

Viewpoint on Value



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A house divided

Shareholder disputes call for valuation expertise

When shareholders fail to see eye-to-eye — for example, when minority shareholders oppose a major corporate decision or a controlling owner is accused of wasting corporate assets — the owners may need an appraisal to equitably part ways. But before valuing a privately held minority interest, an appraiser needs to address several issues.

Sibling rivalry

Shareholders sometimes disagree. To illustrate, consider the hypothetical example of Larson Brothers Pest Control Company. The eldest brother, John, owned 70% of Larson Bros. and wanted to merge it with his new wife's house-cleaning business. His three younger brothers — Paul, George and Ringo — each owned 10% of the stock and opposed the merger.

John hired a valuator who concluded that each 10% interest was worth \$300,000 on a minority, non-marketable basis, using the income approach. The appraisal included a 20% discount for lack of control and a 25% discount for lack of marketability. He offered to buy out his brothers' interests at this estimate of fair market value.

Meanwhile, Paul and George hired their own appraisal expert, who valued their 10% interests at \$500,000 each on a controlling basis — two-thirds more than John's offer. Their attorney advised the expert to omit valuation discounts in accordance with the 1999 Revised Model Business Corporation Act, which defines fair value as:

The value of shares immediately before the corporate action to which the dissenter objects using customary and current valuation concepts and techniques generally employed for similar

businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amending to the certificate of incorporation pursuant to section 13.02.

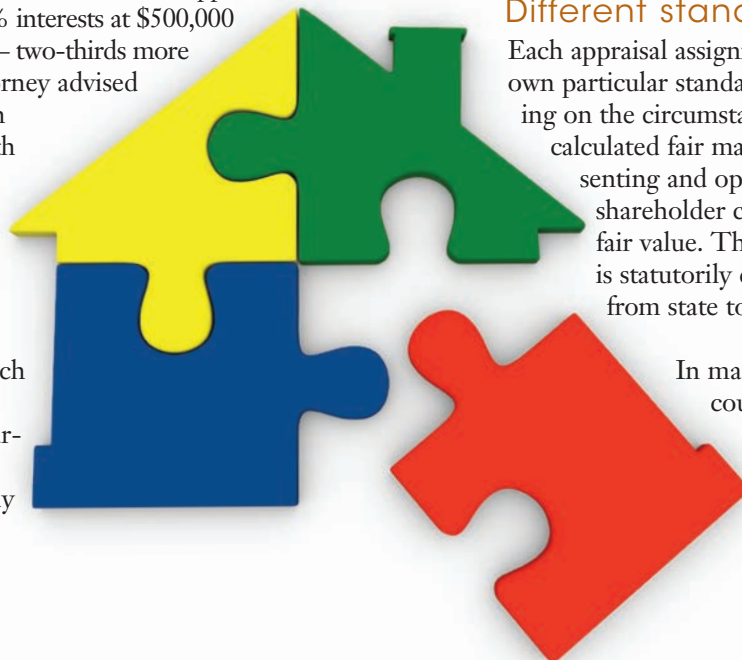
The youngest brother, Ringo, hired a third expert who adjusted the company's income stream for excessive discretionary expenses, including \$150,000 for above-market owner's compensation paid to John and \$50,000 paid to his wife in "management fees." His expert valued Ringo's 10% interest at \$600,000 on a controlling basis, which was double John's offer.

For simplicity, this hypothetical example assumes that all other valuation assumptions were consistent among the three appraisers. In reality, appraisers might differ in other valuation parameters, such as projected income streams, capitalization rates and methodology. However, the example shows the importance of addressing valuation issues — such as the appropriate standard of value, valuation discounts and adjustments, and the effective appraisal date — before valuing the business. If they aren't addressed, different experts may arrive at significantly disparate values.

Different standards

Each appraisal assignment requires its own particular standard of value, depending on the circumstances. John's expert calculated fair market value, but dissenting and oppressed minority shareholder cases typically require fair value. This standard of value is statutorily defined and varies from state to state.

In many jurisdictions, courts exclude discounts for lack of control and marketability when computing





fair value. That's because the buyers and sellers are known and the statutory buyout creates an effective market for the minority interests.

The theory underlying the omission of valuation discounts is that purchasing a minority interest for less than a pro rata share of the entire business's value provides a windfall to controlling shareholders. And in many cases, the buyers (the controlling shareholders) have defrauded the business, wasted corporate assets or otherwise oppressed minority owners. It should be noted that New York routinely permits discounts for lack of marketability in minority buyout cases.

Getting back to normal

Valuators sometimes make well-reasoned adjustments to the subject company's income stream before applying the market or income approaches. In our hypothetical scenario, Ringo's expert adjusted

the Larson Bros. income stream for above-market owner's compensation and management fees.

Appraisers also make normalizing adjustments for such items as extraordinary events, discontinued operations, and nonrecurring income and expenses. Attorneys and appraisers need to discuss which adjustments are appropriate in shareholder disputes.

It's about time

Ambiguity may exist concerning the effective valuation date. And values can swing significantly over time in an uncertain economy. The most common effective dates in minority shareholder litigation include the day before the corporate action to which the dissenter objects, the date of court filing and the trial date.

A valuator also may need to factor in events that occurred after the valuation date, such as a subsequent sale. Another consideration is whether there's any appreciation or depreciation in value from a proposed corporate action.

Forethought is imperative

Appraisers specialize in business valuation and financial issues, not in legal matters. An experienced appraiser discusses these issues with the attorney to determine the valuation's purpose, taking into consideration any statutes that may apply, as well as the applicable standard of value. The appraiser then succinctly defines the assignment in writing before valuing the business. ●

Avoid roadblocks with a reliable buy-sell agreement

Business owners may be lulled into thinking their companies are purring along the road to success. But those same businesses may run into roadblocks when unexpected events, such as death, disability or divorce, send them into uncharted territory. A well-reasoned buy-sell agreement can help

businesses maintain control and ensure orderly ownership transfers.

Spell it out

Many buy-sell agreements are based on a formula or rule of thumb such as book value or some multiple

of earnings or cash flows. Some base the price on the shareholders' judgment of value. But these methods can lead to under- or overvaluation, or to conflicts among the shareholders. This is especially the case because business values may change over time.

One of the leading causes of disputes in buy-sell agreements is their failure to provide valuation guidelines.

The best approach is to provide for valuations by one or more independent appraisers, either periodically or at the time of a triggering event. Buy-sell agreements may call for a single or several appraisers. Some agreements, for example, provide for the buying and selling parties each to select an appraiser. If their valuations are within a specified percentage of each other, the average of the two sets the price. But if their valuations are too far apart, a third appraiser (often selected by the first two appraisers) chooses the "winning" valuation.

Alternatively, the third appraiser might perform a separate valuation, which then is averaged with the others. The possible arrangements are practically limitless as long as the agreement clearly spells them out.

Time it well

Another significant consideration is when the appraiser will be selected. Many buy-sell agreements provide that the parties will select an appraiser after a triggering event occurs. But there are two significant drawbacks to this approach. First, it may be difficult for the parties — who now have conflicting interests — to agree on someone. Second, even if both parties are comfortable with the appraiser, the outcome will be uncertain.

A more effective strategy is to select an appraiser at the time the agreement is signed. Ideally, the appraiser will perform a valuation at that time to set the initial buyout price and then reevaluate the business annually — or every two or three years. This allows the parties to become comfortable with the appraiser's methods and conclusions, keep the valuation up to date and understand what the buyout price will be.

Define your terms

One of the leading causes of disputes in buy-sell agreements is their failure to provide valuation guidelines and define key terms such as:



Standard of value. A buy-sell agreement might state that the buyout price is the value of an interest in the business. But "value" can mean different things in different contexts, so the agreement needs to spell out whether the price should be based on fair market value, fair value, investment value or another standard.

Valuation date. All appraisals value a business or business interest as of a certain date, which can have a big impact on the result. The agreement should

specify whether the date used is the date of the triggering event, the last day of the company's most recent fiscal year or some other date.

Other considerations

Other issues to consider include time limits for completing various valuation steps, appraiser qualifications and alternative dispute resolution. The preferred method of resolving valuation problems inherent in buy-sell agreements is an agreement requiring shareholders to abide by independent findings if the agreement's terms trigger a valuation. Some agreements also contain a binding arbitration clause.



In addition to maintaining corporate harmony, independent valuation can help shareholders avoid legal battles. Objectively derived company stock values stand up well under IRS and court examination.

Stay on the right road

Independent professional valuation services increasingly are favored in buy-sell agreements because shareholders must agree on a valuation firm's qualifications and independence. The resulting valuation under the agreement will be objective and independent of any individual shareholder's interests, and therefore fair to all shareholders. ●

Go deep

Superficial overviews won't pass muster in patent infringement cases

Valuators often are hired to quantify patent infringement losses — which may involve estimating lost profits or determining reasonable royalties. But conclusions based solely on the outdated 25% rule of thumb or a superficial overview of the *Georgia-Pacific* factors won't pass muster, according to recent U.S. Federal Circuit Court decisions.

Goodbye, shortcut

For years, courts passively tolerated the "25% rule" as a starting point for quantifying reasonable royalty rates on infringed technology. The logic underlying the 25% rule was that an inventor typically should receive 25% of a product's profits for coming up with the concept.

The licensee was entitled to the remaining 75% of profits for what it brought to the table — including manufacturing, marketing and distribution expertise.

Valuation experts would take that number and adjust their conclusions up or down based on factors such as the strength of the patent or whether substitute technology existed.

The landmark case that deemed the 25% rule a "legally inadequate methodology" for establishing prospective royalties was *Uniloc USA, Inc. v. Microsoft Corporation*. Here, the Federal Circuit Court decided that the 25% rule "fails to tie a reasonable royalty rate to the facts of the case."

Hello, targeted analysis

Similarly, the Federal Circuit reversed an \$8.3-million patent infringement loss award in *WhitServe LLC v. Computer Packages Inc. (CPI)*. WhitServe accused CPI of infringing four patents related to automated delivery of professional services and client data backup. The accused products generate reminders to clients



about upcoming patent or trademark annuity or maintenance fee deadlines.

The appellate court upheld that the defendant had infringed these patents and that the plaintiff’s expert used a reasonable revenue base for estimating lost profits. But it determined that the expert’s royalty rate was too speculative and his cursory recitation of the *Georgia-Pacific* factors without sufficient in-depth analysis was superficial. (See “What are the *Georgia-Pacific* factors?” at right.)

More specifically, the court encouraged experts to “concentrate on fully analyzing the applicable factors, not cursorily reciting all fifteen.” In other words, valuers should provide some explanation of both why and to what extent each particular factor affects the royalty rate calculation.

The plaintiff’s expert in *WhitServe* also erred by applying the 25% rule to *profits*, and then expressing a final royalty rate as a percentage of *revenues*. Moreover, the court criticized the \$8.3-million award because it was “out of line with economic reality.” The expert’s proposed lump-sum payments would have consumed three-quarters of the defendant’s profits.

This case was remanded for a new trial on damages. It’s interesting to note that the original trial in *WhitServe* occurred prior to the *Uniloc* decision, while the appellate case occurred afterward.

A place for rules of thumb

In the aftermath of *Uniloc* and *WhitServe*, the 25% rule can no longer solely be used to shortcut royalty rate calculations, primarily because it is just a “rule of thumb” and doesn’t constitute empirical evidence. But it still has a place in a valuator’s analysis as a sanity check and in many cases a reasonable royalty rate conclusion may justifiably be higher or lower than 25%. ●

What are the *Georgia-Pacific* factors?

When determining losses from patent infringement, valuers typically consider the 15 factors first set out in 1970 in *Georgia-Pacific Corp. v. U.S. Plywood Corp.* These include:

1. Royalties, including those the inventor has received for licensing the patent and rates paid by the licensee for the use of comparable patents,
2. The nature and scope of the license, such as whether it’s exclusive or nonexclusive, restricted or nonrestricted — by territory or product type,
3. Whether the inventor and licensees are competitors,
4. The patent’s duration and the license’s term,
5. The nature of the invention and benefits to its users as well as the extent to which the infringer uses the invention and the value of that use,
6. The portion of the realizable profit that should be credited to the invention rather than to any unpatented elements, processes, risks or improvements the infringer has added, and
7. Opinion testimony of qualified experts.

Site tours: Why experts visit before they value

Few people make a major purchase, such as a car or a home, without physically inspecting it first. Similarly, appraisers tour facilities and interview management before they draw value conclusions. Site visits and management interviews are integral parts of the valuation process; they shouldn't be overlooked.

Site visits add credibility

Courts agree. In a recent divorce case, *In re Marriage of Hanscam*, the Court of Appeals of Oregon commended the thoroughness of the husband's appraiser — in part, because he'd visited the husband's CPA office and interviewed partners before valuing the business. The wife's expert didn't tour the facility, and the court rejected his appraisal. The court implied that onsite assessments are especially important when appraisers rely on "subjective criteria."

Other landmark cases that underscore the importance of timely site visits and the credibility they lend to an appraiser's analysis include *Zeeffe v. Zeeffe* and *Okerlund v. United States*.

Seeing is believing

Site visits provide a firsthand opportunity to learn about subject company operations. During a tour, valuers consider characteristics such as:

- Operating efficiency and safety,
- Fixed asset condition,
- Physical controls,
- Capacity constraints,
- Signage, parking and access,
- Staff morale, attitude and skill level, and
- Hidden liabilities and risks.

Most valuers aren't operations experts or forensic accountants. But they do employ professional



skepticism when touring a business's facilities. For example, a valuator will note blatant risk factors — such as unhappy or idle workers, dusty or broken equipment, unlocked doors, or cluttered aisles — in his or her valuation report and raise these issues with management before concluding the tour.

Asking the right questions

Discussing concerns, asking questions and clarifying gray areas are essential to an effective site visit. Sometimes an appraiser asks to speak to several managers separately for about half an hour each. By speaking with more than one person, the appraiser gains a broader perspective and can corroborate employees' impressions of the company's strengths, weaknesses, opportunities and threats.

Confidentiality is especially important when interviewing managers in an adversarial situation, such as a divorce or shareholder dispute. An experienced appraiser knows how to set up and conduct interviews in a way designed to preserve the integrity of all parties involved.

Connecting the dots

Valuing a business involves more than scouring the books and crunching the numbers. By taking the time to visit a company's facilities and talk to management, an appraiser gets a clearer picture of business operations and sometimes unearths surprises that affect the final value conclusion. ●



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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at 203 - 255 - 3805. The fax is 203 - 380 - 1289, and e-mail is Mac@LeaskBV.Com.

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John M. Leask II CPA, LLC.
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If you have a business valuation problem, Mac is always available to discuss your options — at no charge.