



Business Valuation Standards Support Adjustments in Shareholder Buyout Case

Blackburn v. TKT and Associates, Inc., 2010 WL 2035369 (S.C.) (May 24, 2010)

Two shareholders in a medical equipment company sued for statutory dissolution and damages based on claims that the other two shareholders were draining profits by paying themselves excessive salaries. The trial court found in favor of the plaintiffs but permitted the defendants to buy back their shares at statutory fair value.

The parties agreed on an appraiser and a valuation method, selecting an income approach. In his engagement letter, the appraiser specifically stated he would conform to the *Statement on Standards for Valuation Services* of the American Institute of Certified Public Accountants (AICPA) as well as the professional standards of the National Association of Certified Valuation Analysts (NACVA).

In the midst of his valuation, the appraiser contacted the attorneys for both parties, requesting their input on the defendant shareholders' salaries. Not surprisingly, defense counsel maintained that his clients' salaries were consistent with their contributions to the company, but that perhaps the appraiser should refer to the trial court's record. More specifically, plaintiffs' counsel said the appraiser should follow the judge's findings that the "vast majority" of salary payments to the two defendant shareholders were excessive and should be "properly normalized" to reflect corporate income. Despite this exchange, the appraiser did not adjust the owners' salaries and valued the company at only \$34,300, and the plaintiff shareholders appealed.

The plaintiffs claimed the income approach required the appraiser to normalize the defendants' salaries. His omission also contradicted the trial court's specific findings, effectively rewarding the defendant owners for their misconduct by factoring "unmerited salaries into calculating the corporation's future value," the plaintiffs

said. Finally, both the AICPA and NACVA professional standards require normalization adjustments as a "key step" in the income approach.

On review, the state appellate court disagreed, finding the trial court had "no evidence or information" showing the appraiser prepared his report incorrectly, but the state Supreme Court reversed. The trial judge had the appraiser's report, which clearly did not make any normalization adjustments. The plaintiffs also offered the AICPA and NACVA standards as evidence of appropriate valuation adjustments, which the trial court simply "declined to consider." At a minimum, pursuant to the agreed-on income approach, "some normalization adjustment was required," the court held, and vacated the appraisal.

Discount Rate Roundup: The 14 Essential Decisions in Economic Damages Cases

Not many published decisions discuss the development of a discount rate in any meaningful detail. The following 14 cases provide essential guidance to experts and attorneys alike:

1. Energy Capital Corp. v. United States, 302 F.2d 1314 (Fed. Cir. 2002)

The plaintiff's expert applied the risk-free rate of return on 10-year Treasury bonds (5.9%), adjusted for company specific-risks to 10.5%. The government's expert believed a 25% discount rate was more appropriate. The trial court adopted the 5.9% risk-free rate without adjustment, but the Federal Circuit

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Court of Appeals reversed, finding a risk-free rate did not apply when both experts testified the rate should reflect the riskiness of the plaintiff's venture. "We do not hold that in every case a risk-adjusted discount rate is required," the court explained. Rather, the appropriate discount rate is a question of fact, which should reflect the time value of money and adjustments to the cash flow based on risk.

2. Franconia Associates v. United States, 61 Fed. Cl. 718 (2004)

In this case against the federal government for breach of low-income housing loans, the U.S. Federal Court of Claims cited *Energy Capital Corp.* for its holding that the discount rate must reflect the risk and rate of return an investor would demand in the same type of venture. "The higher the risk, the higher the rate of return an investor would require," the court said. Accordingly, it adopted the 11% discount rate applied by the government's expert, who testified that risk was a "major component" of his calculation, compared to the 6% by the plaintiff's expert.

3. AlphaMed Pharmaceuticals, Inc. v. Arriva Pharmaceuticals, Inc., 432 F. Supp. 2d 1319 (S.D. Fla. 2006)

In calculating damages for the defendant's misappropriation of a pharmaceutical, the plaintiff's expert applied a 35% discount rate, citing the risks of development but also stating that the drug was already "proven" in the market. The jury awarded the plaintiff over \$78 million in damages and the defendant moved for judgment as a matter of law. The court agreed, finding the plaintiff presented a faulty "chain of assumptions" to link its losses to the alleged harm. Moreover, its expert's "unquestioning" reliance on these assumptions "fatally undermined" his 35% discount rate, and the court reversed the award.

4. In re Magna Cum Latte, Inc., 2008 WL 2047937 (Bankr. 2008)

The plaintiff's expert used a risk-free rate to calculate damages for breach of a lease, compared to the defendant's expert's "risk-adjusted" discount rate of 27.7%. Citing *Energy Capital Corp.*, the federal bankruptcy court found the plaintiff's venture was "substantially risky" and settled on a 15% discount rate—or roughly splitting the difference between the two rates.

5. Miller Bros. Coal v. Consol of Kentucky, Inc., 2009 WL 4904032 (Bkrcty. E.D. Ky.)

In assessing damages for breach of a fixed-price coal mining contract, the plaintiff's expert applied a 10% discount rate based on the plaintiff's actual cost of capital plus a slight risk premium. The expert also believed the 10% discount rate was consistent with the annuity nature of the income stream under the contract, especially given its fixed price and costs. However, a 10% rate was too low, the federal bankruptcy court held, finding 15% "more reasonable in light of the normal attendant risks of mining coal."

6. Purina Mills, L.L.C. v. Less, 295 F. Supp. 2d 1017 (N.D. Iowa 2003)

A pig seller won breach of contract damages of just over \$225,000. Neither party proposed a discount rate, and the federal district court applied the then-current U.S. Treasury bond ratings, ranging from 1.24% to 3.17% (or just about the lowest in any published decision).

7. Munters Corp. v. Swissco-Young Industries, Inc., 100 S.W.3d 292 (Tex. App. 2003)

At trial, the court awarded the plaintiff nearly \$975,000 in damages for the defendant's deceptive trade practices, based on a discounted cash flow analysis by the plaintiff's expert, who used a 10% discount rate. On appeal, the defendant argued (based on its expert's testimony) that the discount factor "should have been somewhere in the twenties." The appellate court disagreed, finding the plaintiff's expert based his opinion on objective facts, figures, and historical data.

8. Kool, Mann, Coffee & Co. v. Coffey, 300 F.3d 340 (3d Cir. 2002)

After finding fraud in the sale of a family-owned business, the bankruptcy court found for the expert's 18.5% discount rate based on "industry standards" in valuing the particular company at issue, and on appeal, the federal district court affirmed.

9. Diesel Machinery, Inc. v. B.R. Lee Industries, Inc., 418 F.3d 820 (8th Cir. 2005)

To determine damages for breach of a franchise agreement, the plaintiff's expert assumed the plaintiff would invest a lump-sum award back into its business and adjusted the discount rate by the risks of the related cash flows. The defendant objected to the analysis because it did not conform to the applicable (South Dakota) jury instruction on present value. The trial court agreed, striking the expert's testimony, and the U.S. Court of Appeals for the Eighth Circuit affirmed, finding the expert used a "sound" methodology but failed to comply with state jury instructions. (Note:

This ruling is likely limited to cases applying South Dakota law.)

10. Fairmont Supply Co. v. Hooks Industrial, Inc., 177 S.W.3d 629 (Tex. App. 2005)

On the plaintiff's claim for breach of a requirements contract, its expert applied a 33% discount rate to conclude \$1.6 million in lost profits. The defendant's expert used a 36% discount rate, but did not otherwise contest the financial variables that went into the plaintiff's expert's calculations. The jury ultimately awarded \$1.2 million in damages, which was upheld on appeal as within the range of evidence at trial.

11. Olson v. Nieman's Ltd., 579 N.W.2d 299 (Iowa 1998)

In a suit for misappropriation of trade secrets, the plaintiff's expert used a risk-adjusted rate of 19.4% to conclude over \$670,000 in damages, and the jury awarded \$650,000. On appeal, the federal district court found the verdict fell "within the parameters of that evidence," and affirmed.

12. Knox v. Taylor, 992 S.W.2d 40 (Tex. App. 1999)

In a suit for tortious interference with contract, the plaintiff's expert used a 7% discount rate to calculate damages ranging from \$9.3 million to \$11.6 million. The defendant's expert believed a 30% discount factor better accounted for the risks in this particular business (contract surety) and calculated damages ranging from \$190,000 to \$895,000. The jury awarded \$2.7 million, and, on appeal, the court found the amount clearly fell within the range of the evidence.

13. Burger King Corp. v. Barnes, 1 F. Supp.2d 1367 (S.D. Fla. 1998)

Burger King sued a franchisee for failing to pay its contractual royalties. Its expert used a discount rate of 9% and the court granted its motion for summary judgment, finding sufficient evidence to support the rate and the claimed damages.

14. American List Corp. v. U.S. News and World Report, 75 N.Y.2d 38 (1989)

After the defendant breached a 10-year contract, the plaintiff's expert used a 10% discount rate to calculate damages. The defendant's expert believed a range of 14% to 20% was more appropriate, based on the risk that the plaintiff would be unable to perform in the future. The trial court ultimately applied a "realistic discount factor" of 18%, but the New York appellate court reversed, finding the method inappropriate for an anticipatory breach of contract, and remanded the

Fair Value Standard in Divorce May Not Be Gaining National Traction

Two recent appellate decisions suggest that the majority rule may be trending away from the fair value standard in divorce, preserving (where applicable) the trial courts' broad, equitable discretion to dispose of marital assets according to the particular facts of the case.

Court discounts an LP interest. In *Alexander v. Alexander*, 2010 WL 2006427 (Ind. App.) (May 20, 2010), the wife held a 5% limited partnership interest in a family-owned farming business. Her parents retained full control as general partners, including the right to prevent a partition and to redeem a departing LP's shares. Accordingly, the wife's expert applied a 25% minority discount and 15% marketability discount to value her interest at roughly \$234,000, which the trial court accepted.

The husband appealed, urging the Court of Appeals (Indiana) to preclude the application of discounts in valuing marital assets in divorce, based on the analogy to shareholder oppression cases. Indeed, a majority of U.S. jurisdictions currently reject minority and marketability discounts when determining fair value appraisals in statutory buyback cases to prevent a windfall to the majority owners at the minority's expense. Given the parents' rights in this case, it was clear that they would be the likely buyers should the wife need to sell her LP interest to effect the distribution of marital property. The wife might even sell to her parents the day after divorce, the court noted, at "considerably more" than the trial court's value.

Nevertheless, the wife had no immediate plans to sell her LP shares, and there was no danger of a windfall to the other partners. According to its broad discretionary powers, "a trial court should be able to determine the present value of a spouse's ownership in light of marketability and minority shareholder discounts," the court ruled, affirming their application in this case.

Court discounts a controlling interest. In *In re Marriage of Thornhill*, 2010 WL 2169086 (Colo.) (June 1, 2010), the Colorado family court adopted a 33% marketability discount for the husband's *controlling* (70%) interest in a \$1.7 million oil and gas operation.

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The wife appealed, but the Colorado Court of Appeals affirmed, rejecting the wife's argument that discounts should be precluded when valuing marital assets for divorce, based on the state precedent in statutory fair value cases.

This time the wife appealed to the state Supreme Court, which reviewed the leading statutory fair value precedent in Colorado. That case turned on the statute's explicit use of the fair value standard and (similar to the rationale expressed in Alexander, above) precluded discounts to prevent a windfall to majority owners at a minority shareholder's expense. By comparison, the state's marital dissolution statute does not contain the same "fair value" language, the court observed; it simply directs family courts to divide marital property "in such proportions as the court deems just after considering all relevant factors." A non-owning spouse cannot always be characterized as a "potential victim" of oppression in divorce cases, the court added.

More importantly, unlike the law in shareholder cases, "there is no clear national trend suggesting that a per se rule against marketability discounts is the majority view when it comes to valuing ownership interests in closely held corporations in divorce proceedings. If anything, the trend appears to go against such per se rules," the court observed. Although New Jersey has extended the rule prohibiting discounts from shareholder dispute cases to divorce, several states (e.g., Oregon, Florida, and South Dakota) "have left the decision of the appropriateness of marketability discounts in valuations within marital dissolutions proceedings to the trial court's discretion."

Finally, compared to the statutory fair value standard—which rejects a case-by-case approach to appraising minority interests as too uncertain and unfair—the Colorado marital dissolution statute specifically contemplates an ad hoc approach to preserve equitable distribution. For all these reasons, the court declined to adopt a per se rule, finding that trial courts may, in their discretion, apply discounts when valuing a spouse's business interest for purposes of divorce.



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