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Value of Luck Is Key to Big-Money Divorce Case

When Jed Clampett went to shoot at a critter, he missed his target but tapped into an oil gusher. Old Jed, the lead character in TV's "The Beverly Hillbillies," got rich and moved to the land of swimming pools and movie stars. The "Jed Clampett defense" is what some court pundits are calling the position an oil billionaire took in his recent divorce case, according to an article in *The New York Times*.

We hope that you are enjoying the spring season. in the 2nd Quarter 2015 newsletter, you will find the following short articles:

- Value of Luck Is Key to Big-Money Divorce Case
- DOL Scuttles 'Appraiser-as-Fiduciary' Rule for ESOPs
- Top 10 Noteworthy Business Valuation Cases of 2014
- 9th Circuit Calls Tax Court Out Over 'Imaginary Scenarios'
- Economic Update at a Glance

We hope that you enjoy the articles. Please feel free to call us if you need any assistance with valuation matters. Thank you, and we look forward to working with you.

The defense is based on the "active versus passive appreciation" concept in divorce law.

Luck versus skill: In some states, if a spouse owns an asset before the marriage, the increase in value of that asset is not subject to division if the increase was due to "passive" appreciation, that is, if the asset's value increases due to factors outside of either spouse's control. But if the value increases due to the efforts or skills of a spouse, it is considered "active" and is thus subject to division in a divorce. So the question comes down to luck versus skill.

Harold G. Hamm, chief executive and founder of Continental Resources, claimed that it was luck that brought him the bulk of his fortune, which amounted to $18 billion at one point. He says his skills and efforts were responsible for less than 10% of his personal and corporate success. His wife claimed it wasn't mostly luck—his skill was responsible for more than 90% of his wealth. The judge in the case, which took place in Oklahoma, largely sided with the husband and awarded the wife about $1 billion. Both sides are appealing.

The parties managed to have the court seal the proceedings, so details of the case are not available, according to Sylvia Golden, executive legal editor at Business Valuation Resources. "The subject is very interesting—active versus passive appreciation—and it does not come up that often. I thought we might see it more because of the huge amounts of

money involved in tech start-ups and similar enterprises. But it may also be the case that many of the entrepreneurs make prenuptial agreements that take care of the issue."

Trying to quantify active versus passive appreciation can be very challenging. The small amount of academic research on this topic has "often found that broader market forces often have a bigger impact on a company's success than an executive's actions," says the *Times* article.

DOL Scuttles 'Appraiser-as-Fiduciary' Rule for ESOPs

The Department of Labor (DOL) will abandon the "appraiser-as-fiduciary" rule from its planned re-proposal of a broader fiduciary rule, according to a report in *Capital Action*, a publication of the American Society of Appraisers. The proposed rule, in limbo for three years, would have classified appraisers as ERISA fiduciaries in connection with valuations of employee stock ownership plans (ESOPs).

Sigh of relief: Opponents of the proposed rule claimed that it would create a conflict between a fiduciary's strict duty of loyalty to plan participants and professional appraisal standards, which require an appraiser to perform assignments with impartiality, objectivity, and independence. Appraisers also feared that the rule would force them to buy expensive fiduciary insurance, hire specialized counsel, and expose them to unwarranted litigation. "This likely would have made the provision of ESOP valuations cost prohibitive for all but the largest firms," says the ASA report.

BVWire is pleased to acknowledge the efforts of the ASA and other organizations and individuals who urged the DOL to rethink its position.

Top 10 Noteworthy Business Valuation Cases of 2014

The year 2014 produced a number of significant decisions from various federal and state courts that added new layers of understanding of valuation- and expert-related issues. Below is our list of "must know" cases, but subscribers will find digests and opinions for many more cases in *BVLaw* (www.bvlibrary.com).

1. *Estate of Richmond,* 2014 Tax Ct. Memo LEXIS 26 (Feb. 11, 2014)

In this major ruling in an estate tax dispute, the Tax Court prescribes the use of the net asset value method to determine the value of a holding company whose assets are mostly marketable securities and says discounting for the built-in capital gains tax requires determining the present value of the future BICG tax liability.

2. *Chattree v. Chattree,* 2014 Ohio App. LEXIS 479 (Feb. 13, 2014)

An expert gets caught in the middle of the spouses' ugly divorce dispute but manages to survive the attack with his reputation intact by dotting his i's and crossing his t's every step of the way. The appeals court says the husband's obstructive conduct "invited" any error in the opinion.

3. *Sloan Valve Company v. Zurn Industries, Inc.,* 2014 U.S. Dist. LEXIS 39678 (March 26, 2014)

In a patent infringement case, the court excludes a royalty analysis that strayed from the "classic way" in that the expert used the number of infringing products, not revenue, as the royalty base and a dollar amount, not the percentage of the revenue, as the royalty rate.

4. *Laidler v. Hesco Bastion Environmental, Inc.,* 2014 Del. Ch. LEXIS 75 (May 12, 2014)

In a statutory appraisal action arising out of a short-form merger, the Delaware Court of Chancery (J. Glasscock) adopts the direct capitalization of cash flow (DCCF) analysis the parties' experts advocated because of the unique nature of the target's business and factors affecting the transaction.

5. *Brave v. Brave,* 2014 Ark. LEXIS 232 (April 17, 2014)

What a difference a court makes! In a divorce case involving a restaurant, two appellate courts disagree over whether to extend the scope of personal goodwill to businesses other than professional partnerships.

6. ***Adelphia Recovery Trust v. FPL Group, Inc. (In re Adelphia Corp.),*** **2014 Bankr. LEXIS 2011 (May 6, 2014)**

In a protracted bankruptcy case involving a former cable industry giant, the Bankruptcy Court rejects the trust's fraudulent transfer claim, finding its expert's reliance on the discounted cash flow method to value the company "problematic" and "surprising" considering there were no cash flow projections untainted by fraud and the expert's own projections were filled with "uncertainties."

7. ***Estate of Adell v. Commissioner,*** **2014 Tax Ct. Memo LEXIS 155 (Aug. 4, 2014)**

Here is another Tax Court opinion that has caused a spirited debate among valuation professionals. Even though the court disapproves of the estate's "conflicting expert reports" as to the value of the decedent's 100% interest in a C corporation, it ultimately adopts the estate's DCF valuation, finding its treatment of personal goodwill is more credible than the IRS's approach.

8. ***In re LightSquared Inc.,*** **2014 Bankr. LEXIS 2984 (July 11, 2014)**

In the notorious fight over a Chapter 11 satellite and broadband services provider, the Bankruptcy Court rules on the debtors' reorganization plan. Perhaps no aspect of the case raises as many eyebrows as the $1.25 million fee one litigant's valuation expert commanded for three weeks of what the court calls "an unimpressive piece of work."

9. ***Ferolito v. AriZona Beverages USA LLC,*** **2014 N.Y. Misc. LEXIS 4709 (Oct. 14, 2014)**

In one of two important fair value rulings out of New York, a trial court relies solely on the discounted cash flow method to value a truly "sui generis" company. The case featured the largest privately owned beverage company in the United States and its bellicose founders, as well as a cadre of high-caliber valuation experts.

10. ***Zelouf International Corp. v. Zelouf,*** **2014 N.Y. Misc. LEXIS 4341 (Oct. 6, 2014)**

In this second New York fair value ruling, a trial court rejects the proposition that a discount for marketability is mandatory and refuses to apply it where the probability of a sale of a closely held business is "negligible." A DLOM would "artificially depress" the frozen-out minority shareholder's recovery due to a hypothetical sale that will never occur, the court says.

9th Circuit Calls Tax Court Out Over 'Imaginary Scenarios'

Estate of Giustina v. Commissioner, **2014 U.S. App. LEXIS 22961 (Dec. 5, 2014)**

Late in 2014, the 9th Circuit issued a terse, but significant, ruling in an estate tax case involving an Oregon family holding considerable timber assets by way of a limited partnership. The appeals court faulted the Tax Court for several missteps in arriving at its valuation, having to do with the court's use of the net asset value approach and its company-specific risk premium rate.

Recap. The decedent owned a minority interest in a family-owned limited partnership (LP) that was in operation for 15 years and held large tracts of local timberland. The Internal Revenue Service assessed a deficiency of $12.66 million, which was nearly equal to the value the estate stated in its estate tax filing, and an accuracy-related penalty. The estate petitioned the U.S. Tax Court for a review. At trial, the parties' positions had come closer together because the estate's new appraiser proposed a slightly higher value and the IRS's expert a slightly lower value.

The Tax Court accepted only two methods to value the LP interest in this case: discounted cash flow (DCF) and net asset value (NAV). The former accounted for how much the partnership could be expected to earn if it continued timberland operations, and the latter valued the assets as if liquidated. The experts agreed the partnership's timber assets were worth $143 million, allowing for a 40% discount related to expected delays in selling the large tracts. However, they weighted the values from the two approaches differently and disagreed on assumptions inherent in the cash flow approach.

As for the DCF, the court not only rejected the IRS expert's analysis, but also adjusted components of the estate expert's valuation. For one, it lowered the latter's 3.5% company-specific risk premium, noting that, even though the partnership's assets lacked diversity and geographic dispersion, investors could minimize this unique risk by diversifying the portfolio of assets. Therefore, a 1.75% premium was adequate. The court also found that, pursuant to *Gross v. Commissioner,* the estate's expert improperly tax affected his annual cash flow values by 25%. And the court reduced the expert's proposed 35% discount for lack of marketability to 25% in accordance with the rate the IRS expert applied.

The court gave a 75% weighting to the DCF-derived value, which, it found, reflected the probability that the partnership would continue. But it also noted that an asset sale would reap considerably more than the current cash flow generated. The court recognized that an acquirer of the decedent's interest could only force the sale of the partnership by creating a two-thirds majority voting block with other members and that it was uncertain how many partners would favor an asset sale. But it said there was authority that allowed for some degree of speculation about the future composition of management in valuation and consequently assigned a 25% weight to the result from the NAV. It concluded the decedent's interest was worth $27.45 million. (An in-depth discussion of *Estate of Giustina v. Commissioner,* 2011 Tax Ct. Memo LEXIS 141, is available at *BVLaw* (www.bvlibary.com)).

Contradictory assumptions. In its appeal to the 9th Circuit Court of Appeals, the estate claimed there were multiple errors in the Tax Court's valuation, which stated a value that was close to $15 million higher than the estate's value appearing in Form 706.

The 9th Circuit sided with the estate on most points.

1. *NAV weight*. According to the appeals court, the Tax Court's finding that there was a 25% likelihood of liquidation of the partnership conflicted with the evidence in the record. This was a longtime partnership, and "no limited partner ever asked or ever discussed the sale of an interest," said the 9th Circuit. For liquidation to occur, one had to assume that a hypothetical buyer would: (1) "somehow" obtain admission as a limited partner from the general partners to dissolve the partnership; (2) seek to dissolve the partnership or get rid of the general partners who just approved the buyer's admission to the partnership; and (3) succeed in persuading at least two other limited partners to go along with the buyer's plan. Alternatively, and just as unlikely, the appeals court said, one had to assume that the existing limited partners who owned two-thirds of the partnership would suddenly seek dissolution.

According to the 9th Circuit, the Tax Court created "imaginary scenarios" as to the potential buyer and the buyer's willingness to wait, without receiving a return on the investment, as well as what the buyer would be able to arrange with the existing partners. For this reason alone, the 9th Circuit remanded for a revaluation based on the partnership's value as a going concern.

But there was more. The appeals court also found the Tax Court erred when it halved the estate expert's proposed company-specific risk premium. Although diversification of assets was an accepted way to reduce company-specific risk, the reviewing court said, the Tax Court did not seem to take into account how much wealth a potential buyer would need to affect diversification.

Court leaves tax affecting untouched. On several points, the 9th Circuit disagreed with the estate. As for tax affecting, it pointed out that the estate admitted that "tax-affecting is … an unsettled matter of law." Therefore, it was not clear that the Tax Court erred in using a pretax rather than a post-tax method, the 9th Circuit stated.

As for the DLOM rate, the estate's expert proffered a 35% rate but at trial allowed that discounts typically range between 25% and 35%. Therefore, the Tax Court's 25% DLOM was not clear error.

For all of these reasons, the 9th Circuit remanded for recalculation of the valuation.

Economic Update at a Glance

U.S. economic growth slowed significantly in the fourth quarter of 2014, as weak business spending, a growing trade deficit, and declining federal government spending offset a surge in consumer spending. The fourth-quarter GDP growth rate of 2.6% was below economists' expectations of 3.0% in a Bloomberg survey and came on the heels of a strong third quarter where GDP grew at its fastest pace in 11 years. Economists surveyed by Bloomberg and Reuters think the slowdown in the fourth quarter will be short-lived, pointing to the impact of lower gas prices and strong consumer spending.

Bloomberg also noted the strength of domestic demand should more than offset deteriorating economies overseas. A gauge of underlying demand, which excludes trade, inventories, and government, increased at a 3.9% pace in the fourth quarter, compared to the 4.1% rate in the third. The analysts surveyed said the data indicated U.S. fundamentals were strong enough to cushion the blow to economic growth from weakening economies overseas.

Some news that boded well for consumer spending was a notable uptick in consumer confidence. The Conference Board reported that its Consumer Confidence Index increased in December, and consumers' perceptions of current conditions improved to its highest level since February 2008. The Thomson Reuters/University of Michigan's Consumer Sentiment Index also rose in December, reaching its highest reading since July 2007. The report found that consumers held the most favorable attitudes toward the long-term prospects for the economy than at any other time in the past 10 years.

Moreover, the outlook also improved for small business. The National Federation of Independent Business reported that the Small Business Optimism Index rose in December to its highest reading since October 2006. Gains in the components that comprise the index were widespread. Further, The Wells Fargo/Gallup Small Business Index climbed to its highest reading in more than six years. Strong growth came from the component that measures small-business owners' future expectations.

Job growth continued to be strong in the fourth quarter, with employment gains now exceeding 200,000 jobs a month for 11 straight months, the longest stretch since March 1995. The unemployment rate also fell to a six-and-a-half-year low, though some of the decline was attributable to people leaving the workforce. Total employment rose by 2.95 million in 2014, the most in any calendar year since 1999.

The Institute for Supply Management's manufacturing-sector index slipped in December for the second consecutive month. Regardless, the data indicated that the manufacturing sector expanded for the 19th consecutive month and the overall economy grew for the 67th consecutive month.

The Institute for Supply Management's index for the services sector fell in December for the third time in four months. Despite the index's retreat, the December index reading indicated that the services sector has now grown for the 59th consecutive month.

The Federal Reserve reported that industrial production fell in December but grew at an annual rate of 5.6% in the fourth quarter. Increases in manufacturing output and mining output were tempered by a marked drop in utilities, as warmer-than-usual temperatures reduced the demand for heating in December.

The Federal Reserve maintained its decision to not raise interest during the fourth quarter, saying it would remain patient. The Federal Reserve also determined that the time had come to end its asset purchase program since there had been a substantial improvement in the outlook for the labor market since its inception.

Stocks saw strong returns in the fourth quarter, though the market was volatile. Both the Dow Jones Industrial Average and the S&P 500 endured their biggest losses in over two years, then went on to reach new record highs shortly before the end of the quarter. The Nasdaq reached its best level since the

tech bubble of the late 1990s. The S&P 500 and the Dow Jones Industrial Average have now experienced a six-year rally, and the S&P 500 is now up over 230% since the bear-market low on March 9, 2009.

Both the Consumer Price Index and the Producer Price Index fell in December. Consumer prices experienced their sharpest drop since December 2008, while producer prices had their largest fall since October 2011. A sharp decline in the price of gas brought both indexes down.

Housing starts advanced in December, while building permits authorized retreated. Housing starts and building permits authorized remain above their levels from one year ago.

The National Association of Home Builders/Wells Fargo Housing Market Index edged down in December but has remained within a stable range over the past six months. The index continued to remain at a level indicating more builders view sales conditions as good, rather than poor.

The National Association of Realtors reported that existing-home sales rose in December, despite tight inventory conditions. Median home prices for 2014 rose to their highest level since 2007, as year-over-year price gains have continued for 34 consecutive months. The 30-year, conventional, fixed-rate mortgage fell to 3.86% in December, its lowest level since May 2013. The National Association of Realtors' Realtors Confidence Index for current conditions experienced a broad uptick in December, while the reading for future conditions improved significantly.

Note: This newsletter does not constitute legal, valuation, tax or any other type of consulting advice. It is offered as an information service to our clients and friends. For specific legal and accounting issues, it is advisable to seek professional advice. We welcome the opportunity to discuss any specific valuation issues that you may have.

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