

# Viewpoint on Value



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# Who, what, why and when?

## Preparing for an appraisal

Before you pick up the phone to hire a valuation professional, you need to think about what you're looking to achieve and what you should expect throughout the appraisal process. Business owners, attorneys and other interested parties who understand valuation terms, anticipate information requests and provide reasonable timelines will help minimize errors, surprises and haste.

### Outlining the assignment

Every valuation assignment starts with a succinct definition of what's being valued. Obvious details include company name, number of shares, effective appraisal date and estimated completion date.

Other parameters may be less clear. For example, valuations are valid only for the purposes specified in the appraiser's engagement letter. The following parameters are largely determined by the valuation's purpose:

**Standard of value.** Most appraisal assignments call for "fair market value" as the appropriate standard

of value. Revenue Ruling 59-60 defines fair market value as:

The price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Other standards of value sometimes apply. For instance, "strategic value" (value to a particular buyer) may be appropriate in mergers and acquisitions. Or "fair value" may be used for minority oppression and dissention cases, divorces or accounting compliance purposes. Each type of fair value differs and is prescribed by legal precedent or Generally Accepted Accounting Principles (GAAP).

**Basis of value.** This component refers to whether the business interest should be valued on a controlling or minority basis, as well as whether a discount for lack of marketability applies. Sometimes, the application of discounts is straightforward. For example, if an appraiser values a 1% closely held

business interest for gift and estate tax purposes, he or she generally is seeking a minority, nonmarketable basis of value.

If, on the other hand, the appraiser is valuing a 50% interest or a controlling interest in a small private firm, applying and quantifying discounts is less straightforward.

An appraiser should support all discounts with detailed empirical evidence, customized to the unique characteristics of the subject company. Early identification of contentious issues helps to solidify defensive



strategy and ward off scrutiny from opposing counsel, IRS agents, auditors, judges and others who rely on the valuation.

## Fact finding

Valuing a business requires a series of fact-finding steps. After the assignment has been clearly outlined, the valuator starts gathering data. Typically, he or she will provide a list of documents the business owner or CFO must collect. Beyond financial statements and tax returns for the past five years, the valuator may request:

- Budgets, business plans and forecasts,
- Partner or shareholder agreements,
- Fixed asset and inventory ledgers,
- Marketing materials, such as brochures, price lists, newsletters and advertisements, and
- Schedules of owners' compensation and related-party transactions.

The valuator also may require personal financial statements from all shareholders and copies of all prior appraisal reports for the company and any of its assets. Other areas of inquiry may include business history, operations, technology, industry conditions and contractual arrangements.

The appraiser's goal is to get to know the subject company. He or she is forming an opinion about key value drivers, potential financial statement adjustments, internal and external risk factors and relevant economic trends. The appraiser also looks for alternative value indicators, such as previous offers to purchase stock, buy-sell agreements, loan applications and key person insurance policies.

If management isn't inclined to complete paperwork or if time is tight, the appraiser might opt to verbally interview them during the site visit. Interviews also enable the appraiser to dig deeper into the written responses.

Touring the company facilities is also an essential step in the valuation process.

Site visits provide a hands-on impression of business operations. Risk factors valutors watch for include nonoperating, idle or damaged equipment; inadequate security, ingress and egress, and parking; hazardous working conditions; and weak employee morale.

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## Communicate early and often

Your initial call to hire an appraiser and define the assignment won't be your last. Expect to communicate with your expert on a regular basis. Valuators need the owner's help to understand the business. After collecting all relevant data, the appraiser crunches the numbers and typically reports his or her findings in a formal appraisal report.

But the process of arriving at an accurate value is a team effort. ●

## How to handle a "War of the Roses"

Not all appraisal assignments involve amicable business relationships. But discord between disputing parties stunts the flow of information — and it can lead to inaccurate conclusions.

If you suspect foul play or unequal access to financial information, be proactive. As soon as your case has been filed, hire your own appraiser and ask what he or she will need to value the business. Then petition the court for access to all requisite documents, to require the controlling shareholder to complete your appraiser's questionnaire, and to schedule a facility tour and management interview.



# Getting a fair deal

A fairness opinion can help

A fundamental question concerning any business transaction is whether it's a fair deal. But how is fairness determined? A fairness opinion stating whether a proposed merger, acquisition or other transaction seems fair in light of the financial circumstances is typically the first step, and it can give you peace of mind if you're inexperienced or unsure about a complex deal. It also can reassure bankers providing financing.

But if the fairness opinion isn't well supported and well reasoned, it may not hold up to legal scrutiny.

## What is a fairness opinion?

A fairness opinion typically takes the form of a letter addressed to a company's board of directors (or other decision maker) stating whether a major transaction is fair from a financial perspective (but not necessarily a legal or procedural perspective). In deciding whether a transaction is fair, the financial expert considers the transaction's price and terms as well as the company's characteristics.

To be sound, a fairness opinion must demonstrate that it took into account any potential conflicts of interest. It should also show basic due diligence regarding risk analysis, deal structure, pricing, comparable transactions and timeliness. Data quality and the time allowed for the analysis will also affect the quality of the final opinion.

In many ways, a fairness opinion's analysis is similar to that of a business valuation. For instance, in determining whether a company's purchase price is fair, a valuator considers the value of the company's assets (the asset-based approach), sales of comparable companies (the market approach) and the present value of the company's cash flow (the income approach).

## Why do companies need them?

Currently, fairness opinions aren't a legal requirement. But both publicly traded and privately held companies can benefit from obtaining them for major

transactions as well as for related-party or other controversial transactions.

Think of a fairness opinion as an insurance policy. A fairness opinion protects you from a minority shareholder claiming you didn't obtain a fair value in a given transaction. In addition, a business loan covenant may require management to obtain a fairness opinion before embarking on a major transaction such as a business segment's merger or sale.

Fairness opinions provide evidence that management complied with the "business judgment rule," which requires that an executive act on an informed basis, in good faith, in the best interests of the company's shareholders and without fraud or self-dealing.



## What are the limits?

Fairness opinions are useful only if you understand their parameters. For instance, just because a transaction is found to be fair doesn't mean the company should pursue the opportunity. A fairness opinion determines whether the price offered in a proposed transaction is fair from a *financial* perspective. It doesn't typically address structural or legal fairness.

## Fairness opinions and beyond: Helping distressed companies

A valuator's fairness opinion can provide needed objectivity in a liquidation situation. But in addition to providing fairness opinions for management buyouts and third-party acquisitions, valuers can advise distressed businesses on other issues, such as devising and implementing reorganization plans. Valuation experts can help project expected cash flows and estimate going-concern values for reorganization alternatives, as well as negotiate debt restructuring with creditors.

Nor does it constitute an endorsement of a particular course of action.

In addition, fairness opinions can't protect unscrupulous managers involved in self-dealing. They also fall short when the expert's standard of fairness differs from that prescribed by law, underscoring the importance of

reviewing relevant state laws and legal precedents before obtaining a fairness opinion.

And fairness opinions are typically subject to legal or client-imposed limitations, often to reduce the engagement's completion time or costs. These limitations should be disclosed in an addendum to the fairness opinion letter.

### How can a valuator help?

Executives increasingly are turning to independent valuers for fairness opinions. Both a company's accountant (who performs ongoing audit, tax and consulting services) and its investment banker (who receives a variable commission when the deal closes) have future interests in the company. Thus, opposing counsel could argue that these parties are biased and concluded that a transaction was fair only to protect their future interests in the company.

An independent valuator's fairness opinion can circumvent this argument. What's more, a valuator is more likely than a traditional CPA or a banker to have the specialized valuation experience fairness opinions require. ●

# Winning the battle, but losing the war

A look at *Estate of Gallagher*

A recent U.S. Tax Court case, *Estate of Gallagher*, provides insight into the court's stance on a broad range of valuation issues. The case addressed, among other things, the admissibility of subsequent data, the guideline public company method, tax affecting, and valuation discounts.

Although no additional tax liability was assessed against the estate, this decision isn't entirely a victory

for taxpayers. The court sided with the IRS on many key issues — and criticized the taxpayer's expert for failing to support his conclusions.

### Facts of the case

Louise Paxton Gallagher owned 15% of Paxton Media Group's (PMG's) outstanding units when she died in July 2004. PMG operated a privately held chain of newspapers that dominated smaller markets in the southeastern and midwestern United



States, as well as a TV station and several special media providers.

PMG's president valued Gallagher's interest at approximately \$34.9 million. The IRS subsequently issued a deficiency notice to the estate, claiming the interest was worth \$49.5 million. After consulting with valuation experts, the estate lowered its value to \$28.2 million, and the IRS revised its appraisal to approximately \$40.9 million.

### Key issues

*Estate of Gallagher* concerned several significant issues, including:

**Subsequent data.** The estate's expert used financial statements as of May 31, 2004, because second-quarter results were unpublished on the date of death. But the Tax Court accepted June 30, 2004, financial data for the subject company and its comparables. The court ruled that any hypothetical buyer would have inquired about second-quarter results. In addition, the estate didn't identify any intervening

events that would have caused the subsequent data to be incorrect.

**Guideline public company method.** Both experts considered the guideline public company method. But only the IRS expert gave it any weight in his conclusion. The court decided that the four public stocks were insufficiently comparable to PMG's. In addition, the sample was too small to provide a meaningful analysis.

**Tax affecting.** PMG, a limited liability company, elected to be taxed as a flow-through entity, which means the individual owners are taxed at the personal level, but the company isn't taxed at the entity level. The estate's expert adjusted PMG's earnings to reflect the taxes that might have been paid if it had operated as a C corporation.

The court disallowed the tax-affecting adjustment, citing *Gross v. Commissioner*. The estate's expert provided no explanation for ignoring the tax benefits from operating as a flow-through entity. So the court would not "impose an unjustified fictitious corporate tax rate burden on PMG's future earnings."

**Valuation discounts.** Both experts agreed that discounts for lack of control and marketability were relevant. The estate's expert didn't apply a distinct discount for lack of control. Instead, his minority interest discount was inherent in his discounted cash flow analyses.

After cobbling together pieces of both experts' reports, the judge valued the interest at approximately \$32.6 million — \$2.3 million less than the original tax filing.

The IRS's expert, however, applied a 17% discount for lack of control, based on 2004 Mergerstat Review control premium data. The court increased the

discount to 23%, based on the medians and averages found in the control premium study.

Both experts quantified a discount for lack of marketability based largely on restricted stock studies. The court had previously disdained the use of restricted stock data in *Furman v. Commissioner*. Because both sides relied on this data, however, the court accepted it as a benchmark and adopted a 31% discount for lack of marketability.

After cobbling together pieces of both experts' reports, the judge valued the interest at approximately

\$32.6 million — \$2.3 million less than the original tax filing (but \$4.4 million more than the estate's expert's subsequent valuation).

### Lessons learned

The Gallagher estate won the war but lost several key battles. Most notably, the estate's expert provided insufficient support for his assumptions and conclusions. The best line of defense when going up against the IRS is a solid written valuation report that covers all foreseeable bases. ●

## What to look for in an appraiser

Many business owners and attorneys are unsure what credentials to look for when they need a business appraised. On the coattails of *Ringgold Telephone Co. v. Commissioner*, a hot-button question these days is: Should I hire an industry consultant or a business valuation professional?

In *Ringgold*, the U.S. Tax Court accepted the taxpayer's expert's conclusion because he possessed "substantial experience" that enabled him to "factor in the specific conditions and outlook of the telecommunications industry." The IRS's expert had never valued a telecom company and had only recently returned to the appraisal profession after a 10-year hiatus.

Some have mistakenly interpreted this case to mean that industry experience alone qualifies an expert to appraise a subject company in that industry. But specific industry experience is *not* a prerequisite for admission of an economic expert. Nor is it a substitute for formal business valuation training. This point of view is supported by numerous court cases, such as *Viner v. Sweet*, a malpractice case involving the sale of a business that issued audio books. The California Court of Appeals for the Second District allowed economic expert witness testimony from an accountant and appraiser, even though she lacked hands-on industry experience.

Also beware of industry experts who rely on gut instinct and rules of thumb when valuing a business. For instance, in *R&R International v. Manzen*, the U.S. District Court for the Southern District of Florida disregarded an industry expert's lost-profit calculations because he'd failed to use scientific methods, market surveys or reliable benchmark data.

Experienced business appraisers understand where industry analyses fall in the valuation paradigm. Due diligence concerning the subject company's industry is just one piece of the valuation puzzle. Valuing a business requires a broad, intimate understanding of finance, accounting and economics.

