceedings was the intrinsic value of the business.

Three months later, the husband filed for Chapter 13 bankruptcy and asked the Bankruptcy Court for plan confirmation. In his schedules, he listed the value of the practice at \$15,800. The wife, who was the principal unsecured creditor, objected to the confirmation, arguing the plan failed the applicable liquidation test, which requires that creditors in a Chapter 13 bankruptcy receive present value payments that are at least equal to the amount the creditors would receive in a Chapter 7 case. The analysis involves determining the amount each unsecured creditor would receive if the estate were liquidated in a hypothetical Chapter 7 case.

The wife contended the divorce court's valuation was controlling. Based on that value determination, the distribution to unsecured creditors in a hypothetical Chapter 7 liquidation would be much greater than under the husband's Chapter 13 plan. However, the Bankruptcy Court said the divorce valuation was not determinative in this context. It noted that, in a hypothetical Chapter 7 liquidation, a Chapter 7 trustee is asked "to reduce to money the property of the bankruptcy estate" by selling or disposing of the property in other ways. "This is different from determining the intrinsic value, or its worth to the parties, in a divorce proceeding."

But the court also rejected the husband's valuation. Regardless of various impediments to liquidating the asset, there was evidence that it would have "significant value" in a Chapter 7 liquidation, the court said. It was safe to assume a Chapter 7 trustee in this case could recover the amount payable under the buyout provisions of the shareholder agreement. Given this valuation, which exceeded the husband's scheduled valuation by over \$145,000, the court found the husband's plan failed to satisfy the liquidation test.

Takeaway: In ruling on the confirmability of a debtor's Chapter 13 plan, the court declined to adopt the valuation that prevailed in the debtor's divorce proceeding because the value determination entailed a different line of inquiry than was applicable in a hypothetical Chapter 7 liquidation. The most reliable indicator of value was the amount resulting from the shareholder agreement formula, the court decided.

Find an extended discussion of *In re Cole*, 2016 Bankr. LEXIS 932 (March 24, 2016)

Key ESOP ruling zeroes in on valuation and remedies issues

In a gnarled ESOP case, the 5th Circuit Court of Appeals recently issued an important decision on fiduciary liability and remedies in case of breach. The trial court had found the trustees violated their duties of loyalty and prudence and engaged in a prohibited transaction assisted by a disreputable appraiser. It expressly noted the remedy questions were harder to resolve than the liability questions, and it suggested its valuation-related findings might be "vulnerable" on appeal. It need not have worried.

Overpayment: When the owner of a closely held company wanted to divest himself of the company, he orchestrated a series of transactions to sell 100% of the company's shares to its employees by way of an employee stock ownership plan. In each transaction, the plan bought stock through an employee stock ownership trust for which the owner-seller and two persons with whom he had a close working relationship served as trustees. The trustees based the share price on valuations an appraiser, who was beholden to the owner-cum-seller-cum-trustee, had performed.

Subsequently, the DOL and two plan participants filed separate lawsuits alleging the trustees overpaid for the stock because the appraiser's valuations did not reflect the fair market value (FMV) of the stock. The district court, which consolidated the suits, found that neither the appraiser nor the trustees were truly independent and looking out for the interests of the ESOP and that it was not reasonable for the trustees to rely on the appraiser's valuations.

The court rejected the DOL's demand to rescind the transactions and instead awarded over \$4.5 million in equitable restitution in the amount the ESOP overpaid. Overpayment was a function of the contract price and the stock's fair market value on each transaction date. To calculate FMV, the court considered the testimony of three noted valuation experts retained by the plaintiffs, the DOL, and the defendants, respectively. The experts were equally credible, the court said. Different experts used different methods, different assumptions, different estimates, and they reached different conclusions. To arrive at a final value determination, they all averaged the results. "This method tempered the outliers that some methods produced," the court observed with approval.

'Thoughtful approach': The defendants appealed the liability and remedy findings with the 5th Circuit, and the DOL cross-appealed on the remedy. The appeals court largely affirmed. It noted that the parties "fought bitterly" over valuation and remedies issues. On appeal, the defendants and the DOL particularly objected to the district court's averaging process. Their arguments had no traction.

Prior decisions "have frequently accepted an average of expert valuations or estimates falling within a range of evidence offered," the 5th Circuit pointed out. Here, the district court "carefully" set forth its findings and explained their basis in the record. The district court's "thoughtful approach to a complex question was founded in established valuation

methodology," the appeals court concluded.

Takeaway: In a complex ESOP case in which valuation and remedies issues were paramount, the 5th Circuit upholds the district court's decision to grant equitable restitution based on the lower court's computation of how much the ESOP overpaid.

Find an expanded discussion of *Perez v. Bruister*, 2016 U.S. App. LEXIS 8046 (May 3, 2016) (Bruister II)

Excerpts from BV Wire - June 8, 2016

Chancery's controversial Dell fair value opinion

The Delaware Court of Chancery's just-published opinion in the Dell Inc. statutory appraisal action, which arose out of the 2013 management buyout led by the company's founder, Michael Dell, has stunned finance professionals. How could the court find the deal price did not reflect fair value while recognizing that the board and Dell himself made every effort to perform a proper sale? The board appointed a special committee, which hired financial advisors, which prepared copious valuations as the transaction unfolded. Moreover, several recent decisions from the Chancery found the merger price was the most reliable indicator of value.

Shareholders shortchanged: In the Dell buyout, the final merger consideration was \$13.75 per share (plus a \$0.13 special dividend), whereas the court, performing a discounted cash flow analysis that drew on analysis from both sides' experts, came up with a value of \$17.62 per share. There were about 1.76 billion shares outstanding. In other words, Dell sold the company for about \$7 billion too little. The crux of the Chancery's long and dense opinion is that a statutory appraisal determination is not an investigation of a breach of fiduciary duty claim. Although no one in this transaction breached any fiduciary duty, the common stockholders also did not receive fair value.

According to the court, there was "a lack of meaningful price competition during the pre-signing phase," and the post-signing phase, which included a go-shop period, did not cure this defect. The paramount problem was that the players all were financial sponsors—there was no outreach to strategic bidders—and all the valuations driving the merger were premised on leverage buyout models, which calculate what a financial investor would be willing to pay to achieve a certain internal rate of return. That's not a "fair value" determination, the court said. "Fair value" under the appraisal statute means "the value to a stockholder of the firm as a going concern as opposed to the firm's value in the context of an acquisition or other transaction."

As for the two bids that came in during the go-shop period and that led to a 2% increase in the final merger consideration, they ultimately went nowhere. If anything, the court said, the two bids showed that the original merger price was too low. Worse, for the respondents' case, the fact that the two bids exceeded the final merger price "undercut the notion that the Final Merger Consideration provided fair value."

Valuations way apart: At trial, both parties' experts used a DCF analysis and achieved startlingly different results. The petitioner's expert said the company had a fair value of \$28.61 per share on the closing date; the respondents' expert said the value was \$12.68 per share. "Two highly distinguished scholars of valuation science, applying similar valuation principles, thus generated opinions that differed by 126%, or approximately \$28 billion. This is a recurring problem," the court observed. Because the experts disagreed sharply over critical inputs, including forecasts and taxes, they reached significantly different outcomes.

Neither analysis was entirely credible, the court found. The petitioner expert's result suggested that the merger undervalued the company by \$23 billion. "Had a value disparity of that magnitude existed, HP or another technology firm would have emerged to acquire the Company on the cheap," the court observed. On the other hand, the respondent expert's result was below the final merger consideration (\$13.75 per share, plus a \$0.13 special dividend). If, as the court found, the deal price undervalued the company, the respondent expert's valuation did even more so. The court performed its own DCF by drawing on elements from both experts.

The projected cash flows underlying the experts' analysis accounted for much of the difference in value, the court said. Both experts used projections an independent third-party expert had prepared at the request of the special committee, after it had started the merger process. The court found the projections "impressively thorough, with over 1,100 assumptions. The resulting model was dynamic and transparent."

Another credible set of projections was closer in time to the closing date, but the respondents' expert made adjustments to account for nonrecurring restructuring expenses and stock-based compensation.

Litigation-driven adjustments are somewhat suspect, the court noted. Normally, the Chancery prefers valuations "based on contemporaneously prepared management projections." In this instance, however, the respondents' expert "persuasively justified his changes." The court adopted the projections for its own analysis.

Tax rate: Taxes also figured prominently in the valuations. The petitioners' expert used a 21% tax rate throughout his forecast period based on rates in the valuations models the company's financial advisors prepared. The respondents' expert used a 17.8% rate during the projection and transition periods, but a 35.8% marginal tax rate for the terminal period. He justified the latter by citing to academic literature.

The court adopted the 21% rate. It noted the company had not paid taxes at the marginal rate since at least 2000. In the five years leading up to the merger it paid effective rates of between 16.5% and 29.2%. Its cash tax rates ranged from 9.6% to 24.1%. The low effective rate stemmed from the company's "indefinite reinvestment election," meaning it represented to auditors that it planned to defer indefinitely paying U.S. taxes on overseas profits. To suggest, as the respondent expert's model did, that the company would in the near future pay a marginal tax rate of 35.8%, not to mention perpetually, contradicted historical practice, the court said.

Ultimately, the court arrived at a fair value of \$17.62 per share-almost \$4 per share more than the deal price.

Read the opinion: BVLaw offers a complimentary download of the court's opinion, In re Appraisal of Dell Inc., 2016 Del. Ch. LEXIS 81 (May 31, 2016).

Excerpts from BV Wire - June 14-21, 2016

Computer trademark values

We all use a computer, and we're all familiar with computer brands. Some of the most famous corporations in the world, such as Apple, IBM, HP, Dell, and Acer are in the computer business. A closer look at the value of 13 different computer brands reported in transactions is rather sobering.

Low multiples: This month's peer group analysis from Markables, a transaction database, includes brands such as Compaq, Gateway, Sun, IBM, and Packard Bell, among others. Enterprise valuation multiples indicate low profits for the sector, with sales/EV multiples ranging from 0.18x to 0.64x (see the table below). Many businesses struggle to keep pace with critical mass, mass market commoditization, short product life cycles, and new technology. Trademark royalty rates range from 0.4% to 1.5% on revenues, with a median rate of 0.5%. Considering the high portion of trademarks with short useful lives, trademark value accounts for an average 10% of enterprise value.

Two opposing aspects influence trademark value: business profitability and brand strength. While large brands in the mass market show some signs of brand strengths, they often have weak profitability. On the other side, specialized niche offerings show better profitability but are rather unknown brands. Most computer trademarks are assumed to have finite lives and are to be replaced by new brands and new products sometime in the future.

Computers and computer hardware

(includes personal computers, servers, super computers, and network terminals; not included are computer peripherals and input/output devices of all kinds)

no. of observations: 13
period: 2002-2012
countries: 5

	Trademark royalty rate	Trademark profit split	Enterprise value
	% of revenues	trademark value in % of enterprise value	revenue multiple
25% quartile	0.4%	3.8%	0.18x
median	0.5%	6.1%	0.32x
75% quartile	1.5%	23.4%	0.64x
mean	1.2%	17.4%	0.49x

Trademark life

- indefinite life: 38%
- definite life: 62% with average useful live of 7 years

Trademark revenues

from US\$ 8 million to US\$ 38.5 billion

Source: www.markables.net

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