



DE Chancery Advocates ‘Triangular’ Approach to Business Valuation

S. Muoio & Co., LLC v. Hallmark Entertainment Investments, 2011 WL 863007 (Del. Ch.) (March 9, 2011)

In its recent letter opinion, *In re Hanover Direct, Inc. Shareholders Litigation*, Consol. C.A. No. 1969-CC (2010), the Delaware Chancery court confirmed that “there is no single preferred or accepted valuation methodology . . . that establishes beyond question a company’s value.” At the same time, “there are commonly accepted methodologies that a prudent expert should use in coordination with one another to demonstrate the reliability of its valuation,” the court said, in rejecting an expert’s opinion that relied solely on a discounted cash flow (DCF) analysis.

Another company on the brink. Like the troubled company in *Hanover*, Crown Media Holdings, Inc. (the owner of the Hallmark Channel) was foundering under declining revenues, and it couldn’t find a buyer to cover the \$1.1 billion debt to its controlling stockholder, Hallmark Cards. In 2010, a special committee approved recapitalizing the debt, based on an independent appraisal that said the company was worth only \$750 million and on the brink of bankruptcy. A single minority stockholder sued to rescind the deal, claiming that both the process and the price of recapitalization were unfair and drastically undervalued the company—which was worth nearly \$3 billion, according to its expert’s DCF.

Under an entire fairness review, however, the Delaware Court of Chancery found that the special

committee was independent and had negotiated the Hallmark recapitalization at arm’s length. Further, the plaintiff’s \$3 billion DCF valuation failed to explain why no other potential buyer came forward during the company’s bidding process to capture the alleged excess value. It also failed to recognize “the brute facts” of the company’s near-bankruptcy, the court held.

Finally, the plaintiff’s expert failed to incorporate any other valuation method into his conclusions.

A DCF approach is only reliable when it can be verified by “alternative methods” or “real world valuations..”

In fact, the expert had performed a comparable companies analysis (\$803 million) and a comparable transactions analysis (\$1.3 billion), but he rejected those approaches as “absurdly low.” Such an outlier valuation reinforced its lack of credibility, the court said, citing *Hanover*. A DCF approach is only reliable when it can be verified by “alternative methods” or “real world valuations,” particularly valuations by potential third-party buyers, the court explained:

Thus, it is preferable to take a more robust approach involving multiple techniques—such as a DCF analysis, a comparable transaction analysis . . . and a comparable companies analysis . . . to triangulate a value range, as all three methodologies individually have their own limitations.

The court also rejected the expert’s DCF for ignoring contemporaneous management projections in favor of his own, and dismissed the plaintiff’s suit.

Divorce Roundup: Best (and Worst) Practices for Valuing Small Businesses

A summary of recent cases highlight both the best and worst practices for valuing small businesses in divorce, including the benefits of using an experienced BV expert; the possible limits to using a joint expert; and the continuing complexity of valuing goodwill and tax/marketability discounts.

Joint experts in divorce: When to seek a second opinion? In *Cox v. Cox*, 2011 WL 208312 (Miss. App.)(Jan. 25, 2011), a joint expert valued the husband's structural steel company at \$4.3 million before the marriage and \$4.9 million at the end, but discounted the latter by 50% due to declining industry and company conditions. At trial, the wife argued the expert should have discounted the premarital value of the business as well, but the trial court accepted the expert's reasoning and the wife appealed. On review, the appellate court affirmed that the value was supported by "substantial evidence" from the joint expert, including his conclusion that the closely held steel company "lacked an active market" and was "by definition . . . illiquid." Moreover, the wife had "ample opportunity" before trial to present her own evidence on the premarital value of the company, but failed to do so, and the court affirmed the finding of no appreciation.

Courts prefer credentials, compliance, and experience. In *Nuveen v. Nuveen*, 2011 WL 988826 (N.D.)(March 22, 2011), the husband presented a certified appraiser to value his orthodontic practice; the wife presented a lawyer-broker, who typically appraised dental practices. Both experts considered the husband's purchase of intangible assets three years before the divorce—but only the broker doubled that value, due to the practice's consistently high earnings. The trial court found the husband's expert more credible, not only because he was certified and prepared his report according to BV professional standards, but his intangible value was more accurate given the flat market conditions. The court declined to apply the expert's 12% marketability discount, however, and the appellate court confirmed, finding the valuation was within the range of evidence presented by both parties.

By contrast, in *In re Marriage of Bruns*, 2011 WL 237969 (Iowa App.)(Jan. 20, 2011)(unpub.), the husband presented a broker-expert who valued his dental practice at \$77,000. But this was only slightly higher than the \$75,000 that the husband had paid for the practice 30 years before, and it excluded goodwill. The wife's expert, a certified appraiser, said the practice was worth \$241,000, including goodwill. The trial court valued the practice at \$115,000, finding the broker understated the value but the BV appraiser had limited experience valuing dental practices. The appellate court affirmed, noting that the value complied with state precedent regarding the exclusion of professional practice goodwill.

Also of note: In *In re Marriage of Meek-Duncomb*, 2011 WL 768831 (Iowa App.)(March 7, 2011), the wife presented a CPA to value the husband's trucking business at \$145,000. But the CPA admitted he did not perform "certified valuations," and the trial court found his opinion was "less credible than a business audit." It valued the husband's semi-truck at less than \$10,000, and the appellate court affirmed.

Has Mississippi muddied the goodwill waters? Mississippi and Kansas are the only two states that still decline to assign any value to the goodwill of a marital business. In *Rhodes v. Rhodes*, 2011 WL 80222 (Miss. App.)(Jan. 11, 2011), the Mississippi Court of Appeals recited the long-standing precedent: "goodwill is simply not property; thus it cannot be deemed a marital asset," in affirming the trial court's rejection of an expert who failed to exclude goodwill or assign it a separate value in his appraisal of the husband's home furnishings business. A strong dissent argued that a proper reading of state law precludes goodwill only from professional practices.

However, less than a month later, the Mississippi Supreme Court decided *Lewis v. Lewis*, 2011 WL 322410 (Miss.)(Feb. 3, 2011), which said the law of the state is "clear and comprehensive," and "stare decisis demands" the valuation of the parties' real estate firm, excluding any goodwill. The issue may not be so settled; two Supreme Court justices dissented, arguing that general accounting principles support valuing a business's intangible assets, including goodwill.

Tax and other discounts depend on facts. In *Shuck v. Shuck*, 2010 WL 206845 (Neb. App.)(Jan. 25, 2011), the Nebraska Court of Appeals held that discounting the value of a marital business for

built-in capital gains tax liability is relevant only in two situations: when the sale of the business is reasonably certain to occur in the near future; or when liquidation is necessary to satisfy the owner-spouse's financial obligations in divorce. At the same time, tax adjustments to the entity's cash flow streams under the income approach are proper, because these relate to the business's obligation to pay annual, ordinary income taxes rather than to any built-in depreciation or capital gains tax realized on sale. Lastly, the court affirmed that under state law the application of minority and marketability discounts to the value of a marital business falls to the trial court's discretion, depending on the particular facts of the case.

Uncooperative owner-spouse may hurt his own appeal. In *Salumbides v. Salumbides*, 2011 WL 835102 (Neb. App.)(March 8, 2011)(unpub.), the husband failed to disclose sufficient financial information to value his neurosurgery practice. The trial court conceded the difficulty, and ultimately valued the practice at a "significantly low" \$155,000 based on the wife's appraiser's assessment of accounts receivable and tangible assets. The husband appealed the value for lack of support, but the appellate court affirmed, noting that he could hardly complain of a situation he helped create.

Reasonable Compensation for Directors of Closely Held Is 4% to 7% of Sales, Plus Premium

Rubin v. Murray, 2011 WL 873472 (Mass. App.) (March 16, 2011)

A minority shareholder of a closely held manufacturing company sued the directors for breach of fiduciary duty, claiming that the nearly \$15 million they had paid themselves over 15 years as performance-based bonuses were in fact disguised dividends. At trial, both parties presented experts to testify on what constituted reasonable compensation for the company's executives.

Bonuses took up all the net profits. The plaintiff's expert, a financial analyst, reviewed comparable data from two published compensation surveys. In light of this data and the defendants' skills and roles in the company, its sales growth and gross profit

margins (before payment of the executive bonuses), the expert concluded that all of the amounts over and above the defendants' salaries were excessive. By contrast, the defendants' expert asserted that the performance-based bonuses were merited by the critical roles that the defendants had played in the company's 30-year success. The IRS had never audited the company's tax returns for unreasonable compensation, he also noted. When the company's treasurer testified, however, he was unable to identify any performance-based or empirical criteria for the defendants' bonuses.

The court found it significant that the bonuses corresponded to the defendants' respective ownership percentages in the company rather than to any objective performance factors, and comprised a "very high percentage" of the company's net profits. In fact, since 1995 they had paid themselves nearly all the profits remaining after contributions to an employee profit-sharing plan. The court also accepted the findings from the plaintiff's expert that the defendants had paid themselves nearly twice the typical compensation for top executives, but it denied that all

compensation in excess of salaries was unreasonable. Instead, the court found that comparable officer compensation for the years in question fell between 4% and 7% of net sales among comparable companies. It then added a "success premium" based on the individual defendants' "significant abilities and contributions" to the company's profitability and concluded that reasonable compensation for the defendants equaled 10% of the company's average annual net sales.

Accordingly, the court ordered the defendants to repay just over \$5.8 million to the company as excessive compensation, and the defendants appealed the award as speculative. After reviewing the expert evidence and the trial court's findings for clear error, however, the appellate court confirmed its conclusions regarding reasonable compensation and the award.

The court also accepted the findings from the plaintiff's expert that the defendants had paid themselves nearly twice the typical compensation for top executives..."

Discounts are Appropriate When Oppressed Minority Wants to Sell Shares

**Ritchie v. Rupe, 2011 WL 1107214 (Tex. App.)
(March 28, 2011)**

A successful investment corporation in Texas was owned by four siblings. When one died, passing his 18% interest to his wife, she tried to sell the shares back to the company, but the parties were unable to agree on a price. In 2004, she hired a broker to help her sell her interest, but the company denied information and access to any potential buyer. Ultimately, the broker was unable to find a buyer, and the widow sued the corporation for shareholder oppression and asked for a forced buyout.

After a trial, a jury found the company liable and then determined a buyout price, based on evidence from the minority shareholder's experts, who concluded that the fair value of her 18% interest was worth between \$7.37 and \$8.92 million, without discounts. The jury awarded the minority shareholder \$7.3 million, and the majority owner appealed, claiming the jury used an incorrect valuation date and erroneously excluded discounts.

Two types of fair value. As a preliminary matter, the Texas Court of Appeals confirmed that a buyout remedy is available in shareholder oppression cases in Texas. The court also found no error in the valuation date, because the appellants failed to show any material change in share value between the date of oppression (the company's refusal to meet with potential buyers) and the date of its last audited financial.

Turning to whether to include discounts in the buyout price, the court explained that there are "two types" of "fair value": enterprise value and fair market value. Although enterprise value of stock is determined by the value of the company as a whole, the court said, "fair market value" turns on the hypothetical willing seller/willing buyer standard. In this case, the jury awarded enterprise fair value, which is appropriate when a minority shareholder, "with no desire to leave the corporation, has been forced to relinquish his ownership position by the oppressive conduct of the majority," the court



ClarityBV provides independent business valuation services, including financial reporting and tax valuations, litigation support, and transaction consulting.

For more information, contact:

Brian M. Alwine, CPA, ASA
10775 McKinley Highway, Ste. C
Osceola, Indiana 46561
Email: balwine@claritybv.com
Phone: (574) 970-7810

**Subscribe to this newsletter
and access past issues at:**

www.claritybv.com/newsletter

said. Enterprise fair value is also appropriate in the context of a "squeeze out" merger, when there may be a willing buyer but the minority shareholder is an unwilling seller.

In this case, however, the trial court should have provided the specific relief that the majority owners' oppressive conduct sought to prevent: i.e., a sale at fair market value. She was entitled to "no more than that," the appellate court said. Two factors affect a sale at fair market value: the stock's lack of marketability and its minority status. By expressly instructing the jury to exclude these factors in determining "fair value," the trial court erred by ordering the company to buy back the minority shareholder's interest at more than fair market value, thus providing her "excessive relief," the court held.

There was some evidence for discounting the minority shareholder's interest, the court added. For instance, her experts testified that an appropriate marketability discount could range from 13% to 45%, with an average of about 30%; an appropriate minority discount would fall between 5% and 30%. The appellate court declined to decide the factual issue, however, and remanded the case to the trial court to determine the fair market value of the stock.