Business Valuations

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Lack of trading does not eliminate fair market value standard for stock options

***Noeldner v. Imago Scientific Instruments Corp.*, 2005 Wisc. App. LEXIS 475 (June 2, 2005).** *Per Curiam.*

Noeldner sought damages for Imago Scientific Corporation's (Imago's) failure to pay him on stock options. The trial court valued Noeldner's damages as the fair market value of the stock on the date Imago breached the stock option agreement, less the price to exercise the option.

Imago argued that there could be no fair market valuation for a stock that was not regularly bought and sold on the open market. The court held that there is no rule that such stock can never be assigned a fair market value as a matter of law, and found that Noeldner presented sufficient evidence to establish as a matter of fact the fair market value for the stock, including testimony from Imago about the value it placed in the stock, and the price placed on the stock in two recent sales. Accordingly, the court affirmed the trial court's valuation of damages based on the stock price of $8.00 per share.

Debt capacity of seasonal businesses should be tied to permanent working capital levels

The enterprise value of a business is very important to its creditors, especially when the business is distressed and debt capacity is questioned. A common way to calculate enterprise value is through a discounted cash flow (DCF) analysis, with related working capital projections. This can be a daunting task for seasonal companies. Often, seasonal businesses will have working capital changes that are temporary, resulting in a cash flow impact that will later be reversed. So, when valuing a seasonal business using an annual DCF, it is crucial to understand where the business is in its annual cycle.

During an off season of a seasonable business, inventory, accounts receivable, accounts payable, and the revolving debt balance would be at relatively low levels. Because seasonal balance sheet changes are not reflected in the cash flows of an annual DCF analysis, the amount of excess seasonal working capital at the valuation date (if any) needs to be calculated and added to the results concluded from the discounted annual cash flows.

Gary Durham, in a recent analysis from National Litigation Consultants Review, argues that if a seasonal company is valued as of its "slow" period, where working capital and revolving debt balances are at their lowest, no adjustments for excess working capital need to be made as they are at "permanent" levels. If the valuation date is at any other period, the working capital balance (excluding revolving debt from the calculation) in excess of the slow level must be added to the conclusion using an annual DCF to arrive at an enterprise value. Subtract total debt to arrive at equity value.

Court rejects DCF approach where inputs are "untethered to reality"

***Finkelstein v. Liberty Digital, Inc.*, 2005 Del. Ch. LEXIS 53 (April 25, 2005).** *Judge Strine.*

Liberty Digital, Inc., was merged on March 14, 2002, and survived the merger as a wholly owned subsidiary of Liberty Media. The parties agreed to a fair value of Liberty Digital's assets—except for an "Access Agreement" with AT&T.

This Access Agreement was a binding "agreement to agree" on terms whereby Liberty Digital would have preferential access to channel space on AT&T's digital cable network if and when AT&T deployed "advanced set-top boxes." By 2001, prospects that AT&T would deploy advanced set-top boxes in the near future had dimmed.

Nonetheless, the dissenting shareholders contended

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that the Access Agreement was worth $2.2 billion. To arrive at this value, their expert used primarily a discounted cash flow (DCF) analysis. Their valuation started from the assumption that Liberty Digital would ultimately provide 12 interactive channels on AT&T's digital networks, each channel earning revenues equal to $0.75 per AT&T digital subscriber to be adjusted upwards 2 percent annually for inflation. They projected that AT&T's digital subscribers would grow 20 percent annually until they reached 80 percent of AT&T's overall customer base.

Despite these aggressive assumptions, the shareholder's expert claimed he was "lowballing" because he calculated the value of nine years of cash flow, and did not include a terminal value.

DCF input unacceptable

The Delaware Chancery Court "trashed" this clearly optimistic valuation, starting with the following:

There is a well-known phrase, "if wishes were horses, then beggars would ride." If [the valuation expert's] wishes were horses, the petitioners would have ridden and owned Secretariat, Seattle Slew, and (the trial judge's favorite) Affirmed, Triple Crown winners all.

First, the expert admitted that he had no evidence that AT&T had any plans to roll out advanced set-top boxes within any foreseeable time period. The court's response was:

> If Chuck Berry had envisioned the iPod in 1955, he would have had a good idea but no way to make money off it absent technological innovations decades away; thus, he was far better off giving us the gift of Maybellene.

Second, the court next faulted the valuation for disregarding Liberty Digital's inability to forge an advantageous, definitive affiliation agreement with AT&T in the years leading up to the merger—at least partially because Liberty Digital's plans for interactive channels were essentially conceptual and turned on its ability to sign up programming and product partners, none of whom would sign with Liberty Digital until it had an advantageous and specific final access agreement with AT&T.

Other problems with the DCF analysis were that it ignored competitors such as Home Shopping Network and QVC, pretended it would cost nothing to bring a channel to market, and inflated per subscriber revenues.

Finally, the court also found that paying lip service to other valuation approaches (e.g., comparable company approach and assumptions) was equally flawed. As to these, the court mused:

> Anyone who would place weight on these valuations would be well-advised to ask themselves this question first: If my family had to derive its nutrition during the next six months exclusively from food delivered to our home by Webvan during the next six months, would we live to tell about it?

Precedent transactions analysis preferred

In contrast with the "flights of fancy," the court found that the company's expert, who used a precedent transactions analysis, was essentially on the mark.

Report is inadmissible unless expert is certified, uses correct methodology, and does independent analysis

***In re Med Diversified, Inc.,* 2005 Bankr. LEXIS 2236 (Bankr. F.D.N.Y. November 14, 2005).** *Judge Bernstein.*

In a case of first impression in a bankruptcy adversary proceeding, the narrow issue was whether the proposed business valuation expert witness for Addus Healthcare, Inc. (Addus), was qualified and whether his purported expertise satisfied the standards of relevance and reliability under Daubert v. Merrill Dow Pharmaceuticals, Inc., 509 U.S. 579, (1993).

Addus, the defendant in the case, called the expert to testify on the value of 100 percent of Addus's shares, as well as on the reasonably equivalent value of an alleged option payment of $7.5 million paid by Med Diversified, Inc. (Med D) for a 6 ½ month extension to close its purchase of these shares. Med D was insolvent at the time of the payment, and the bankruptcy trustee for Chartwell Litigation Trust (Chartwell), Med D's successor, was attempting to set aside the payment as a constructive fraudulent transfer.

Qualification and reliability of alleged valuator rejected

Chartwell filed a motion in limine to exclude all of the expert's testimony on the ground that he did not qualify as an expert on valuation of all of the shares of a privately held health care services company. This motion gave rise to the court's exercise of its gatekeeper function under Daubert, to "ensure that

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the courtroom door remains closed to junk science while admitting reliable expert testimony that will assist the trier of fact."

The expert had no peer-granted certifications or formal education as an expert on business valuations. His support staff was certified business valuators who provided input into the Expert Report, but those valuators were not available for cross-examination.

The court indicated it was not prepared to admit an Expert Report submitted by a corporate entity, saying that "the person who signs the report has to testify until the admission of his Report for all evidentiary purposes has been stipulated to." The court also indicated that it would not qualify the expert because he had neither sufficient experience in the field nor formal training or certification, even though he had worked for over twenty-plus years as an accountant and as a liquidating agent or bankruptcy trustee.

The court also found that even if the expert was found to be otherwise qualified, his testimony would still be inadmissible because he "showed a discernible measure of negligence in purportedly applying the alleged professional standards and techniques found in the published practical treatises, including the standards and techniques published in the writings of Dr. Shannon Pratt and his co-authors, which were repeatedly propounded by both the Defendants and the Plaintiffs." He based his analysis on inadequate data, conflated the discreetly different concepts of gross cash flow and net cash flow from operations, and failed to explain why the DCF method was excluded. If this wasn't enough, he did not independently analyze the data from the databases from which he derived his figures—"Mergerstat" and "Factset;" in choosing the comparable companies and transactions.

Absent court appearance by appraiser, valuation report is hearsay

***Van Der AA Investments, Inc. v. Commissioner,* 2005 U.S. Tax Ct. LEXIS 21 (July 6, 2005).** *Judge Halpern.*

In the tax court, business valuation experts must be available for cross-examination. In a case where the IRS challenged the calculation of net unrealized built-in gain that has been based on a contemporaneous valuation of the assets subject to built-in gain tax, the valuation report by itself constitutes inadmissible hearsay where the preparing appraiser is not available for cross-examination; the valuation report in such a case does not fall under the business record exception.

Failure to challenge distinction between personal and professional goodwill leads to affirmation for opposing valuation

***Geaccone v. Geaccone,* 2005 Tex. App. LEXIS 5857 (Tex. App. July 28, 2005).** *Judge Hanks.*

One of the issues in this marital dissolution was the value of husband's dental practice.

The wife's expert submitted a report indicating that the dental practice had an appraised market value of $433,000, and testified that his "values all excluded the issue of personal goodwill."

The husband's expert valued the dental practice between $19,000 and $47,000, depending on the accounts receivable, arguing that the opposing valuation "includes a substantial amount of goodwill, which in my understanding is not divisible [in] Texas."

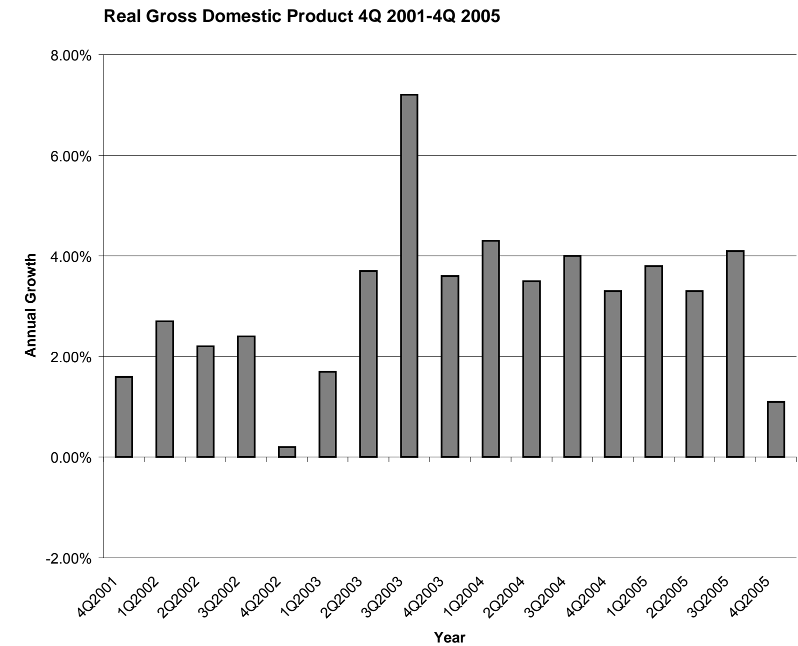
The trial court concluded that the dental practice had a net value of $377,740. The court concluded that because the husband's expert had not challenged the opposing report at trial, and had not attempted to distinguish between personal and professional goodwill, it could not determine if there had been error. Therefore, the court held that because the wife's expert testified that his values all excluded the issue of personal goodwill, the trial court did not abuse it discretion in its valuation of the dental practice.

4th Quarter 2005 General Economic Conditions

The U.S. economy, hampered by rising interest rates and surging energy prices, grew at a its slowest pace in three years during the fourth quarter of 2005. Although the fourth-quarter figure was much lower than expected, the gross domestic product (GDP), which is the broadest measure of the economy's health, still grew for the 17th consecutive quarter. While the Fed is still expected to increase interest rates at the beginning of 2006, inflationary pressures in the fourth quarter of 2005 remained moderate.

4th Quarter 2005 Gross Domestic Product

The U.S. Department of Commerce reported that the nation's economy increased at an annual rate of 1.1 percent in the fourth quarter of 2005, as indicated by the GDP, and marked the slowest pace since the last quarter in 2002. This is down from the 4.1 percent rate that was posted in the third quarter of this year. The fourth-quarter GDP marked the end of the streak of eight straight quarters of GDP growth between 3 and 4.5 percent, which was the longest streak of such consistent growth since World War II. In 2005, the economy grew by 3.5 percent, compared to an increase of 4.2 percent in 2004 and 2.7 percent in 2003. The deceleration in fourth-quarter GDP growth was largely contributed to the slowdown in consumer and defense spending, business investment, housing construction, and the widening trade deficit.



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