

VALUATION MATTERS

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Impact of New Federal Rules On E-Discovery and Experts

On December 1, 2006, new amendments to the Federal Rules of Civil Procedure (FRCP) went into effect. The amendments expand the duties of parties, both actual and potential, to federal proceedings to preserve and protect all forms of relevant electronic data. Parties must now take steps to preserve all relevant, discoverable data, including preventing the destruction of electronic evidence. These new duties permit attorneys to assess the role that experts such as business appraisers and valuation specialists can take as requestors, recipients, and suppliers of electronic information in litigation matters.

The major changes

The amendments standardize procedures regarding “electronically stored information” (ESI) within the federal court system; they recognize and give ESI equal status as paper documents during discovery. The primary focus is on the early disclosure and preservation of any electronic data that may become evidence in a case.

Parties now have an affirmative duty, during the initial stages of litigation, to develop a plan to preserve and produce electronic evidence and to provide that information in a “readable” format. Amended Form 35 now provides a “report” to the court regarding these initial

discussions. Should any dispute arise, the parties

must meet and confer before filing a motion to compel. The rules do limit discovery for data that is not “reasonably accessible” because of “undue burden or cost” (determinable by the court on a subjective basis). The scheduling order may also contain post-production, agreed-upon limits for privilege or work-product exceptions; this minimizes the risk of inadvertent waiver while facilitating the discovery process.

The rules do permit exceptions for electronic data that is lost or destroyed as a result of “routine, good-faith operation of an electronic information system.” But they also require the parties to consider the systems in place and possible destruction of ESI when developing their discovery plan. Accordingly, parties to litigation may want to (i) adopt a document retention policy that meets the safe harbor provisions; (ii) have procedures in place to halt destruction of documents when notified of a dispute; and (iii) recruit or retain a knowledgeable information technology (IT) person to help respond to discovery requests.

Including experts early

Depending on the size and complexity of the case, attorneys may want to consider including experts early in the discovery of electronic *(continued on back page)*

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Which is More Credible: An Owner's Projections or Those Used for Financing?

Aukeman v. Aukeman, 2007 Mich. App. LEXIS 1524 (June 12, 2007)

In assessing the value of a business during divorce proceedings, it's not unusual for attorneys to obtain—and analysts to review—financial statements and/or projections prepared by the company (or its owner) to apply for lender financing. It's also not unusual to hear the owner-spouse forecast projections for the company far below those in the loan application. The question for the trial court judge: which is more credible?

Values double, depending on the source

In *Aukeman*, the husband testified that weekly sales for his business averaged \$58,000, and he predicted that future sales would increase only slightly. His expert used that figure to value the business—which owned and oper-

ated three grocery stores—at just over \$1.53 million.

By contrast, the wife's expert relied on sales projections the husband/owner created to obtain financing for one of the grocery stores. Predicting weekly sales averages of \$122,000, the wife's expert valued the business at just over \$3 million.

Faced with such divergent valuations, the trial court did what many before it have done: It discredited both, finding that the experts relied on speculative projections—and confirming once again that any source of projections must be reliable and well-supported.

Accordingly, it valued the business between the two assessments, at \$2,225,000, and the appeals court affirmed, finding the value within the range established by the evidence.

Another 'Bad Facts' FLP Falls to Established Criteria of Section 2036(a)

Erickson v. Comm'r, 2007 Tax Ct. Memo LEXIS 108 (April 30, 2007)

This is the latest in yet another “bad facts” case that was captured by the broad reach of Internal Revenue Code § 2036(a)(1). The daughter of a widow suffering from late-stage Alzheimer's enlisted the help of an attorney to form a family limited partnership (FLP), primarily with real estate assets and securities worth over \$2 million. A second daughter joined the first as a general and limited partner.

However, it wasn't until a couple of days before their mother died (at age eighty-two) that the daughters completed the funding for the FLP and the gifting of partnerships interests to other family members. None of the partners had separate legal counsel—and it was doubtful the daughters (or the mother) fully understood the arrangement.

A mere 'asset container'

Given these facts, the Tax Court swiftly concluded that § 2036(a)(1) applied. The Court also found that the “bona fide sale” exception did not apply, as there was no credible evidence the FLP had any substantial, nontax business or investment purpose. In fact, the FLP served as “just a vehicle for changing the form of the investment in the assets, a mere asset container.” Accordingly, the Court included the FLP's assets in the decedent's taxable estate.

Divorce Court Accepts Double-Dipping Argument From Valuation Analyst

In re Marriage of Porter, 2007 Wash. App. LEXIS 1161 (May 21, 2007)

The Porter husband owned a successful radiology practice and imaging services. His trial expert, a certified business appraiser, valued the business at \$1.5 million, including an assessment of goodwill at \$500,000. The expert used an excess earnings method to arrive at the goodwill value, which the trial court adopted in its determinations regarding property distributions and maintenance.

In particular, the expert testified that because goodwill was based on the income stream from the doctor's businesses, and because it was included in the property distribution, it should not be counted again in any maintenance determinations. Doing so would be “double-dipping,” he explained. To use his analogy, this would be tantamount to the court requiring the physician to “buy” his practice (from the non-owning spouse) based on the income stream it generates, and then using that same income stream as the basis for determining maintenance to the non-owning spouse.

The husband's attorney cited the expert's analysis in his closing argument, urging the trial court to base maintenance on the “reasonable compensation” of \$368,000 per year (gross). Although projections forecasted the husband as earning \$430,000 in wages and \$510,000 in income from his businesses during the *(continued on back page)*

Divorce Court Credits Buy-Sell—And Discredits ‘Controlling’ Owner—in Business Value

Silver v. Silver, 2007 Ohio App. LEXIS 2428 (May 25, 2007)

In divorce cases, courts often hear business valuations among a host of testimony regarding the owner’s temperament as a spouse and/or a parent. At times, it must be impossible to separate “personality” evidence from “professional.” At other times, the personal information may be related if not relevant to the business valuation, especially in the case of a small, closely held company with a single owner.

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organized as an S corporation.

Controlling parent, controlling owner

In discussing the children’s issues, the trial court determined that the husband—although possessing a

cool and logical

demeanor—

was “[i]n reality...controlling and manipulative and very absolute in his thinking.”

When it came time to determine support and valuation



separate “personality” evidence from “professional.” At other times, the personal information may be related if not relevant to the business valuation, especially in the case of a small, closely held company with a single owner.

The Silver case addressed the three major issues common to marital dissolutions: the custody of the couple’s children, the support of the children, and the valuation of a business. The husband in this case was the sole shareholder of the business – an employee consulting/recruiting firm,

of the husband’s business, these same character traits appeared to influence the court’s ruling.

The husband’s expert valued the business at \$59,000 with goodwill (\$13,000 without). The wife’s expert valued the business at \$380,000. In considering the disparate values and, in particular, evidence of the husband’s income, the magistrate exercised “heightened scrutiny.” As sole shareholder, the husband could “control distribution and retention of the net profits of the business.”

Moreover, there was the possibility of manipulation of income.

For example, the experts valued the business as of the end of 2004, when the husband’s annual income was approximately \$146,000. By contrast, for the years 2001 through 2003, he earned an average of \$94,000.

Although the husband argued that a share of future net income could be needed for capital expenditures, he did not offer specific evidence of what these might be. Moreover, both experts agreed the business was not capital-intensive.

Buy-sell is credible evidence

In considering the overall value of the business, the magistrate favored the analysis by the wife’s expert, including his “avoidance of factors generally used in the valuation of publicly traded companies.” The expert also relied on a 2004 buy-sell agreement – which valued 100% of the company stock at \$400,000 – as a credible indication of fair market value. The magistrate accepted this view, especially as there was no contravening evidence.

Finally, the magistrate discussed “at length how certain key numbers or percentages could significantly affect the valuation of a business.” As the wife’s expert provided a better explanation for the numbers he used than did the husband’s expert—and in consideration of all the evidence, the magistrate valued the business at \$380,000. Based on the sufficiency of the record, the appeals court affirmed.

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information. For example, valuation analysts could assist in defining the most “usable” format to produce ESI—which can be critical, as once a request for a certain format is made, alternative formats may not be permitted.

The experts’ retention of electronic data is also an important consideration; attorneys should ensure sure that routine document management (and destruction) by experts does not reach the level of spoliation. The risks of spoliation claims decrease if parties take early steps to identify and preserve ESI. Cost is a final consideration. Typically, the management of e-discovery requires a higher level of expertise than paper discovery, and document review, consultants’ time, and disruption can add to the overall expense of a case. As the courts, counsel, and clients become more familiar with the new rules, the parameters for preserving and producing e-evidence will become clearer.

Note: A copy of the amended FRCP is available at http://www.uscourts.gov/rules/EDiscovery_w_Notes.pdf. The Advisory Committee notes are also included.

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year of the divorce, there was also testimony that he was going to cut back his workload due to health concerns. After considering all the evidence, the trial court awarded the wife two years of maintenance at \$8,000 per month and four years at \$6,000 per month.

Wife wanted \$15,000 per month

In her appeal, the wife contested the award. She claimed \$15,000 in monthly expenses—and that the \$8,000 maintenance amounted to only 15% of the doctor’s projected monthly income of \$54,000. But on review of the trial record, the appeals court confirmed that the husband’s estimated net income would likely decline because of his health. Further, the projections included business income that the trial court already accounted for in its property distribution. “To consider that income stream twice would, according to [the doctor’s] expert, amount to double dipping.” The trial court was entitled to rely on that testimony and to base maintenance on the doctor’s reasonable replacement compensation of \$20,800 per month.

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