A BVR Special Report

Current Trends in NORMALIZATION ADJUSTMENTS

BVR
What It's Worth

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BVR
What It's Worth
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What It's Worth

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Table of Contents

Introduction

Adjustments to the income stream would seem to be part of every valuation using the income approach. The concept seems straightforward enough and is addressed in most valuation textbooks and training courses with little controversy. In contrast to such lightning-rod issues as the cost of capital or discounts for lack of marketability, normalization adjustments would appear positively mundane. But observations from the real world tell us something different. They tell us that there is room for a little extra guidance. The authors of the accompanying articles agree, and all have put their thoughts in writing to share with their colleagues.

Until a few years ago, I cannot recall normalization referring to anything other than financial statement normalization (generally the income statement). All that changed in 2008 when the collapse of U.S. financial markets set off the migration from equities to U.S. treasuries, often referred to as the "flight to quality." The result was a reduction in treasury yields to post-World War II levels. This brought about the question, "Do we need to *normalize* the risk-free rate when estimating the cost of capital under CAPM or the buildup method?" So now we have another normalization to debate. This guide includes a few papers on that subject as well. Unlike normalization of the income stream, the subject of normalizing the risk-free rate will become moot sometime after the U.S. (and the world's) economy stabilizes. That's going to happen, right?

Reading the accompanying papers will confirm that there are no "automatic" adjustments. Each one must be carefully considered. As always, facts and circumstances matter. Context matters, too. You might consider adjustments for an M&A transaction, but not for estate and gift tax. Level of value matters, i.e., controlling versus minority. Our authors rightly emphasize the importance of classifying and grouping your adjustments. Doing so not only provides clarity to the user of the valuation report, but also clarity to your own analysis. You should always ask along the way, "Why are we making this adjustment?" "Because we always do" is not a valid answer.

Proving the need for a normalizing adjustment is only half the task. You must also determine the degree of adjustment, and you must justify the means by which you made the determination.

You must be prepared, for example, to justify your estimate of fair compensation for the owner/manager, of fair rental for the related-party-owned warehouse, etc. A reading of the accompanying cases makes this point very clear.

The accompanying papers may open your eyes to some things you have overlooked or forgotten, or they may reinforce what you already know and practice. Perhaps you will disagree with some of the authors' opinions. Whatever the effect, it is worth your time to read them. Whichever set of valuation standards you practice under, it is a given that the exercise of professional judgment is required. Do not forget that it is your *personal* judgment, *your* opinion, that is actually being exercised. Exercise it thoughtfully when approaching normalization adjustments.

Ted Israel, CPA/ABV/CFF, CVA
Eckhoff Forensic & Valuation Services
July 14, 2012

1. Normalizing Adjustments—Time to Revisit

By Rod P. Burkert, CPA/ABV, CVA

For most valuations, adjusting entity-level earnings to develop control and minority interest values has become a generally accepted business valuation practice. This is a good thing. It frees us from extrapolating data from questionable control premium studies that, in the aggregate, measure a combination of strategic control, financial control, and hubris and from interpolating implied minority interest discounts from those studies.[1] It's also a bad thing. Not all appraisers agree about the extent of the adjustments that should be made to entity-level earnings.

In adjusting entity-level earnings, appraisers make normalization adjustments. These adjustments reveal the base-level[2] earnings of the private company that is (a) the source of *realizable* value to a control interest buyer who will gain control over the benefit stream; and (b) the source of *potential* value to a minority interest buyer who must make decisions about how and when future value will be realized.

Understanding this is key, because it shows that normalization adjustments are required to develop an entity-level (not an interest-level) minority, marketable value, that is, an "as-if freely traded" value. This terminology in our various levels of value charts emphasizes that earnings are normalized to where they would be if our private company were public; it does not require that the private company have the potential to go public.

Most appraisers have little difficulty identifying and making the relatively "easy" normalization adjustments. Such adjustments remove the effects of unusual, nonrecurring items and the income and expense associated with nonoperating assets and liabilities. Rarely is there any debate about the propriety of making these adjustments.

1 A minority interest discount is derived from control premium information using the formula MID = 1 – [1/(1 + CP)].

2 I say "base-level" benefit stream because in the valuation of a control interest, the buyer can make further adjustments that reflect his or her ability to run the company "better" (financial control) or operate it "differently" (strategic control).

The real controversy involves normalization adjustments that reduce officer/owner salaries to market levels and remove other discretionary expenses that would not exist in a well-run public company. Many appraisers do not make these adjustments when valuing a minority interest because they assert that a minority interest lacks the power to make such changes. These appraisers argue that these adjustments are "control" adjustments and that not adjusting for these items serves as a proxy for a minority interest discount. This position is not defensible, as can be seen from these related arguments:[3]

1. Minority shareholders in public companies also lack control over officer salaries and discretionary expenses. But they expect normalized operations, and generally, they get them.

2. Using inadequately adjusted earnings implies, vis-à-vis a terminal value calculation or market pricing multiples, that a minority shareholder will be disenfranchised into perpetuity and never receive his or her pro rata value—even if/when the company is sold.

3. Discount rates based on market data and multiples obtained from guideline public companies are derived from normalized earnings and, therefore, should be applied to private company earnings that are similarly adjusted to a public equivalent basis.

4. Items 1, 2, and 3 place our private company at the minority, marketable level of value. If we start with adjusted earnings that are less robust, we are at some make-believe level of value—call it the "being taken advantage of minority, marketable" level of value.

5. Discounts for lack of marketability based on restricted stock studies and pre-IPO stock studies are deducted from the minority, marketable level of value, not a "being taken advantage of" level of value.

6. And finally, couldn't a rational hypothetical investor sue under a state's shareholder rights statutes if he or she was being permanently deprived of pro rata value because of egregious owner salaries and discretionary expenses?

Let's face it. Excessive owner compensation comes up more often in businesses that are "family-owned" and less often in those that are "closely held." In the family-owned cases, there seems to be a "nod-nod, wink-wink" atmosphere where control and minority owners know the compensation is excessive or that discretionary expenses exist, but no one questions the practice because it's mom or dad. Thus, not making an adjustment can be easy to rationalize if the purpose is to value a minority interest in that business.

But I have a problem with this. At the extreme, what if excessive compensation and discretionary expenses take the cash flows of the company down to zero? Would we submit a report to the IRS claiming a zero value for the minority interest? Few, if any, appraisers would. So where do we draw the line as to when an adjustment needs to be made? Because once we admit that a line needs to be

3 As far as I know, Chris Mercer was the first to raise this issue and argue these points. See Mercer Capital, Sept. 24, 2004 and *Business Valuation: An Integrated Theory, 2nd Edition*, John Wiley & Sons Inc., 2008.

drawn, we might as well adjust for excessive compensation and discretionary expense in all cases.

Suboptimal earnings are transitory in the real world—the one that is being mirrored by the minority, marketable level of value. And normalizing officer salaries and discretionary expenses correctly reflects the fact that these items do not affect the value of the enterprise at the minority, marketable level of value. If we need to consider the impairment of value that owner salaries and discretionary expenses have on the value of the minority interest, we should consider it in our determination of the appropriate discount for lack of marketability.

It is often said that valuation is as much an art as it is a science; however, no one said anything about make-believe. If we do not make adjustments to normalize officer salaries and remove discretionary expenses, our conclusion cannot be at a minority, nonmarketable level of value. The result will be at some other level of value that is neither supported by valuation theory nor recognized in the valuation community.

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2. Mastering the Art of Normalization Rates[1]

By James D. Ewart,[2] CPA/ABV/CFF, CVA

As we develop the benefit stream for an ongoing business enterprise that we're ultimately going to capitalize or discount, normalization can have a substantial effect on our value conclusions. Generally, when valuing an interest in a closely held business, the income approach is the most preferred. The components of the income approach are the benefit stream to be capitalized or discounted and the risk rate. Our good friend James Hitchner defines it thus: "the rate of return that investors require to draw them to a particular investment rather than an alternative investment."[3] The normalization process and the resulting effects thereof are beneficial and instrumental in our financial statement analysis in comparison to the industry or peer groups.

Income v. Cash Flow

First, let's focus on what we are capitalizing or discounting in the income approach.

According to *Ibbotson*, we should focus on free cash flow, because it represents the total amount of cash that can potentially flow to the shareholders and long-term interest-bearing debt holders of the company.[4] Free cash flow drives the value for all equity and debt holders of the entity.

Ibbotson also states: "It is incorrect to focus on earnings as the cash flow stream to be valued, because earnings contains a number of accounting adjustments and already include the impact of capital structure."[5] So it's pretty clear then that we are discounting or capitalizing a form of cash flow. Whether it's free cash flow or some other form of cash flow that we define, cash flow should be the driving force.

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1 This article is based on a Business Valuation Resources (BVR) webinar on Jan. 20, 2010, which the speaker updated in July 2012.
2 James Ewart is a director in the Dixon Hughes Charleston East Bay office. His comments are his own, not those of his company, and any tax advice should not be construed as outside the bounds of IRS Circular 230.
3 James R. Hitchner, *Financial Valuation: Applications and Models.* John Wiley & Sons, Inc., 2003, p. 86.
4 *2009 Ibbotson Stocks, Bonds, Bills, and Inflation Valuation Yearbook.* Morningstar Inc., p. 13.
5 Ibid., p. 14.

Free cash flow is an after-tax concept that ignores existing capital structure. While the starting point is earnings before interest and taxes (EBIT), EBIT is tax-adjusted to get to an after-tax amount. Also, EBIT ignores current capital structure. We start with EBIT and tax-adjust those earnings. This doesn't mean that we can't use other cash flow measurements, such as cash flow to equity, but what is suggested is that the measurement attribute is cash flow.

Second, pure accounting adjustments need to be adjusted out of the analysis for the statement made by and contained in Ibbotson.

Finally, adjustments to cash flow necessary to maintain the company's ongoing capacity must be considered and quantified. These adjustments include capital expenditures to maintain plant, property, equipment, or other capital expenditures that arise out of the ordinary course of business.

Another common adjustment is changes in working capital. As companies grow, they accumulate additional accounts receivable and other working capital elements that require additional cash to support them.

The calculation can be adjusted by introducing the existing capital structure for a minority interest valuation by subtracting interest and changes in interest-bearing debt, which would yield certainly cash flow to equity.

If differing levels of equity have demands on cash flow, however we define it, those demands can also be identified and quantified—for example, preferred stock premiums, dividend premiums, and the like. While net income multiples may be used in the market approach, the income approach focuses on cash flow.

Exhibit 1 is the cash flow formula, which is EBIT times [1 – t], which is the tax rate; plus depreciation and amortization, which are noncash items; deferred taxes, which are likewise the same; capital expenditures; and changes in working capital to derive free cash flow.

Exhibit 1. Income Versus Cash Flow

Cash Flow Formula
EBIT * [1 – t]

+ Depreciation and amortization
+ Deferred taxes
- Capital expenditures
<u>- Changes in working capital</u>
Free cash flow

We could further adjust that number by subtracting changes in interest-bearing debt and interest to arrive at the cash flow available to equity.

Why Normalize?

The premise underlying the income approach is that "the value of an investment is typically captured in its expected benefit streams as return of and on investment and 'failure to develop the appropriate normalizing adjustments may result in a significant overstatement or understatement of value.'"[6] Exhibit 2 shows a basic example.

Exhibit 2. Why Normalize? An Example

	Without Adjustment	With Adjustment	Difference
Expected Cash Flow	$ 2,000,000	$ 1,500,000	$ 500,000
Multiple	5	5	5
Indicated Value, As if Freely Traded	**$ 10,000,000**	**$ 7,500,000**	**$ 2,500,000**

If we had an expected cash flow without adjustment of $2 million, with an adjustment of $1.5 million—the difference being $500,000—if our multiple is a 5% or 20% cap rate, then our indicated value, as if freely traded, would be affected by $2.5 million. It would be reduced from $10 million to $7.5 million.

So the effects of normalization or adjustments can be rather substantial.

Remember that the benefit stream, cash flow, is expectational and should be representative of the ongoing business enterprise that we are valuing. This is true whether we are using the capitalization of future benefits method or the discounted future benefits method with the terminal value. The cash flow can be either a control cash flow or a minority cash flow.

In addition, the multiple, or the inverse of the cap rate, if derived from public company sources such as Ibbotson or Duff & Phelps, when applied, yields a marketable or as if freely traded value. So whether the cash flow is control or minority, the multiple yields a marketable number.

Normalization Adjustments—Definitions

Normalization adjustments are also consistent with the definition of fair market value when the buyer and seller are hypothetical. Hypothetical doesn't mean lacking realism. It simply means that it's not reflecting actual events or transactions. It does mean, however, that it should be based on real and appropriate circumstances.

So therefore, normalization adjustments, as defined in SSVS-1, "are hypothetical in nature and are

6 2008 AICPA National Business Valuation School—Supplemental Material, Chapter 4.

not intended to present restated results or forecasts of the future in accordance with GAAP or AICPA guidelines."[7] They're hypothetical, and that's a critical component of this normalization process.

Normalization adjustments yield normalized earnings, and the AICPA, through the International Definitions adopted by that organization and others, defines normalized earnings as the "economic benefits adjusted for non-recurring, non-economic, or other unusual items to eliminate anomalies and/or facilitate comparison."[8] We need to look at this definition in connection with the other and highlight the key components of normalization adjustments as to whether they are nonrecurring, noneconomic, or unusual.

Normalization adjustments do not include adjustments that have economic consequences. They are reductions of or increases in expenses or revenues to capture the noneconomic effects they have on the benefit stream being measured. The adjustments take out or increase the item so that the benefit stream, as adjusted, reflects the economics of the enterprise.

So normalization adjustments can have an economic effect, but what we're trying to do is isolate, either plus or minus, what effect those adjustments would have on the hypothetical benefit stream that we're trying to value. That is, if they belong on the income statement, then they should be there. If they don't, they do not relate to the business enterprise on a recurring basis.

A classic example of this is compensation or perks, which are economic transactions—that is, the money is being spent. However, they are noneconomic because they relate to the benefit stream that we're attempting to determine because they're excessive in that example. They don't contribute or relate to the benefit stream. They relate to something else.

Normalized earnings, therefore, then lead to normalized statements, and those are "financial statements adjusted for non-operating assets and liabilities and/or for non-recurring, non-economic, or other unusual items to eliminate anomalies and/or facilitate comparison."

Presumably, these adjustments yield financial statements that level the playing field and provide an opportunity for an apples-to-apples comparison, while producing a benefit stream or base benefit stream that is reflective of the business. Our comparative process should be a two-step process: 1) based on existing financial statement information, and 2) based on the normalized or adjusted financial statement information.

As we all understand, a part of the evaluation process of risk, or determining risk, relates to the financial analysis, both to the industry and comparable companies, if appropriate; therefore, this is an important step in the process.

The income approach focuses on two things: history as a predictor of the future, and that's quite often employed with the capitalization of benefits method; or management's projections of the future, which is the discounted future benefits method.

7 Statement on Standards for Valuation Services 1 (SSVS-1), AICPA.
8 *International Glossary of Business Terms.*

The numerator of the fraction represents the future economic benefit accruing to the holder of the equity interest, and the denominator represents the risk rate associated with achieving the benefit stream.

As we continue to develop these concepts, we're going to see that the numerator of the fraction—that is, the benefit stream or cash flow—is driving whether the result in value is a control value or a minority value regardless of the sources of the numerator. This is also consistent with the hypothetical nature of the entire exercise of valuation, the assumption being that the benefit stream should be adjusted to reflect nonrecurring, noneconomic, or unusual items.

There are five categories of adjustments that meet the criteria as defined in the *International Glossary* and the SSVS-1.

Categories of Adjustments

1. *Ownership characteristic adjustments.* These typically result in a minority or a control cash flow stream that's to be valued. The ownership characteristics "drive whether the cash flow stream is either a 'controlling' or 'minority' interest cash flow stream." Within these characteristics are several adjustment categories.

   But first, the basic questions that we need to ask ourselves with respect to the exercise are: What adjustments, if any, are appropriate, who decides who can make them, and how are they made?

   Therefore, typically, adjustments made under this category—that is, ownership characteristics—relate to changing historical company methods, policies, and practices and, thus, are made by the control owner and yield a control benefit stream.

2. *GAAP departures, extraordinary, nonrecurring, and other unusual items.*

3. *Nonoperating assets and liabilities and related income and expenses.*

4. *Taxes.* If we are adjusting the benefit stream for whatever reason, taxes need to be recalculated. This is often overlooked.

5. *Investment value.* The synergy from mergers and acquisitions are certainly adjustments, but we are not going to delve into those. We're going to stay in the fair market value arena on the hypothetical side as opposed to the "real world" of M&A. This does not mean, however, that this process doesn't relate to a minority interest valuation, as we're going to talk about later. It simply means that these types of adjustments generally yield a controlling benefit stream and a controlling value.

Ownership Characteristics

The control categories within this characteristic are:

a. Compensation and perks.

b. Discretionary expenses and operating inefficiencies.

c. Transactions with family members or other insiders. The question there is, "Are they conducted at market rates and market prices?"

d. Modifications to the capital structure and the intended adjustments to the benefit stream resulting from those changes.

We need to consider the entirety of the process such that, if we are making adjustments to the benefit stream or the components of the benefit stream, we need to follow those to their logical conclusions throughout the process.

Typical control adjustments include:

a. Shareholder transactions.

b. Intercompany transactions.

c. Ownership compensation. We also can't forget about the related adjustment to payroll taxes for any adjustment to owner comp.—I've learned this one the hard way.

d. Whether or not there is rent, which is quite often the case in valuing closely held businesses, when the real estate is owned outside of the operating entity. We need to conclude that the rent that is being charged is fair and reasonable in light of the relationship.

e. Healthcare and fringe benefits. The issue there is whether they exceed "typical" industry coverage or are below "typical" industry coverage. That's a tough one as far as getting information, but it is one that has been popping up on the radar screen.

f. Other related party transactions—kids on the payroll, those kinds of things.

g. Expense reimbursements.

h. Capital structures.

For each of these types of transactions or expenses, the appropriate question is whether they reflect economic reality as we understand it and serve a business purpose apart from the personal requirements or needs of the shareholder employee. The secondary question is the quantification of the economics of the transaction.

Thus, we have to conclude that some adjustment is required, and then we need to quantify what that adjustment may be, whether it's plus or minus.

Excluding the obvious or the blatant items that we are familiar with, such as family vacations and paramour expenses, jewelry, etc., where do we get information that can help us make the quantification decision?

The emphasis that's placed on this quite often relates to the nature or the reason for the underlying valuation in and of itself. In a family law context, far more emphasis tends to be placed on the expenditures by the control shareholder. All sorts of things get caught up in those expenditures—such as jewelry. I said paramour expenses—such as travel expenses. Those are really the types of expenses that are unrelated to the business—debtor party's jewelry, gifts. It goes on and on.

We use various sources of information for this issue. We use RMA, Integra, and ERI, which is certainly popular with the IRS. We'll go to trade association sites and try to get information out of it. We have found a couple of websites that are helpful in this: salaryexpert.com, payscale.com, salary.com, and monster.salary.com.

When we're looking at this area, we need to make sure we're examining all of the hats that the typical owner of a closely held business wears. Certainly the larger the closely held business, the more diversified and depth of management there is. Often, in the closely held arena, the shareholder/employee is not only the CEO, but also the treasurer; this person could be the controller but probably has a bookkeeper; he or she is likely to have an office manager but still may be involved with human resources; he or she does all the planning, is heavily involved in the sales calls, and is heavily involved in the production side even though there may be a production manager. So this person wears several different hats.

How can we identify the various hats that he or she is wearing, and where can we get information so that we can ascertain what those may be at differing levels of hat wearing? One way is to prorate time and the related various pay scales to arrive at totals.

We have developed, with the firm's tax department, various methodologies of applying business valuation theories to solve for what cash flow should be and then match that against what the cash flow actually is to ascertain whether adjustments are necessary to the closely held company's officer's compensation. It is not a be-all-and-end-all, but it lets us know at the beginning whether there is a mismatch between rates of return that the market is demanding and the rates of return that are being earned by the closely held company. If the gap isn't big enough—that is, if the rates of return at the closely held level aren't as strong as those being earned in the marketplace—maybe something needs to be considered as far as that compensation is concerned.

That aspect of it, however, does not consider history—that is, whether they have been underpaid in the past. But what it does do is track the line of cases that deal with using an investment analysis as a factor in determining whether reasonable compensation exists.

We've been successful in doing that on two or three occasions. Particularly, in one case, we were able to move the IRS adjustment from $2 million to under $300,000.

Another question is, "If you don't take a DLOC on the basis that you are using a noncontrolling cash flow, does it fully capture the minority shareholder's inability to compel distributions and liquidations?"

For intercompany transactions or transactions between family members, for rents and other property charges from related parties or to related parties, we rely on commercial real estate brokers, equipment leasing companies, banks, or other financial institutions.

At least in *our shop*, we're not hard asset appraisers per se. We don't value real estate. We don't value equipment. We'll value intangibles, for sure. We reach out to folks we know in the community that have been very helpful to us in documenting what those rates ought to be, and we will rely on it. And often, we'll actually get formal opinions or writings from them.

Given what's going on in healthcare with the rising costs and employers adjusting to that through increased participation by the employee in the underwriting of that coverage, either through higher deductibles and/or paying for a portion of the premium, I think it behooves us to bring that a little higher up on our radar screens when we're looking at potential adjustments to the reported costs on the financial statements.

Often, in a closely held environment, while there are some ramifications of having disproportionate coverages, we need to be aware that the control owners could have a plan that is far superior to anything else that's out there, and we may choose to consider adjusting that expense. From a practical matter, that's probably more applicable to the smaller company than a larger, closely held company. I think the more employees you have, the less likely that's the case.

GAAP Departures, Extraordinary, Nonrecurring, and/or Unusual Items

The primary objectives are to make adjustments that present the most likely expense structure (and revenue structure) and to determine the expected ongoing earnings capacity of the subject company.

We're trying to foster comparative information so that we're making apples-to-apples comparisons as opposed to something else.

The purpose of our definitions that related to normalization was to provide a benefit stream and financial statements that facilitate comparison.

I'm not saying that we should adjust all the financial statements to GAAP necessarily. I'm saying that we need to make sure that whatever we're comparing to is on the same basis as what we've got. If that requires making some changes that bring you closer to GAAP, then I think it's worth considering and taking a look at, but it's really just making sure we understand the underlying information. That's a thread that's going to bear through this entire presentation, knowing what it is that we're comparing to that drives a lot of what we're doing.

A common error that I've seen is when someone will take a P/E multiple and apply it to a tax-based net income. I think that's as fundamental an error as we can find, in that if the P/E is developed on a GAAP basis, which it is, and you apply it against a tax-driven financial statement, you're just not comparing the same two. They may happen to end up being the same, but that doesn't necessarily mean that's what they are.

Normalization also requires us to consider extraordinary items. Those are defined as "events or transactions that are distinguished by their unusual nature and by the infrequency of their occurrence."

Nonrecurring items are defined as "events or transactions that are not reasonably expected to recur in the foreseeable future, taking into account the environment in which the entity operates."

Unusual items are defined as "events or transactions that possess a high degree of abnormality and are of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates."

The source of these is APB 30, Section 107(a).

So the key thread through each of those definitions, whether it's extraordinary, nonrecurring, or unusual, is that the entity in which it operates is the driver. We need to understand that—and that the item or the event that we're looking at is either extraordinary, nonrecurring (so it's a one time), or unusual. That doesn't mean that it won't happen again. It's just that it's outside the norm.

Typical adjustments could include:

1. Strikes;
2. Litigation;
3. Fire and flood or other catastrophic loss;
4. Corporate restructure;
5. Life insurance proceeds; and
6. Insurance proceeds from some other casualty. And obviously, if you see the insurance proceeds coming in from either one of those two sources, there are obviously some lead questions that follow from that fact.

Be careful when considering litigation. It has become part of what business is about these days. So litigation expenses may show up on the books for the first time, and whether they meet the definition of extraordinary, nonrecurring, or unusual really depends on the fact and circumstances. It's obviously something that we need to be aware of and look into.

In the current economic environment, legal expenses may be rising, for several reasons. Typically, when things get tight, people become less tolerant, which tends to translate into people suing. In addition, battles with lenders require our legal brethren to get involved, or we could be soliciting their help in ascertaining bankruptcy filings, workouts, and the like. Thus legal expenses need to be reviewed and whether they are going to continue needs to be determined.

I think we've gone through a restructuring during the recent period where folks were laid off. Some have had to convert debt to equity. Those restructure expenses are similar to litigation in that we need to take a look at what it's about, whether those will be repetitive and whether they should be adjusted or not.

Nonoperating Assets and Liabilities and Related Income and Expenses

The *International Glossary of Business Valuation Terms* defines nonoperating assets as "assets not necessary to ongoing operations of the business enterprise."

I suggest that nonoperating *liabilities*, although not defined, would carry a similar definition as liabilities not necessary to ongoing operations of the business enterprise. The identification and quantification of nonoperating assets is often a matter for our judgment in a fair market value hypothetical environment. Often, these assets are identified during the financial analysis work because the ratios tend to be above or off the charts when they're compared to the industry information.

And often, these assets are typically broken down in three general categories—cash, marketable securities, and real estate—and they are not related to the business.

But they may be there for a reason. So there are basically two reasons why those assets may be there. One is that the control owner may have a conservative view of things and wants to hoard cash. He or she does not want to distribute it and wants it left in the business. So the owner invests it in either short-term money markets or securities and often real estate that is not directly tied to the business. But it may be held for expansion, which is different.

But other times, the presence of these assets is the result of greed. That is, the control owner simply doesn't want to pay additional tax upon distribution. So it's a form of a tax reduction scheme. And sometimes, depending on the person, it could be an attempt to hide the assets from the spouse.

The difficulty arises, however, in how valuators deal with these assets and liabilities.

If we're talking about a controlling interest valuation and we've got nonoperating assets, I think it's pretty clear what we do there. What we do is relieve the income and expense out of the cash flow stream and value the operating business.

Then what we will do is add to that the value of the nonoperating assets. Whether it's cash, marketable securities, or real estate, we'll get the value. So we'll sum the two parts that make up the underlying value of the business enterprise. From a controlling interest standpoint, I think that's a fairly straightforward approach.

But what do you do with nonoperating assets in a minority valuation?

There are basically two schools of thought related to this.

One is that you can leave it alone. The monies are being spent the way they are. The minority shareholder really doesn't have any control over that, and, if so, it would not be appropriate to separately value those assets.

In this case, it's no different from anything else that we do. If normalization is required, we should do it. That normalization would then isolate the operating activity much like we would do in a control situation. We would separately value the business. We would add to that the underlying value of those nonoperating assets. Then we would take a minority discount.

The other school of thought is, well, not so fast. It may be that we should show an operating entity and take a control discount.

But should we take a separate identifiable discount with respect to the nonoperating assets, and what if we adjust out the nonoperating assets and leave the cash flow as it is, which would mean it's a minority cash flow?

And should we then add back fully the nonoperating assets or should we adjust those for some form of discount and expected holding period?

Any of those approaches are certainly valid. They're certainly sound in valuation theory.

Typically, on the nonoperating side, I will attempt to isolate those out of the benefit stream and value a minority interest cash flow in the operating entity, separately value those assets, probably use the similar discount rate as that used in the build-up, whether it's based on Ibbotson or Duff & Phelps or however I've determined it.

The question there is the holding period. That is, when could you expect to realize the value of the nonoperating assets?

In part, that's a function of lots of things, but somewhere in the neighborhood of a 10-year hold in a typical business would be the period. There's nothing scientific to that, by the way. While it's an assumption that doesn't fully reflect the value, it does separately identify the value, which I think is the important component.

What is clear in a hypothetical buyer/hypothetical seller is that the hypothetical buyer will pay for it. The hypothetical seller will want something for it. The disconnect comes between the seller and the buyer. The seller obviously is going to want more than what the buyer is probably prepared to pay.

The way that I just described reaches a happy medium, and it's not free of doubt. But over a 10-year period, it should not have a material effect on the concluded value of the enterprise overall, which would be the value of the minority interest.

Now talk about the question that we had earlier about this minority interest, and this time I want to take a different approach to it.

Let me just reference Hitchner's book. He says when you're talking about valuing a minority interest that, when a benefit stream may be influenced by those in control and the subject interest is noncontrolling, it may be preferable to make no normalizing adjustments outside of any adjustments for GAAP and extraordinary or unusual items.

Obviously, this is the "no adjust" logic that we just talked about for nonoperating assets, and the school of thought is fairly obvious.

The point, if I could add to that, would be how can we value something using a hypothetical cash flow that is fundamentally different from that generated by the business when the interest being valued cannot change it? That's a pretty compelling thought about whether we're better served skipping the normalization side and just focusing on the comparative side of things. I'm not saying that's right, but I am saying it's compelling.

Traditional Normalization Practices for Noncontrolling Interests

As we have talked about the benefit stream, there may be adjustments that are outside those defined as control.

The logic of that argument further develops that this takes the subjectivity out of the discount for lack of control, and it may prove to be more defensible. I don't know whether that's necessarily the case, but again, it's something that we should really consider.

So we've got two bookends. We've got the one school that says that cash flow is what it is. We certainly should adjust for those things that are just inaccurate. We should not adjust those things that we really can't control. And with respect to nonoperating assets, we might want to leave those alone or use one of those other theories.

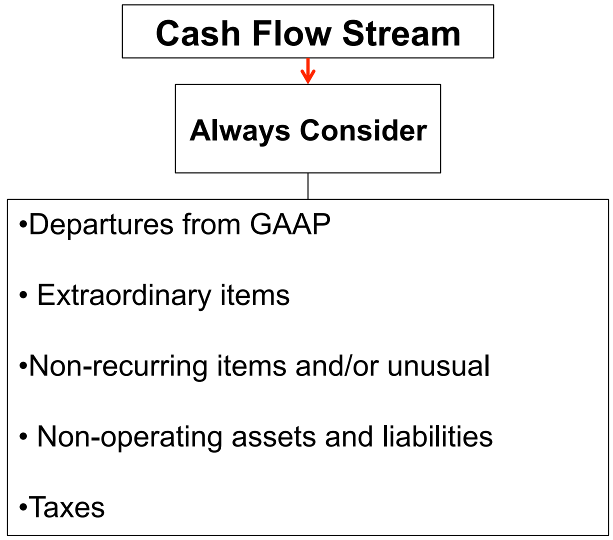
The other bookend is no, we should do all of it. We should go ahead and make the adjustments. We should make the normalization entries and then adjust that value with a minority discount.

I've put together a chart to illustrate those two bookends here (see Exhibit 3).

Regardless of the position that you may choose to be in, which school you come from, what we're always going to do is consider departures from GAAP for comparative purposes. So if we are looking at public companies or financially reporting entities, we've got to get our comparative straight. Depending on the source of the comparative data, we may or may not. This GAAP may not become as important an issue.

We always have to adjust for extraordinary, nonrecurring, and unusual items. Again, we're trying to come up with the expectational benefit that's coming in the future. Whether we use history as a predictor or actually have management's shot at it, we still have to address those issues and deal with them.

Exhibit 3

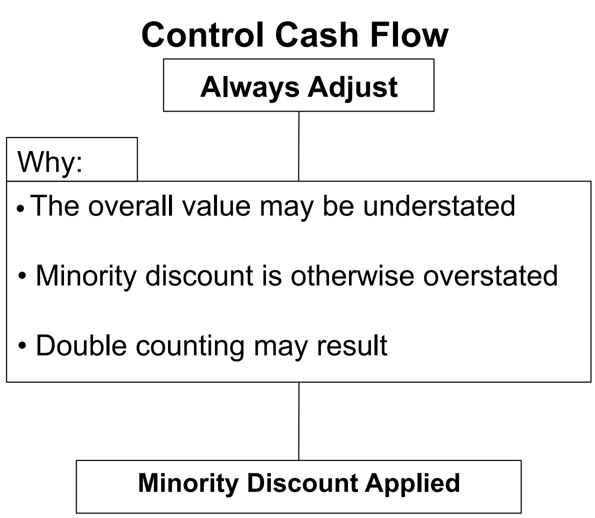


Then on the nonoperating assets and liabilities side, it's really going to decide which school of thought you're in on that as well. The consistency of the thought process is what's important here. I don't think there's a best way or a wrong way to do it.

If we're mucking with the income statement and the items on it, we then need to recalculate taxes.

The control school of thought will say that you always consider and adjust. I learned a long time ago that "always" is always a bad choice of words when doing something like this. But it makes the point that we always adjust these categories of items, that we always provide normalization

Exhibit 4



adjustments, and that we ascertain a minority or lack of control discount to achieve a minority marketable value (see Exhibit 4).

The logic from this school says that if you don't, you're likely to overvalue, that your minority discount could very well be overstated, and that you may end up double counting those two components together by not separately isolating the components of value.

Chris Mercer's book on the *Integrated Theory*, while different from what we're talking about here, is insightful when looking at this issue.

The other school is the minority cash flow group. We need to understand that there's a fine line between normalization and control adjustments. Normalization adjustments are those that we make when we are attempting to ascertain what the ongoing capacity will be when it is not influenced by control. And certainly the discretionary or control adjustments are those that are influenced by control (see Exhibit 5).

I suggest, as a general rule, that if we're increasing expenses, it's probably more normalization, and if we're decreasing expenses, it's probably more of a control adjustment that we're doing, and those would be more directed at officers' compensation, rent, and things like that.

This school of thought argues that if one cannot change it, how can one use a benefit stream different from one that's actually being realized? Further, access to information by a minority shareholder is more difficult than that of a control shareholder. There are legal ways to get to the information, but nonetheless, it's still a fact.

So therefore, if the information is difficult to get, how can one really definitively come up with answers?

Exhibit 5

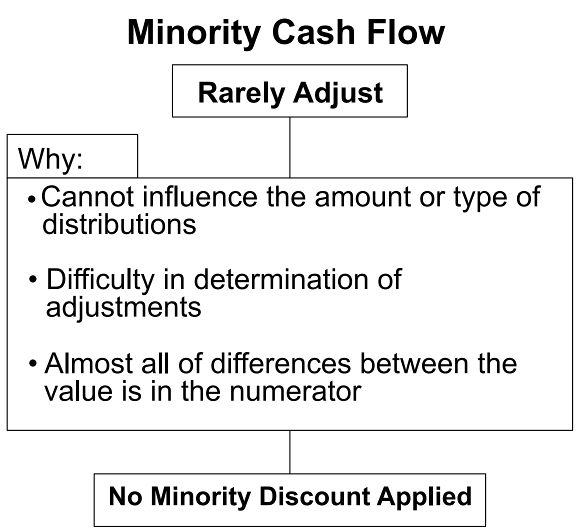
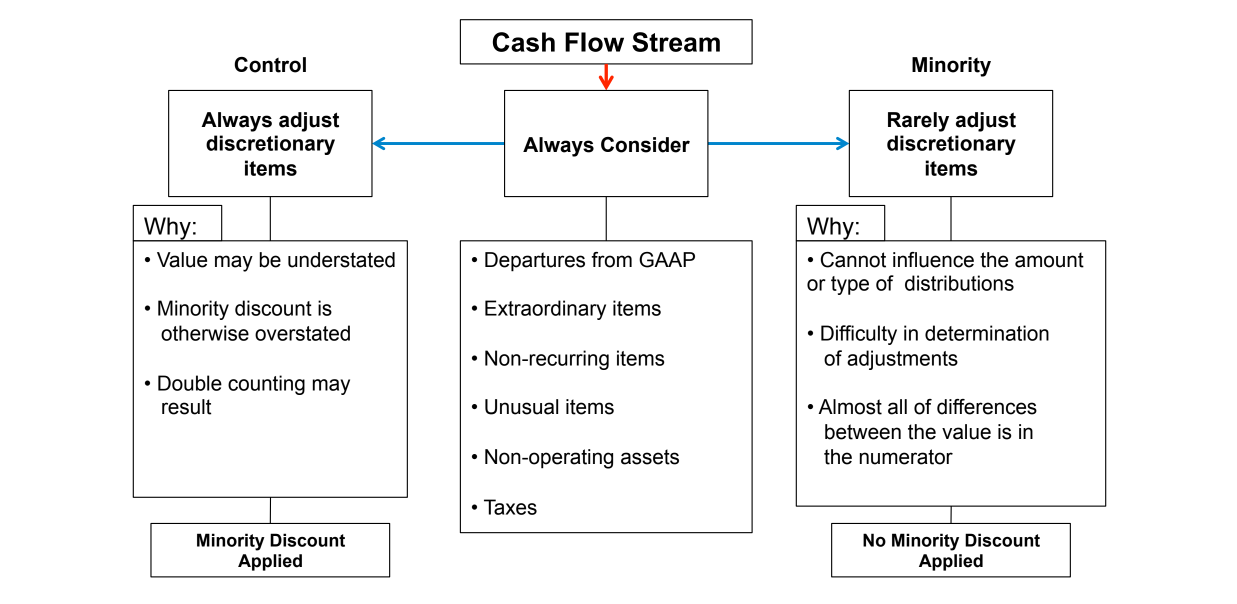


Exhibit 6



The adjustments might be more speculative, which leads back to the first question we had about how are we qualified to come up with officers' compensation.

Exhibit 6 is a summary, and basically what it's presenting is that on the left-hand side, we've got the control school. Again, those are the ones that are saying we should always do all of these things and separately calculate the enterprise value, separately calculate the minority discount value.

The other school of thought is, "It is what it is."

I've been describing this as if it is black and white, and, of course, it's not that clear.

There have been situations when I have written valuation opinions that were on the right-hand side because it was quite clear that it was a very small interest in a company. There weren't relationships that were involved. I mean there was family, but it wasn't brother, sister. It was more like second uncle. It was second- or third-generation ownership, those kinds of things. management was in place. The company was run as a business enterprise. It had outside board members. There was depth in management. There was financial reporting. Since the likelihood of adjustments was minimal, I took the right side.

However, when I'm looking at the son who's a 25% owner, working for the dad, and he got the 25% as a gift from the father through inheritance. In such a case, it really is their piggybank because they've got their fishing boat in there, they've got the condo, other things. Then I think there's a different attitude toward how the company is run, how a hypothetical buyer would view that company, and, yes, I would be more down the lines of the control side.

Clearly, when I am coupling the business valuation with the succession planning of a company that is either to a third-party sale or to management or however the plan is decided to be implemented, the left side becomes far more important. Here, if you shore up the inside operations of the company, what comes out the other end in the form of value or likely value is better demonstrated that way.

As I said earlier, these are the schools of thought, this is the result of the applications of those theories, and it's dependent upon the facts and circumstances of each situation where you would fall within those.

It's very important for us to have the understanding on the books as to how depreciation is being calculated, how it relates to the economics. It is a noncash item, but it still needs to be viewed because it may in our comparative analysis, have impact, and if we are using market multiples outside Ibbotson and Duff & Phelps data—well, even with the Duff & Phelps—it could become more important. We are checking to make sure that the benefit stream is reflective of what the

Exhibit 7

Source	Typical Adjustments	Reason
• Footnotes to audited financials • Tax return work papers	• Inventory methods – adjusting for LIFO • Depreciation and depletion • Is EBITDA an acceptable alternative? • Intangible assets • Revenue and expense recognition • Net operating income and losses • Interests in affiliates • Unusual gains and losses	• Fosters comparison if the industry is non-LIFO • Fosters comparison if the industry uses another method • Example: PV of the difference between actual and market value rental rates for leasehold interests. • Apples to apples • Losses are generally adjusted out • Cost, equity, or consolidated • Even if not extraordinary (designation is so restrictive for accounting purposes), the item may still be "non-recurring". Particular attention should be given to unusual assets or liability activity.
Considerations	**Typical Adjustments**	**Reason**
• Accounts receivable • Other liabilities • Effect of discontinued operations on prior years	• Allowance for doubtful accounts • Adequacy of contingent liabilities and/or pension liabilities • Non-recurring gains and losses	• What percent is actually collectible? • Post retirement benefit obligation actuarial assumptions… • The discontinued operations will no longer utilize company resources—but consider the redeployment of those resources to other activities

costs of maintaining that capacity will be, and properly capturing the tax cost associated with that benefit stream.

Exhibit 7 is a list of where the financial statements and tax returns may be and what the applications may be.

Importance of the Site Visit

The management interview is fundamental.

I have talked with valuators that conduct these by phone. My personal opinion is that that's a mistake. I think it's less personal. It doesn't give the valuator the opportunity to clearly demonstrate his or her understanding of the business, his or her interest in the business, his or her interest in really comprehending what it is the company that we're being asked to evaluate does.

I can't emphasize enough the importance of the management interview being done on site, face-to-face.

It also tells us, depending on the nature or the purpose of the valuation, whether it'd be for family law or some litigation aspect and how the company is run. We can tell a lot by how people interact, what they're working from or with or on or in.

All of those intangible aspects of what it is that we do are important, so I can't emphasize enough the site visit.

I also feel strongly that the visit should come after we have performed some analytic work. Whether we've adjusted anything I think is not as important as having a baseline understanding of how this company that we're valuing relates to some matrix. Whether it's the industry, some guidelines that we think might match up, or whatever it might be, I think that preliminary work should be done.

Again, it's part of letting the person we're interviewing know that 1) we've taken an interest in what we're doing, and 2) we're serious about what we're doing and that we understand some basic information about the company. So I think that it should be done as well.

That homework is important, particularly if it's for a controlling interest. They'll likely be paying our bill, and we want to make sure that they understand that we're doing our homework and that we're serious about it.

Certainly, as we've talked about it, the financial statements, if they exist, that have notes, are important. If they're audited, even better—no question about that.

The tax return work papers are important. They can provide us all sorts of information with respect to positions that are being taken on the tax returns, the risk associated with those positions, the cost of what those might be, and where they may be inside the tax return when we're looking at the controlling or discretionary kinds of things.

The audited financials also give us the description of the revenue recognition. If they're on LIFO, it should provide us with the description of the reserve that would need to be added back.

If we're dealing with that situation, which we are in a lot of cases now with net operating losses, we need to look at when those benefits may be realized, whether there's a carry back, and whether that one has been booked into whether that will be a source of cash flow that will help finance the situation.

Certainly, if there are investments in brother, sister, or parent subsituations, we need to have an understanding of how all of that is factored into either the financial statements or the tax return.

Also, certainly the gains or loss schedules, either D or 4797, or the exhibits thereto, will give us a heads up on gains and losses and whether those are of a recurring type.

So how do these normalization adjustments and the schools of thought of whether you do it, how you do it, and whether there are operating assets and nonoperating assets relate to today?

Normalization and the Distressed Economic Environment

We need to, in our management interview and in our reading with respect to the company and the industry, just try to get a sense of what might be the causes of the distress or the impairment on the company.

Now we all know the economy has been in the toilet, but not everybody has been in the toilet. Some have flourished, and that's a result of being responsive to what was going on.

So we need to understand the industry, understand how the local economy, if it's a smaller company, is impacted by the general downturn, and whether a company has found itself where it is because of the use of bank debt and what have been the impacts of that on the company, whether the company has been able to maintain it or what the company's plans are to deal with it, whether the company's suppliers or customers have been affected and, if so, how, and how is that getting back through to the company.

During this management interview, again, I think it's important to really understand what its plan is. I'm surprised we're there unless somebody has asked us to be there independent of the company. So we could be there because of the bank trying to look at it. It could be that an investor is not real pleased with what's going on. There could be lots of reasons why we're there and why we're doing the valuation. It could be to capitalize on the downturn so that there can be a shifting of more of the company. There are lots of reasons, but we need to understand what the plan is to address the situation and what's in place.

Through our reading, we need to ascertain whether what we're being told makes sense. We always have that fallback, which is 1) whatever we're doing is making sense, and 2) the answer we're getting in light of the situation of the general economics is also making sense.

The income approach is probably going to be the driver in this marketplace. It's not likely to be of the company data or any of those things at the level that I'm envisioning, a company that we're valuing, a smaller, closely held company.

The net asset approach is going to be the floor. I think we all realize that's what it will be, and in some cases, that floor could be real ugly. In fact, it could possibly be less than book.

So we need to focus on what the cash flows are going to be and how they are going to get there. The historic cash flows, I think, are likely to be not real helpful.

I don't think it's necessarily going to be a good predictor, but again, I think it's like anything else that we're doing in this arena. If the historical earnings are all over the place and we're going to use an average and management says, "Hey, that's a good predictor of the future," I'm saying, yeah, you might do that.

If you've got three years of financial information with a steady decline and you're looking at the last 12 months as a predictor of the future and management has no basis to say something other than that, then yeah, I could probably use it there.

However, if I've had a three-year trend in that industry and the industry is going to be looking at returning to four or five years ago, then I would suggest that no, maybe it's not.

That doesn't mean, however, that my discount rate, the risk rate that I would be discounting those future earnings, would certainly reflect that risk of recovery as well.

My objective here was to say if what we typically do is average earnings and look at the last 12 months and off we go, I think that's a mistake. What I'm trying to say here is that the future is likely to be a better predictor of where it's going than the past, given where we've been over the last two or three years. That's my point.

Items that we need to be looking at in the history when we're looking at what the future is going to be are certainly costs that we may have incurred that were outside the ordinary. Again, those could be relating to legal. They could be looking to accounting fees for putting together or assisting in projection development. It could be related to assisting the client in bank workouts or getting information together or summarizing information for them in a cognizant manner. It could relate to third-party accounting firms and law firms outside their normal auditor being involved in that process as well. It could be involved with experts.

So those costs need to be scrutinized and they need to be identified as to what they relate to, and those that are of a nonrecurring nature should be taken out. Now that doesn't necessarily mean also. Everything is tempered here in that there may be a two- or three-year period where that kind of help is needed, then it will go away. So it's not in one year, out the next. But I think common sense in what the plan is needs to be focused there.

It could very well be that the company has come up with a large pay down to get real estate refinanced. Whether that strain or drain on cash flow is going to be required is another question. What normally might have been "excess cash" or what's tied up in marketable securities, at one time, might have been considered excess. Today, it may not be.

So the models that we use to ascertain those may need to be relooked at in looking at those tests.

I certainly feel that the industry comparison isn't less meaningful—more meaningful—we should have been doing our job to start with, but when times are good and things are rocking along, it may be that we need to reemphasize what's going on there.

What's happening in the industry as far as consolidation could have an effect on how we view risk, particularly if the facts seem to fit the situation that we're valuing.

I think what all of this is relating to is that what we do isn't black and white, that normalization adjustments, given the right set of fact patterns, I think, require us just to think more about what we're doing, as opposed to just a mentality that can fit into all of this of "plug and chug." We need to be able to take a look at what we're doing, affirmative to conclude why we're doing it, lay out why the plan and approach that we're taking to the valuation makes sense, and how it fits into the normalization side of things, which, I think, falls out as a result of that.

Questions From Webinar Participants

Question 1: "Do you believe business valuators are qualified to determine what an officer/owner's reasonable level of compensation should be?"

Answer: I think we can answer the question, "Is it reasonable?" I don't think we can answer the question, "Is it the right number?" I think we can answer the question yes or no, whether it's reasonable, and I think we can also determine whether, if it's unreasonable, what the number should be.

Question 2: "Assume you have made only the adjustments to cash flow that apply to a minority interest shareholder. You arrive at minority cash flow. Then do you still take a minority interest discount, such as using Mergerstat data?"

Answer: I don't know that I fully follow the question, so if the person who submitted it could clarify it for me, I would appreciate it.

But if the question is, "If I believe that I have a minority cash flow, would I gross it up to come up with a control interest cash flow, then turn around and take a lack of minority discount?" my answer is no, I wouldn't do that.

I think there are several writings out there about Mergerstat and questions as to what that information, in fact, is. I'm not suggesting that it's not appropriate to use it, whichever way you want to interpret that. It's not a knock on it at all. It's just simply that I think there are ways to deal with the issue independent of that calculation.

So if that's not the answer or that's not the question or I didn't understand it right, please clarify it for me.

Question 3: "Can you, at some point, delve deeply into when it is not appropriate to normalize, for example, when valuing a minority interest? Along the same lines, discuss when normalization should be appropriate if, say, I am valuing a 33% interest when the other two owners are the subject owner's brothers."

Answer: I think those are two interesting points and questions.

If I come from the one school of thought, frankly, on the control side of things, I would say I couldn't think of a situation when I wouldn't normalize or make control adjustments or adjust the cash flow and then calculate what an appropriate minority discount would be.

If I'm in the other school, I think it is more in line with where the second question would be coming from, which would be when would it be appropriate to normalize even though you're a minority owner. I think you're touching on the point of when that might be. Is this person really a minority owner or is he really just part of the group that is sitting in a room, taking the same salary, driving the Lexis, using the bank account of the company as their own for purposes of travel and other perks, and those kinds of things?

So in that situation, I might lean toward making these kinds of adjustments and going down the path of then coming up with the control discount.

I think it also would be important on what's the purpose of the valuation. So if I'm doing it for a buy/sell, it may be that coming up with the definition of cash flow to be used in the buy/sell agreement would be as reported cash flow.

However, if it's being done for an estate or gift and the other two or all three shareholders are sitting in a room just coming up with how they're whacking the pie up in the form of compensation and other perks, I think I would also then make that adjustment.

What's difficult with that is how do you go about getting the information to ascertain whether that's the case? That's where the financial analysis comes in as to what are the levels of compensation, what roles each of the parties is playing, and how is their compensation developed and structured. All of those points, as we know, are unrelated to business valuation, but they are important to ascertain the reasonableness of compensation under Section 162.

If the amount of compensation is known in advance, the duties are defined in advance, and the compensation is paid pursuant to that and unrelated to other events, then whatever is bargained for between the parties has a better chance of being sustained than if they're defining their roles but they're leaving their compensation open, depending upon the profitability of company. Those are much different fact patterns and criteria than the first example.

Question 4: "You say DCF is the only reasonable income method. Does this mean you do not use the capitalization of earnings method?"

Answer: I think historical cash flows are not likely to be of real value in a distressed situation. They may not be reflective of what will be going on in the future. That doesn't mean I wouldn't use a capitalization of earnings method if what has happened is a good predictor of the future, but I feel that the DCF would be the primary method. Again, if it's based on what management plans on doing, then it's management's take on it.

3. Use Four Categories of Normalization Adjustments to Get the Best Cash Flow Analysis

"I look at a lot of opposing reports, or reports from friends that are about to get opposed, and I can report that the cash flow statement analysis is often the thinnest part," said Brandi Ruffalo in her session on normalizing financial statements at a NACVA conference. "Every time we do that, we give up control of half of the math of the valuation equation."

And the math is pretty simple. "If I make a $10,000 adjustment in a cash flow statement for a client with a 20% cost of capital, I've changed the value $50,000," Ruffalo says. As a result, she doesn't have much patience with appraisers or clients who say "don't waste any time or money on our forecasts or P&L. Just use what we have."

"It doesn't matter whether it's a large or a small company," she says.

Further confirmation of the need to focus analysis on the numerator of the value equation. Garth Tebay commented on this at the Pepperdine Private Capital conference a few weeks earlier. "They already have a clear idea at each silo of capital what the cost of capital is, so there's very little debate among funding sources as to what discount rate to use," he says. "They spend *all* their time on cash flow normalizations. I talked to mezz and venture capital sources who claim they have 20 or more standard normalization steps."

"I've never seen a valuation report that has that many adjustments," commented Ruffalo.

Normalization adjustments have different categories. Tebay refers to a spreadsheet example he has from Chris Mercer. The adjustments can be sorted into the following categories:

1. The adjustments you always make—nonrecurring, accounting, and other—to arrive at enterprise value.

2. Control adjustments specifically for owner's compensation or controllable expenses.

3. Financial control adjustments for the private capital markets and what they bring to the table, on the assumption that those potential investors bring capital and resources that may reduce the costs of the business.

4. Strategic buyer adjustments based on things such as consolidations, market advantage, and other competitive benefits.

But most appraisers rarely go past the first two categories, and some barely leave the first.

"If you ask the owners what keeps them awake at night and what it would take to make those issues go away, you often get very close to normalization assumptions," Ruffalo says, citing her experience. "We're financial analysts; this is what we do naturally," but often normalization adjustments are still shortchanged.

Owner's compensation is often one of the most material issues. There's the South Carolina *Blackburn* case (*Blackburn v. TKT and Associates, Inc.* 2010 WL 2035369 (S.C.)), for instance, where the appraisers agreed on both the message and the need to normalize for the jobs performed by the appraiser. But one did not normalize, and eventually the S.C. Supreme Court vacated the reports because the appraisers "violated the agreed-upon method … and failed to comply with the income approach."

Or the *Ackerman* case (*Ackerman v. Ackerman* 2006 Cal. App. LEXIS 2056) in California, where the court determined it could not rely on the study used by either appraiser and determined its own reasonable compensation figures.

Tebay feels that appraisers should spend as much time on owner's comp adjustments as they do on their discount rate analyses. The kinds of work that will help here are:

1. Use of studies that match the facts and circumstances;

2. Employee interviews; and

3. Other research as necessary to find comparables.

The *Heitz* court case is also often cited because it lists nine factors to be identified for compensation analyses. It's an essential read before handling this kind of work.

4. The Use of Organization Charts to Describe Normalization Adjustments

By Mark W. Norris, CPA/ABV, CVA, CFFA, ASA

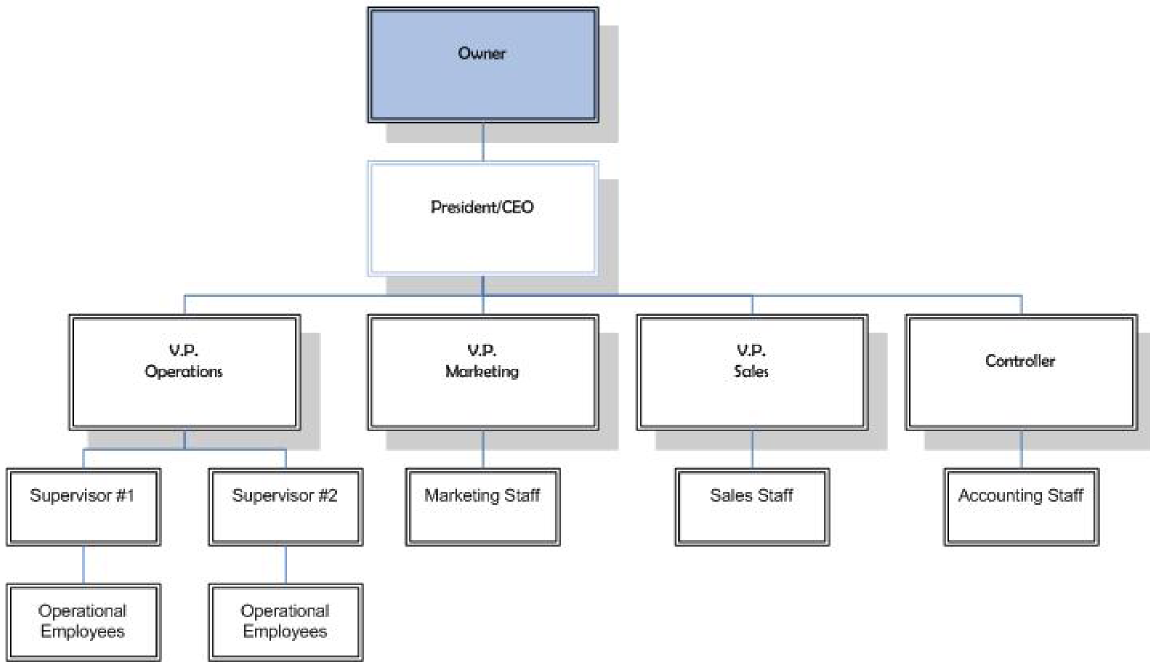
While serving as an expert in a litigation case, I testified on the valuation of a person's equity ownership interest in a business. During the process, I realized how difficult it was for a trier of fact (whether judge or jury) to understand how normalization adjustments were calculated and why they were required in the first place. An organization chart would have been ideal to explain the need for the normalization adjustments contained in my report.

In my case, a relative of the owner provided CEO and COO services to the company. In addition, a management company owned by this relative provided accounting, technological, marketing, and design services. The opposing expert erroneously took the position that since a "related party" provided these services, they were not ordinary and necessary expenses that the company would have incurred in producing goods and services. But regardless of who provided them, the company needed the services to conduct its business. An organization chart would have substantiated that position.

As valuation experts, we must realize that most triers of fact don't do what we do and have difficulty understanding how a business runs, the related financial issues, and how these issues affect the valuation of the business. The use of an organization chart brings to life the age-old adage, "A picture is worth a thousand words." An organization chart illustrates and documents the various departments and functions of a company. For instance, the president/CEO would typically be at the top of the chart. The various department heads would be listed below that position, documenting who reports to whom and what their function is. Some of these departments or functions would include operations, sales and marketing, human resources, accounting and finance, and technology.

I realized how effective such a chart (see Exhibit 1) would have been in explaining to the trier of fact how the business operated and what functions were required for it to produce its goods and

Exhibit 1. Organization Chart of a Closely Held Business



services. The trier of fact would have greatly appreciated my taking the time to do that at the beginning of my testimony.

Even more important, the use of an organization chart would have documented why the opposing expert was in error when he eliminated all expenses for services that were provided by the management company, simply because it was a related party. For example, I would have explained to the trier of fact that the company only employed people in the operations area of the company. It did not employ people to provide all other functions and related services illustrated on the organization chart, including the president/CEO, COO, sales and marketing, human resources, accounting, finance, and technology. Therefore, a logical question I would have proposed would have been: How can the company operate without these services, which was the position of the opposing expert? Once I was able to show the need for these services, I could demonstrate that the company would have to incur costs for them, i.e., the need for normalization adjustments to account for these costs based on market, or arm's-length, rates.

In conclusion, I recommend all valuation experts consider the use of an organization chart to help document not only how the company operates, but also support the need for certain normalization adjustments. Furthermore, I would recommend that any attorneys involved in litigation who use the services of valuation experts suggest they use organization charts in their reports and, if applicable, their testimony at trial.

***Mark W. Norris, CPA/ABV, CVA, CFFA, ASA**, is a managing director of Tucker & Meltzer. He can be reached at mark@tuckerandmeltzer.com.*

5. Normalizing Adjustments Are Potentially Critical in Statutory Fair Value Determinations

By Z. Christopher Mercer, ASA, CFA, ABAR

Normalizing adjustments can be important in statutory fair value determinations. If excess owner compensation is considered part of how a company is operated, then controllers of corporations can artificially lower "fair value" and at the same time, benefit from the reduction in the form of nonprorata distributions. That may be "fair" in some jurisdictions and part of the "operational reality" of a business. However, normal appraisal procedure would call for normalization of earnings prior to determining enterprise value.

This discussion on normalization adjustments could provide useful information to courts in their determinations of statutory fair value. Judges should make equitable decisions in light of relevant valuation theory and practice. Normalizing adjustments modify the income statement of a private company to reveal a "public equivalent" income stream. If such adjustments are not made, the resulting indication of value is something other than a marketable minority value. Resulting values would not be "as-if freely traded."

For appraisers using benchmark analysis to determine marketability discounts, this would be disastrous, since the restricted stock studies are based on freely traded (marketable minority) stock prices. Note that, in creating a public equivalent for a private company, the subject company need not have all of the characteristics of potential IPO candidates. Another name given to the marketable minority level of value is "as-if-freely traded." This terminology emphasizes that earnings are being normalized to where they would be if the company were public. The framework does not require that a company be public or even that it have the potential to become public.

Normalizing Adjustments Explained

A vocabulary is needed to clarify the nature of normalizing income statement adjustments. There are two types of normalizing adjustments. Being very original, we call them Type 1 and Type 2.

- *Type 1 normalizing adjustments.* These adjustments eliminate one-time gains or losses, other unusual items, discontinued business operations, expenses of nonoperating assets, and the like. Every appraiser employs such income statement adjustments in the process of adjusting (normalizing) historical income statements. Regardless of the name given to them, there is virtually universal acceptance that Type 1 Normalizing Adjustments are appropriate.

- *Type 2 normalizing adjustments.* These adjustments normalize officer/owner compensation and other discretionary expenses that would not exist in a reasonably well-run, publicly traded company. Type 2 normalizing adjustments should not be confused with control adjustments or Type 1 normalizing adjustments.

Normalizing adjustments reveal the income stream that is the source of potential value for the minority investor. Normalizing adjustments also reveal the base income stream available to the controlling interest buyer who may be able to further enhance that income stream. Appraisers should not be confused by the fact that minority shareholders of private companies lack the control to make normalizing adjustments. Some have argued that because minority shareholders lack the ability to change, for example, things such as excess owner compensation, normalizing adjustments should not be made in minority interest appraisals. This position is incorrect, although it is enduring among appraisers.

Minority shareholders of public companies also lack control. However, they expect normalized operations. If management of a public company receives egregious salaries or fails to reasonably manage expenses, minority shareholders of the public company will invest their money elsewhere. In addition, the market value of such companies normally reflects this lack of investor interest, exposing incumbent management to the threat of hostile takeover (followed shortly thereafter by unemployment).

Shareholders of nonmarketable minority interests generally lack this ability to "take my money and run." These considerations have no impact on the underlying value of the enterprise. Rather, they reduce the value of the interest in the enterprise in relationship to its pro rata share of enterprise value. This diminution of value must be considered separately from, but in conjunction with, the valuation of the enterprise.

Some appraisers still disagree regarding the applicability of Type 2 normalizing adjustments. I find the arguments supporting their use compelling.

In Exhibit 1 on the following page, ABC Inc. is a company reporting sales of $10 million and operating profit of $300,000. Assume that we are appraising ABC and are now considering normalizing adjustments. There is one Type 1, or unusual, nonrecurring, normalizing adjustment to be made

Exhibit 1. Organization Chart of a Closely Held Business

ABC, Inc.
Normalizing Adjustments
($000s)

		Normalizing Adjustments		
		Type 1	Type 2	
	Reported	Nonrecurring Items	Normalize to Public Equivalent	Normalized
Sales	$10,000	$0	$0	$10,000
COGS	$5,800	$0	$0	$5,800
Gross Profit	$4,200	$0	$0	$4,200
Litigation Settlement	$200	($200)	$0	$0
Selling (Cousin Joe)	$800	$0	($100)	$700
G&A (Cousin Al)	$1,800	$0	($100)	$1,700
Owner Comp (Big Daddy)	$900	$0	($600)	$300
Chalet (Big Daddy's Vacation Home)	$200	$0	($200)	$0
	$3,900	($200)	($1,000)	$2,700
Operating Profit	$300			$1,500
Operating Margin (No debt)	3.0%			15.0%

in this particular appraisal. There are also several Type 2 normalizing adjustments that relate to the owner and the controlling shareholder of the business.

Type 1 Normalizing Adjustment (Nonrecurring Items)

- The company settled a lawsuit regarding damages when one of its vehicles was in an accident. The settlement, inclusive of attorneys' fees, was $200,000 in the most recent year. Expenses associated with the lawsuit are eliminated from operating expenses.

Type 2 Normalizing Adjustments (Agency Costs and Other Discretionary Expenses)

- Our examination of selling expenses reveals that Cousin Joe is on the payroll at $100,000 per year and he is not doing anything for the good of the business. An adjustment is clearly called for regarding Cousin Joe. His compensation must be eliminated to see the "as-if-freely-traded" income stream.

- In the administrative department, Cousin Al comes to work every day, but it is clear someone else is running the department and that Cousin Al is not productive. We adjust by removing his $100,000 salary.

- Big Daddy takes a substantial salary out of the business. Based on a salary survey, earnings should be adjusted by $600,000 for his excess compensation to lower the expense to a normal, market level of compensation.

- Finally the business owns a chalet for Big Daddy's vacation needs, which costs the company about $200,000 a year. Expenses associated with Big Daddy's vacation home are adjusted accordingly.

Summing the Type 1 and Type 2 adjustments, adjustments to operating expenses of $1.2 million have been identified. These adjustments raise the adjusted operating profit to the level expected if this company were publicly traded (even though it likely never will be). The normalized operating margin is 15%.

Are Type 2 Normalizing Adjustments Really Control Adjustments?

Some appraisers remain convinced that Type 2 normalizing adjustments are really control adjustments and that they should not be made when valuing minority interests. Why, they ask, should we not value the minority interest directly and forego making Type 2 normalizing adjustments? Consider that if we do not make these adjustments:

- The resulting earnings stream is not comparable to those of public companies (or "as-if-freely traded").
- A discount rate based on guideline company analysis would not be appropriate, and the resulting value indication would not be at the marketable minority level.
- Marketability discounts referencing restricted stock and pre-IPO transactions involving public companies would be inappropriate if relevant Type 2 normalizing adjustments are not made. The various restricted stock and pre-IPO studies are based on marketable minority values and the resulting, non-normalized base would not be at the marketable minority level.
- There is an implicit assumption that the shareholder will never realize his or her pro rata share of the value of the enterprise. In the alternative, there is no basis to estimate what that future terminal value might be. There would be no basis, for example, to estimate the expected growth in value of the enterprise over any relevant expected holding period, since the base marketable minority value is not specified.

Without making appropriate Type 2 normalizing adjustments, an appraiser cannot assure users that his or her conclusion is at the nonmarketable minority level of value, which is typically the objective of minority interest appraisals.

The bottom line is that failure to make Type 2 normalizing adjustments when valuing nonmarketable minority interests provides neither the appropriate theoretical nor practical bases for valuation conclusions.

Normalizing Adjustments and Statutory Fair Value: Guidance From the Leading Case in New York

The concept of normalizing earnings is important in the context of statutory fair value. If enterprise cash flows are not normalized, for example, for excessive owner compensation, capitalizing non-normalized earnings provides an indication of value below that of the value of the enterprise if it were to be sold in the market as a going concern. In New York, for example, case law guidance is provided in *Beway* (*Matter of Friedman* [Beway Realty Corp.], 87 NY2d 161):

> Thus, we apply to stock fair value determinations under section 623 the principle we enunciated for such determinations under section 1118 that, in fixing fair value, *courts should determine the minority shareholder's proportionate interest in the going concern value of the corporation as a whole,* that is, "'what a willing purchaser, in an arm's length transaction, would offer for the *corporation* as an operating business'" (*Matter of Pace Photographers [Rosen], 71 NY2d at 748, supra*, quoting *Matter of Blake v Blake Agency, 107 AD2d at 146, supra*). [emphasis supplied]

When companies are sold, it is customary for owner compensation to be normalized to market levels. Selling owners are happy to do this to realize the benefit of the capitalized value of above-market salaries. I studied economics as an undergraduate and in graduate school. We often used an expression to prove (or disprove) a point: "If it were not so.…" That might be another way economists have of saying, "on the other hand.…"

If it were not so that owner compensation is normalized in fair value determinations, then controlling owners who are squeezing out a minority shareholder (or allegedly oppressing) would both continue to receive the current benefit of above-market compensation *and* the benefit of a lower value to be paid to the minority shareholder. If this seems too good to be true, then that is likely what the guidance in *Beway* above is attempting to avoid.

Of course, the guidance of *Beway* is not applicable in jurisdictions other than New York. It is provided to illustrate how one court tackled the issue of minority interest discounts. Appraisers providing statutory fair value determinations in any state should obtain guidance from counsel as to the statutory definition of fair value and their legal interpretation of any interpretive cases.

You Be the Judge

This article involves an integrated theory of business valuation being applied to statutory fair value determinations, not determinations of fair market value at the nonmarketable minority level of value. Why? Let's begin to address the question with a few assumptions:

- For simplicity, assume that ABC Inc. has no debt and that the appropriate valuation multiple to determine its equity value is 5x.
- Assume further that ABC Inc. is engaging in a transaction, the effect of which is to "squeeze out" a 10% owner who is not related to Big Daddy. The shareholder appropriately perfected his right to dissent in accordance with the laws of the state and has dissented and is asking for the fair value of his shares.

ABC Inc. hired an appraiser who made no normalizing adjustments. This appraiser determined the fair value of the company to be $1.5 million (5 × $300,000 of operating profit) and the 10% owner's interest at $150,000.

The shareholder hired another appraiser (who had read and studied *Business Valuation: An Integrated Theory,* 2nd edition). This appraiser made the normalizing adjustments in the table above and capitalized adjusted operating profit of $1.5 million. Her conclusion of fair value was $7.5 million (5 × $1.5 million), and her conclusion of the fair value of the 10% interest was, accordingly, $750,000.

The matter is now at trial for an appropriate determination of fair value. In this jurisdiction, it is clear that no minority interest or marketability discounts are applicable. So what is the fair value of the 10% interest in ABC Inc.: $150,000, $750,000, or something in between? You be the judge.

Having put you in the position of judge for our illustration, how would you begin to resolve the problem and articulate a clear valuation rationale if you lacked the vocabulary and understanding as developed in this article (and on my blog ValuationSpeak.com)? It would be difficult, indeed.

Conclusion

It should be clear that without the understanding and vocabulary presented above and the guidance in *Beway*, anything you said about your conclusion would likely lack clarity *from a valuation perspective*. Again, let me say that I am not questioning the equitable decisions that real judges have to make. But I do hope we are beginning to create an ability to articulate conclusions in clear and consistent valuation terms.

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6. Simple Guidelines to Keep Your Normalization Adjustments Separate

Editor's Note: This article was written from a session at the 2012 National Association of Certified Valuators and Analysts (NACVA) Conference. From this session emerged an evergreen list of guidelines to follow in separating normalization adjustments.

"I suggest valuators keep normalized adjustments separate to distinguish between the different types of benefit streams that would be available," says Garth Tebay, CPA, CVA, CM&AA and managing partner at Valued Defined, a business valuation and litigation support firm in Maumee, Ohio. "Each one of these adjustments creates a different level of benefit stream, and therefore, a different type of value." Tebay advises that valuators look at the type of adjustments that fall into particular levels:

- *Nonrecurring, extraordinary items* go into Level 1. Examples include adjustments for nonrecurring legal fees associated with litigation, adjustments for selling expenses associated with a discontinued product or product line, and other items that are one-time gains or losses.

- *GAAP adjustments* go into Level 2. These adjustments convert tax-based to GAAP-based financial data for proper comparison when using the market approach. The concept is apples to apples. Examples include adjustments for inventory method of accounting from LIFO to FIFO or adjustments for income recognition arising from long-term contracts.

- *Type 1 control adjustments* fit into Level 3. Examples include normalized officer's compensation, discretionary expenses, and income taxes associated with Type 1 control adjustments.

- *Type 2 control adjustments* go into Level 4. Examples include adjustments for optimization of sales and marketing systems, adjustments for cost containment arising from contract negotiations and bidding, and adjustments for the income taxes associated with those.

- *Type 3 adjusted strategic control adjustments* fall into Level 5. Examples include adjustments for economy of scale in the finance, management, and operations areas; reductions for interest expense associated with lower financing costs; and adjustments for income taxes associated with Type 3 control adjustments.

7. D&P Suggests Normalizing the Risk-Free Rate When Market Yields Are Abnormally Low

During the financial crisis in late 2008 and early 2009, yields on longer-term government securities in the U.S. declined (dramatically) to approximately 3% (see Exhibit 1). This was not all that remarkable. Financial crises are often accompanied by a "flight to quality," where investors likely care more about preservation of principal than they do about yield. During these times, investors look for places to park funds in securities they consider free from risk of loss of principal, and government-issued bonds (i.e., "sovereign" bonds) have historically been regarded as a relative safe haven in times of economic uncertainty.

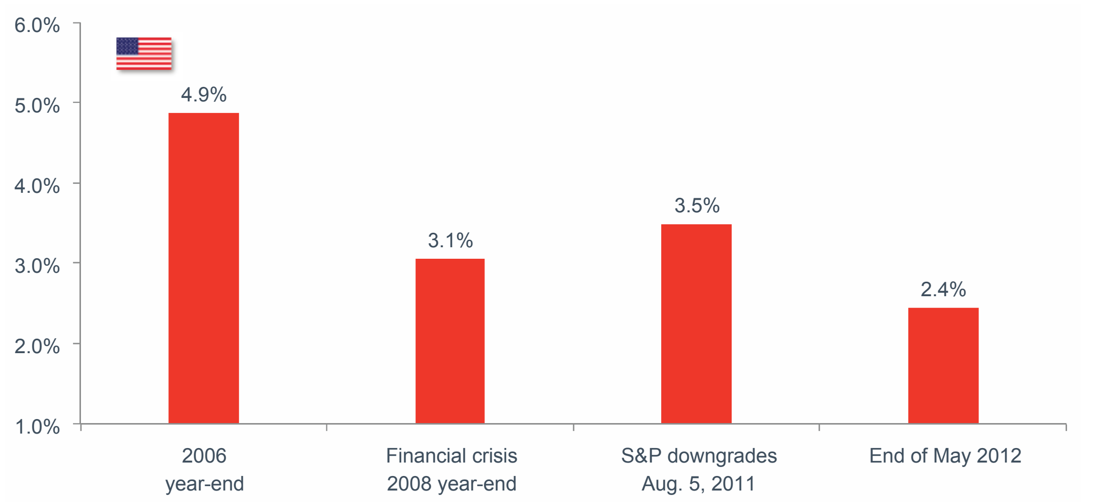
Rating Agencies' Warnings and Downgrades

Anyone who has ever applied for a home mortgage or car loan has probably had his or her credit rating checked. A bank needs this information to help it gauge how much risk it is assuming if it lends you money. All things being equal, the lower your credit rating, the higher your interest rate will be, and vice versa.

Following the 2008 financial crisis, longer-term U.S. yields remained low both in a historical context and relative to the country's credit rating outlook. Indeed, yields declined even further after the downgrade of U.S. sovereign debt by Standard & Poor's (from AAA to AA+) in August 2011 (see Exhibit 1).

While the risk of a "hard" default is not likely for the U.S. (after all, the U.S. government retains the ability to print money to meet its obligations), one can imagine a scenario in which a "soft" default occurs, where the dollar is allowed to depreciate (via inflation) and government debt is paid down with a currency that is not worth as much. However, U.S. inflation has been relatively mild to date and is not expected to increase at least in the near term, according to the Federal Reserve's (Fed) Federal Open Market Committee (FOMC). The FOMC reported in its March 13, 2012, press release that "the recent increase in oil and gasoline prices will push up inflation temporarily, but

Exhibit 1. 20-Year Constant Maturity Treasury Yields, December 2006-May 2012



the Committee anticipates that subsequently inflation will run at or below the rate that it judges most consistent with its dual mandate."

So Why the Low Rates?

This brings us to the question, "Why have yields on U.S. government debt continued to decline following S&P's outright downgrade and other ratings agencies' negative outlook for the country's credit standing?"

The dramatic decrease in yields during the 2008 financial crisis was arguably driven in large part by flight to quality issues. U.S. government securities (alongside various others) were likely perceived as one of the best of a bad bunch. Funds looking for safety could be parked in other currencies (e.g., the Swiss franc), but these other currencies simply do not have the volume of outstanding currency nor liquidity to absorb the amounts of money seeking a safe haven.

On the other hand, the very policies adopted by the Fed (and other countries' central banks) in the years following the credit crisis have included initiatives such as quantitative easing and a number of communication tools. The purchasing of mid-term and longer-term bonds by the central bank has further depressed the yield curve on government bonds over these maturities. One might even argue that these interventions are at times the main driver of lower yields, rather than just a contributing factor.

In a speech made in April 2012 at the St. Louis Federal Reserve, Mohamed A. El-Erian, CEO and co-CIO of PIMCO, addressed (among other issues) the effect that central bank interventions are having on markets (given their "size and scope"), saying that "the result is artificial pricing, lower liquidity and a more cumbersome price discovery process." He goes on to say, "Whether in the U.S. or Europe, government yield curves are essentially floored at exceptionally low rates up to around the five-year point (arguably the segment of the yield curve that has the most impact on economic activity). It is also increasingly uncertain whether, at the current set of market valuations, central banks can rely just on asset purchase programs as a means of enticing investors into doing things that they would not be doing on the basis of fundamentals. Sustainability for investors is more a function of being pulled into an investment due to its inherent attractiveness *rather than being pushed into it by central banks' artificial manipulation of relative prices*."[1] [emphasis added]

But periodic downward spikes in government bond yields persist every time a new episode in the continuing financial crisis saga occurs, suggesting that flights to quality are still impacting the historically low yields. For example, the recent increased economic turbulence in the eurozone due to the threat of a messy Greek exit from the common currency, the euro, and renewed fears that the Spanish and Italian governments might need some sort of bailout has led to another flight to safety. This, in turn, has resulted in a decline in the value of the euro (and an increase in the value of the dollar) and new record low yields for government securities of safe-haven countries. For example, according to a recent *Financial Times* article[2] on May 29, "U.S. 10-year yields fell as low as 1.62%, a level last reached in March 1946," while the UK 10-year yields fell to 1.64%, "the lowest since records for benchmark borrowing costs began in 1703." In addition, German two-year yields fell to zero for the first time, implying that investors are willing to lend to Germany for no income return.

Implications for Cost of Capital Estimates

During periods in which investors are seeking safety above all else and/or when massive interventions are being employed by the central banks, the yields on so-called "risk-free" government-issued securities may actually decline for reasons other than investors' incentives (based on fundamentals) in more normally functioning markets and thus, without adjustment, may be less reliable building blocks upon which to estimate the cost of equity capital. The models commonly used for estimating the cost of capital were developed during periods of relative stability.

A standard practice used by valuation professionals to estimate a base cost of equity capital has been to add the risk-free rate (typically the spot yield of a longer-term government bond) to the equity risk premium (ERP).[3] However, during several periods since 2008, this practice resulted in *lower* estimates of risk, just as risk is likely *rising*.

Duff & Phelps monitors changes in market yields relative to various risk-free rate "building blocks" (e.g., rental rates, horizon premia, and expected inflation) and various other economic indicators (e.g., the flow of funds or implied volatility derived from options). When evidence suggests that market yields are abnormally low, we suggest "normalizing" the risk-free rate for use in estimating the cost of equity capital.

1 Dr. El-Erian made these remarks in a speech given at the Homer Jones Memorial Lecture at the Federal Reserve Bank of St. Louis on April 11, 2012.
2 "Rush for Havens as Euro Fears Rise," *Financial Times* online edition, May 30, 2012.
3 The equity risk premium (often interchangeably referred to as the market risk premium) is defined as the extra return over the expected yield on risk-free securities that investors expect to receive from an investment in a diversified portfolio of common stocks.

Duff & Phelps Calculator Q&A

The online Duff & Phelps Risk Premium Calculator automatically looks up a risk-free rate from the Federal Reserve Board of Governors' site.

Is this rate normalized?

No, this is the raw daily yield of a 20-year U.S. Treasury as of the valuation date entered, but may be overtyped with a custom rate if need be. In most cases, one would prefer to use the existing U.S. Treasury yield available in the market. However, during times of flight to quality or other factors' influence, a lower risk-free rate implies a lower cost of capital—the opposite of what one would expect in times of relative distress—and so a "normalization" adjustment may be considered appropriate. For more information about risk-free rates and other cost of capital issues, including articles, "how-to's" videos, and more, please visit www.DuffandPhelps.com/CostofCapital.

We note that adjusting the risk-free rate is only one of several alternatives available. For example, one could use a spot yield for the risk-free rate and *increase the equity risk premium* to account for higher risks. Both of these adjustments are in principal response to the same underlying concerns and should result in broadly similar costs of capital. Duff & Phelps utilizes a combination of these options. Normalizing the risk-free rate is likely a more direct (and more easily implemented) analysis than adjusting the equity risk premium due to a temporary reduction in the yields on risk-free securities, while longer-term trends may be more appropriately reflected in the equity risk premium.

Closing Thoughts and Conclusion

Since the worldwide 2008 financial crisis, longer-term sovereign yields on both sides of the Atlantic have continued to remain low in both a historical context and in the context of their ratings outlook. Some analysts have suggested that recent declines in yields may be more a function of governmental intervention than a function of flight to quality issues.

The potential of "artificially" low yields resulting from either periods of flight to quality (during which investors likely do not care about yield but are focused on capital preservation) and/or high levels of central bank intervention has necessitated a reevaluation of the methods valuation professionals have traditionally used to estimate cost of capital.

8. The Dangers of Normalization

Kevin Piccolo, ASA, associate director of valuation services at Morningstar Inc., recently completed research on the normalization of interest rates. BVR interviewed Kevin about the results of his research in June 2012.

BVR: What kind of adjustments have you been looking at in your research regarding the risk-free rate and interest rate environment?

Kevin Piccolo: There has been a lot of talk in the industry about adjusting the risk-free rate or the equity risk premium up for special circumstances or historical events. I was reading *The Cost of Capital: Applications and Examples* by Shannon Pratt and Roger Grabowski, and I came across their discussion about their proposed World War II adjustment, which adjusts SBBI's historical ERP by artificially changing long-term interest rates to match inflation during 1942 to 1951.

After reading that segment, I was perplexed: Why isolate a particular period of time given that the market history is so dynamic and so interrelated? The government capped interest rates at 2.5% so the Treasury could borrow at very low interest rates during wartime. I thought about how this World War II adjustment relates to adjustments to interest rates and equity risk premium in today's economic environment.

I decided to do more research, and I discovered that during World War I, the government imposed another cap on interest rates—again, for the Treasury to borrow at very low interest rates. That cap actually lasted over 60 years and was repealed in 1988. So during the 10-year period during and after World War II, there was actually an overlying 4.25% cap from World War I. After an accord was reached between the Fed and the Treasury in 1951, the 2.5% cap was removed. However, the continuous grappling back and forth for over 30 years between the Treasury and the Fed after the accord was reached eventually led to the repeal in 1988 of the World War I 4.25% cap. Since then, interest rates have steadily lowered as the Fed has significant control over the yield curve.

BVR: Could you talk a little bit about government-imposed interest rate caps and their impact on the equity risk premium?

Kevin Piccolo: Roger Grabowski believes that the World War II interest rate cap artificially kept interest rates very low. In general, the authors state that income returns were artificially lower during the period of the 1942 Fed and Treasury agreement, causing inflation to be biased high; therefore, they believe that an adjustment should be made to these income returns. Grabowski created an adjustment that matches the income return with inflation during this 10-year period during and after World War II, without regard to 1949, which was a negative inflationary environment. When Morningstar's historical ERP is recalculated applying this World War II adjustment, it creates a 50-basis-point downward adjustment.

BVR: Should business appraisers have concerns with this proposed 50-basis-point downward adjustment from the World War II interest rate environment?

Kevin Piccolo: I believe that there are several concerns and questions that this raises: There were a lot of government controls on pricing that really kept the inflationary environment very volatile. But when you look before the World War II adjustment, interest rates were at or below 2%. This cap is actually at 2.5%—interest rates never fluctuated above that. Additionally, one would have thought that after this accord was reached in 1951, interest rates would have spiked high because of the pressure that was building over those 10 years due to the interest rate cap. That never happened. Actually, for the next eight years, interest rates increased ever so slightly, up to 4% around 1959, 1960.

When you look at numerous other periods where inflation was above interest rates, why not also adjust those periods? Should we adjust interest rates from World War I to 1988 when the 4.25% interest cap was finally repealed? Should we also adjust other government-type controls, such as Regulation Q and Operation Twist?

As you can see, the element of isolating interest rates is problematic and raises numerous questions. This World War II adjustment artificially moves interest rates up to inflation. For example, in 1946, the income return was around 2% and inflation was 18%. That would mean that you are artificially increasing interest rates 16 percentage points. Imagine the economic repercussions that would have domestically and internationally. As such, I don't believe the context is right for an adjustment like this, and my article addresses a number of other concerns.

BVR: How does this relate to the current risk-free rate and current interest rate environment?

Kevin Piccolo: There's no doubt that the current interest rate environment has been very volatile and there has been a lot of talk about the yields that business appraisers use and their cost of equity dipping very low at various times in the past couple of years. In late 2008, the 10-year interest rate flirted with the 2% level. Now, we are well below, at around 1.5%, which is low by historical standards.

Last year, Prof. Aswath Damodaran wrote an article that addresses the current interest rate environment. He says that mixing and matching a normalized interest rate—albeit 12 months, 24 months, 36 months, or even a 60-month normalized interest rate—is not the same as the current interest rate environment. He adds that interest rates are highly correlated with future economic growth expectations. For instance, if interest rates today are 1.5%, yet the analyst is using, say, a 60-month normalized rate that's substantially higher, he or she is in effect mixing apples and oranges. As such, if an analyst chose to replace today's lower risk-free rate of 1.5% with a normalized rate (say, 4%), results are a higher discount rate and a lower value for the risky asset. Let's say the analyst chose not to invest in that risky asset; where does he or she plan to invest that money instead? In the analyst's normalized bond earning 4%? Given that it exists only in the analyst's spreadsheet, they will have to settle for that "abnormally" low 1.5% interest rate.

Overall, I do not agree with the World War II interest rate adjustment. It is a slippery slope to pick and choose specific time periods or environments to adjust while ignoring the interconnectivity between fundamental economic data and the marketplace. There are many schools of thought regarding normalizing interest rates. However, I caution analysts not to blindly normalize the rates in their financial models without first gathering support about the speed at which they believe interest rates are expected to revert to the mean. Let's say an analyst who believes that interest rates are going to remain low for three years and then begin to fade toward the mean is using one normalized interest rate as a component in his or her discount rate. I argue that this would cause significant distortions in the subject company's value in the initial years before the presumed normalization unfolds. As such, depending upon current economic conditions, one consideration may be to apply a hybrid between the two types of interest rates, whereby the analyst uses the current interest rate for the foreseeable future until market evidence supports a move in interest rates upward, at which time the analyst fades the interest rate into a long-term, normalized rate. All else being equal, I believe that this better aligns current market conditions with future expectations and would result in a more accurate value for the subject company. Keep in mind that the same approach would be applied if current interest rates are higher than the mean.

For more information, you can look for Kevin's article on the dangers of normalization from an interest rate perspective: corporate.morningstar.com/ib/asp/detail.aspx?xmlfile=6626.xml.

9. Normalization Cases

Case name: *Reis v. Hazelett Strip-Casting Corp.*
Citation: 2011 WL 303207 (Del. Ch.)
Date of decision: Jan. 21, 2011
Country: US
State or Federal: State
State/Jurisdiction: Delaware
Court: Court of Chancery
Type of action: Dissenting Shareholder
Experts: Timothy Meinhart (plaintiff); Sheldrick, McGehee & Kohler LLC (defendants)
Judge: Laster

Founded in 1929, the Hazelett Corp. manufactures large strip-casting machines, selling from zero to four units per year for up to $16 million apiece. By far, the bulk of revenues for the Vermont-based, family-run company comes from servicing existing machines and selling spare parts.

Older brother wants to keep control. In 1956, the founder turned over the company to his two sons, giving the eldest 800 shares (or nearly 70% of the equity) and the younger 350 shares. When the younger brother died in 2002, he left his 350 shares to 169 individuals, primarily past and present employees. By then, the older brother was CEO, president, and chairman of the board. According to court records, he "deeply disliked the idea of their family owned company suddenly being opened up to outsiders."

To preserve the company intact, the older brother/CEO authorized it to pay $1,500 for each of the 350 shares held by the younger brother's estate, for a total of roughly $560,000. The price was not based on any current valuation; in fact, he later testified that he "pulled the number out of the air." The beneficiaries held out for a higher value, and the CEO used a reverse stock split to force a buyout. An appraisal firm valued the entire company at $1.83 million, making a fractional interest worth approximately $1,600 per share at the time (October 2005).

The board amended the company charter to complete the measure, but failed to effectively file the amendment until January 2008. In the meantime, one of the 169 beneficiaries challenged the reverse split in the Delaware Chancery Court, alleging that the company, its CEO, and the board had breached their fiduciary duties to shareholders and violated Sec. 155(2) of the Delaware General Corporation Law (requiring a company to pay “fair value” for repurchasing fractional interests). After initial litigation, the court held that the effective date of the reverse split was January 2008.

Before making a fair value determination, however, the court first clarified the review standard and burden of proof. “When a controlling stockholder uses a reverse split to freeze out minority stockholders without any procedural protections,” the court ruled, then the “entire fairness” standard applies and the burden under Sec. 155(2) shifts to the defendant/fiduciary to show it was fair. Applying the standard to this case, the court found that the older brother directly controlled the board of directors, which authorized the reverse split without implementing any shareholder safeguards, such as an independent committee or a “majority-of-the-minority” vote. “There was no dealing in this case that could be called ‘fair,’” the court concluded.

Proper valuation standard. In fashioning an appropriate remedy, the court noted that Sec. 155(2) uses the term “fair value” without referring to the definition of fair value in Sec. 262, Delaware’s appraisal statute. At the same time—after an extensive discussion of the remedies available in an entire fairness case versus an appraisal proceeding—the court found that “the fair value standard is … economically efficient and should be applied consistently to freeze-outs, regardless of form.” The same policies that “animate using a fair value standard” to evaluate a squeeze-out merger “calls for its use when the freeze-out is implemented by a reverse split,” the court added.

After failing to implement a fair process in this case, the defendants “did not serendipitously” arrive at a fair price when they offered to buy out the plaintiff’s shares at the initial $1,500 offer or the subsequent $1,600 appraised value, the court held. To prove fair value for trial purposes, both parties submitted competing appraisals. The defendants offered a second report from the same firm that appraised the company at the time of the reverse split. This time, the firm reached a going concern value as of January 2008 of $1.745 million, or $1,500 per fractional interest—nearly $100 per share *less* than its prior valuation.

The plaintiff/minority shareholders’ expert responded with an appraisal that valued the company’s total equity under various approaches at $6.3 million, or nearly $5,490 per fractional interest. Under the guideline public company analysis, however, the expert selected comparables that were substantially bigger than the Hazelett Corp. and had more diversified customers, better access to capital, deeper management teams, and different economic drivers. The comparables also generated more stable revenues from new sales, rather than parts and servicing. Even with adjustments, the differences were so large that the court found the method was “meaningless” in this case.

The court also rejected the capitalized free cash flow analysis from the plaintiff’s expert, because it required too many normalizing adjustments to produce a reliable going concern value. For example, the expert used only an average of two recent periods (fiscal 2007 and annualized 2008) to derive a cash flow projection. This did not adequately account for the company's fluctuating revenues, and the court "declined" to modify the expert's work, especially since it was redundant of the many adjustments the court decided to make to the third and final approach.

Appropriate methodology and adjustments. Both party experts applied the capitalized earnings method, which "boasts a considerable Delaware pedigree as one of the methodologies comprising the Delaware Block Method," the court observed. Using forecasted earnings is preferable, but when reliable projections are not available, historical averages are acceptable if calculated across a multi-year period. "Under the Delaware block method … a five-year period [is] the norm," the court said.

In this case, the record was devoid of company projections; thus both experts looked to historical performance. However, the defendants' expert failed to make any normalizing adjustments to earnings, enabling him to reach a result "conveniently close" to the original $1,500 buyout price, the court said. At the same time, the plaintiff's expert made several adjustments that were inconsistent with Delaware law. Accordingly, the court used the valuation by the defendants' expert as a starting point, with the following adjustments, adapted from the plaintiff's expert:

1. *Research and development (R&D) costs.* The industry average for R&D was approximately 5% of revenues, according to the plaintiff's expert, and from 2003 to 2007, the company's R&D hovered around these levels, but when the economy began to decline in 2007, it reallocated the expense of idle employees to R&D, nearly doubling its cost. As a result, the plaintiff's expert added back $1.3 million of R&D in 2007. However, the company had a general policy of retaining rather than laying off employees during down cycles, and this "operative reality" was in line with maximizing shareholder value. Since only a new controller would adjust R&D expense to align with a new operative strategy, the court held, the expert's adjustments would reflect a third-party sale rather than a going-concern value, and it rejected the 2007 add-back to earnings.

2. *Controller self-dealing.* This "raised trickier issues," the court said. The company also had a general policy of giving the CEO several "tax-advantaged" returns, such as a high compensation rate (set at a flat 2% of gross revenues) and maintaining a "marine" and "hotel" division, which had nothing to do with the company's main operations, but were tax-efficient ways for the CEO to enjoy his "love of sailing." The company also leased five machine tools from a CEO-owned entity. Under Delaware law, the Chancery court was inclined to adjust company earnings for all three expenses—but interestingly, the plaintiff's expert declined to say whether the CEO's compensation and the lease payments were market rate. The expert did adjust for the "marine" division, and the court adopted the same as a reflection of controller self-dealing.

3. *Nonrecurring revenues.* The plaintiff's expert deducted revenue resulting from nonrecurring sales of fixed assets and from the 2006 sale of company-owned real estate. "These are standard and appropriate normalizing adjustments," the court held, and adopted them as well.

4. *Tax rate.* The court also adjusted the company's earnings by its historic (fiscal years 2003 to 2007) tax rate and a normalized rate of 40% for calendar years 2003 and 2008.

5. *Earnings period.* The court adopted the "six-year average" earnings trend of $283,000 per year, as calculated by the plaintiff's expert. But it also believed that some portion of the CEO's compensation and equipment lease expenses should drop to the net income line; thus this earnings estimate "risked undervaluing the minority interest."

6. *Capitalization rate.* Due to the lack of sufficient peer company comparables, both experts used the buildup method (BUM) to derive a cap rate—18% for the plaintiff's expert, compared to 21% for the defendants'. The defendants' expert also included a "healthy company-specific risk premium" (CSRP) of 6%, the court observed, compared to 2% by the plaintiff's expert. Because of "inherent dangers" of overestimating the CSRP and because the court believed the earnings figures underestimated the company's "real economic returns," it replaced the defendants' 6% CSRP with the plaintiff's 2%, resulting in a cost of equity of 17%.

Before using the inverse of the cost of equity as the capitalization rate, the court needed to deduct an appropriate growth factor. After speaking with management, the defendants' expert applied a 4.4% growth rate, compared to 4% by the plaintiff's expert. Since the defendants' expert had better access to operations and more incentive to be conservative, the court subtracted his higher growth rate (4.4%) from its cost of equity (17%) to produce a cap rate of 11.6%. Dividing the company's six-year average earnings base ($283,000) by the cap rate yielded an equity value of just over $2.44 million. The court added another $260,000 for the value of nonoperating assets, primarily real estate, a net operating loss carryforward.

It did not add another $244,000 for research and other tax credits, however, because the plaintiff failed to ask for it. It also rejected a $560,000 adjustment to reflect the amount the company had already paid the plaintiff and other beneficiaries of the younger brother's estate, because the payment did not come from excess cash but from the company's line of credit. The court could not back out the costs of this debt, however, because the plaintiff's expert did not provide this amount. Overall, the court reached an equity value of $3.65 million for the company under the capitalization of earnings approach, or $3,175 for a fractional interest.

Book value is troubling. Net asset or book value can be an appropriate appraisal method for a company that derives significant value from its physical assets, the court noted. Although the method may undervalue a business with substantial intangible asset value, it can also serve as a conservative "check" against a going-concern valuation. In this case, the company's books reflected a book value of $7.7 million, a figure that had remained relatively stable over the base earnings period. Despite recognizing that asset value typically establishes a "floor" against which to check operational value, the defendants' expert rejected the approach without any credible explanation, the court found.

Moreover, the wide disparity between the court's $3.65 million entity valuation and the company's historic $7.7 million book value "remains troubling" and reinforced its concern that controller self-dealing depressed earnings. To counter this, the court gave an 80% weight to its capitalization of earnings approach and 20% to book value. It also added the $560,000 payment to the estate beneficiaries to book value. Using this blended average approach, the court reached a final fair value determination for the company of $4.57 million, or $3,980 for a fractional interest.

Case name: *Graves v. Tomlinson*
Citation: 2010 WL 4825624 (Tex. App.-Hous.(14 Dist.))
Date of decision: Nov. 30, 2010
Country: US
State or Federal: State
State/Jurisdiction: Texas
Court: Court of Appeals
Type of action: Marital Dissolution
Judge: Boyce
Experts: Bill Stewart (wife); Gregory Schuelke and David Palmer (husband)

The wife owned three separate businesses, all related to providing home healthcare services for the disabled in her Texas community. The first, a sole proprietorship, was founded in 1997. In 2000, the wife formed the second business, a limited liability company (LLC), to gradually take over the assets and customer accounts of the first. She also formed a nonprofit organization to provide multiple services to various providers, including her sole proprietorship and the LLC. By the time of the parties' divorce trial in 2007, the sole proprietorship had 10 times the assets of the LLC—but the LLC had 10 times the revenues, boosting its gross profits from just $21,000 in 2006 to over $3.8 million in 2007.

Wife's expert applies DLOM. In assessing the value of all three businesses, the wife's expert ruled out the market approach, maintaining that he could find no comparables. He also rejected the income approach because it relied on projecting future cash flows, and if the wife left the LLC, her customers would leave with her, he said, "taking their cash flow with them." That left the asset approach, under which he calculated a *negative* $87,000 value to the sole proprietorship and a zero value to the nonprofit. The LLC was worth $400,000, he said, reduced to $200,000 after application of a 50% discount for lack of marketability. (Note: The court's opinion did not provide the expert's rationale for applying a DLOM.) All told, the wife's three businesses were worth no more than $113,000.

By contrast, the husband presented two experts.

First, his forensic accountant noted at least half a dozen discrepancies that required normalization adjustments:

- Texas reimbursement records (from the state Department of Aging and Disability Service) did not match the LLC's revenues;
- The nonprofit's reported expenses did not meet the corresponding items in the LLC and sole proprietorship's financials;
- The collective businesses incurred significant, nonrecurring professional fees related to nonoperational matters;
- The sole proprietorship reported an operational expense of $100,000 without sufficient substantiation;

- The wife charged the sole proprietorship $108,000 as "consulting fees";
- The LLC also paid nearly $40,000 in professional fees related to her divorce;
- The LLC and sole proprietorship reported nearly $750,000 from one customer, but the nonprofit reported only $505,000 from the same; and
- During 2007, the sole proprietorship reported roughly $270,000 in revenues more than it received, while the LLC reported nearly $430,000 less than it received.

Overall, the forensic accountant added back nearly $1 million in 2007 adjusted income to the businesses.

The husband also retained a valuation expert, who relied on the forensic accountant's financial data and adjustments. After looking at the transactions among the businesses, he also decided "the best way to look at the value of the three entities was to push them all together and treat them as if they were just one business with three different divisions." Even so, his report listed the revenues for each business before combining them in his calculations: over $6.3 million for the sole proprietorship in 2007, $5 million for the LLC, and zero for the nonprofit.

He also applied all three valuation techniques, giving the income approach the greatest weight and the asset approach the least. For the market approach, he used data from the sales of 28 comparable companies that "seemed to be in the same relative industry group, that is, health care services, providers like home health care or mental health," he explained. Ultimately, the husband's valuation expert computed a weighted average value for all three businesses of $1.5 million under the asset approach, $4.1 million under the income approach, and $6.2 million under the market approach. After deducting $1 million for the wife's personal goodwill, he arrived at a weighted average vale for all three entities of $3.5 million.

After hearing from all the experts, the Texas jury determined the collective value of the wife's businesses was $1.25 million, and the wife appealed, arguing the husband's experts used flawed methodology and techniques. However, she did not object to those same techniques before or during trial, the appellate court said. Thus, she could not object to the experts' methods on appeal or the jury's reliance on the same in assessing the value of the businesses.

The wife's claim that the husband's valuation expert should have valued each entity separately also failed. The expert's report contained the data and calculations he used under each approach, permitting separate value determinations for each entity. For example, applying his market approach multiples to the LLC's reported income yielded a value that exceeded the $1.25 million assessed by the jury for all three businesses. Thus, the jury's valuation of the LLC fell well within the range established by the husband's expert, on the high end, and even the wife's expert, on the low end. Because there was more than a "scintilla of evidence" supporting the jury's valuation, the appellate court confirmed the same.

Case name: *Blackburn v. TKT and Associates, Inc.*
Citation: 2010 WL 2035369 (S.C.)
Date of decision: May 24, 2010
Country: US
State or Federal: State
State/Jurisdiction: South Carolina
Court: Supreme Court
Type of action: Dissenting Shareholder
Judge: Pleicones
Attorneys: J Rene Josey, C Pierce Campbell, Louis D Nettles
SIC: 3841 Surgical and Medical Instruments and Apparatus (except tranquilizer guns and operating room tables)

Two shareholders in a medical equipment company sued for statutory dissolution and damages based on claims that the two other shareholders were draining profits by paying themselves excessive salaries. The trial court found in favor of the plaintiffs but permitted the defendants to buy back their shares at statutory fair value.

Accordingly, the parties agreed on an appraiser and a valuation method, selecting an income analysis from the three traditional approaches (rejecting the market and asset methods). In his engagement letter, the appraiser specifically stipulated his analysis would conform to the *Statement of Standards for Valuation Services* of the American Institute for Certified Public Accountants (AICPA), as well as the professional standards of the National Association of Certified Valuation Analysts (NACVA).

In the midst of his valuation, the appraiser contacted the attorneys for both parties, requesting their comments on the salaries paid to the defendant shareholders. Not surprisingly, counsel for the defendants maintained that his clients' salaries were consistent with their contributions to the company, but nonetheless, the trial court had found otherwise, and perhaps the appraiser should refer to the record. Just as predictably, counsel for the plaintiffs urged the appraiser to follow the judge's order—in particular, his finding that the "vast majority" of salary payments to the two defendant shareholders were excessive and should be "reversed to properly normalize the corporation's income."

Professional standards are evidence of correct appraisal methods. Despite this exchange with counsel, the appraiser made no adjustment for the owners' salaries in his final valuation. Based on the company's three-year performance (2003 to 2005), he valued it at only $34,300, and the plaintiff shareholders appealed.

In particular, by failing to normalize the defendants' salaries, the appraiser failed to abide by the agreed-upon income approach, the plaintiffs said. The "excessive salaries constituted unusual expenses which should have been removed … to appropriately value the corporation." Moreover, the appraiser's failure to make the adjustments contradicted the trial court's specific findings, effectively rewarding the defendant owners for their misconduct by factoring "unmerited salaries into calculating the corporation's future value." Finally, both the AICPA and NACVA professional standards require normalization adjustments as a "key step" in the income approach, the plaintiffs said.

On review, the state appellate court disagreed, finding the trial court had "no evidence or information" showing the appraiser prepared his report incorrectly. The plaintiffs appealed again, and this time, the state Supreme Court reversed. The trial judge was presented with the appraiser's report, which clearly did not make any normalization adjustments for corporate salaries. The plaintiffs also offered the AICPA and NACVA standards as evidence of appropriate valuation adjustments, which the trial court simply "declined to consider." At a minimum, the plaintiffs showed that the defendants' salaries were excessive, and pursuant to the agreed-on income approach, "some normalization adjustment was required," the court held in vacating the appraisal.

Case name: *Pellom v. Pellom*
Citation: 2008 WL 5056031 (N.C. App.)
Date of decision: Dec. 2, 2008
Country: US
State or Federal: State
State/Jurisdiction: North Carolina
Court: Court of Appeals
Type of action: Marital Dissolution
Judge: McKown
Attorneys: Beth P Von Hagen, Susan H Lewis, Alyscia G Ellis
SIC: 8011 Offices and Clinics of Doctors of Medicine (except mental health specialists, HMO medical centers, and ambulatory surgical and emergency centers)

In an all-too-common scenario in divorce (and other) courts, the opposing experts in this case submitted appraisals that were about $1 million apart. The husband's expert valued his 11% interest in an anesthesiology practice at $183,000 using the income approach, discounted cash flow method. Applying the same approach, the wife's expert determined the interest was worth $1,267,000. In adopting the higher value, the trial court examined the following factors, as reviewed on appeal:

1. *Normalized income.* The wife's expert used $525,000 as the husband's normalized annual income, based on his historic salary as of the separation date (June 2004), including 2003, in which his earnings reached an all-time high. By contrast, the husband's expert claimed it was more appropriate to use the doctor's earnings for all of 2004 and 2005, which had declined. The court noted that between 1999 and 2003, the doctor's earnings had steadily increased. However, it also found that the wife's expert properly valued the business at the correct valuation date, taking into account the "best information" available at the time.

2. *Compensation data.* The wife's expert used data from the Medical Group Management Association's (MGMA) 2003 compensation survey to plot the husband among the 75th percentile of similarly situated anesthesiologists. The husband's expert said that data from the 2004 MGMA survey were more applicable, especially because the study was available at the valuation date. But the husband's expert did not claim that the 2004 data would have changed the outcome—and in fact, the wife's expert noted that using the 2004 MGMA survey would have placed the husband in the 73rd percentile, a difference of only two points. "Even if it would have been better practice to use a more recent version," the Court of Appeals held, accepting figures based on the 2003 report did not amount to an abuse of discretion at trial. Moreover, the trial court accepted the prior MGMA survey after taking multiple factors into account—including clinical hours worked and retirement benefits.

3. *Productivity.* Based on the number of annual procedures that his practice performed (2,000 per physician), the husband's expert said that he belonged in the 90th percentile of MGMA doctors, because they performed 1,400 procedures annually, compared to those in the 75th percentile (who perform 1,153 procedures per year). However, the trial court found that the

MGMA—and the husband's expert—did not take into account how many of these procedures were performed by certified registered nurse anesthetists (CRNAs). "The MGMA does not account for this factor because under the laws of most states, CRNAs are not allowed to perform these procedures," the Court of Appeals observed. In fact, the doctors' practice had 31 CRNAs performing procedures that were attributed to its overall, annual productivity figure of 20,000. Thus, the trial court did not err in accepting the productivity figures used by the wife's expert.

4. *Goodwill and accounts receivable.* The husband's expert did not account for the practice's goodwill in his valuation and did not value its accounts receivable. The trial court found that the practice had a goodwill value and that the wife's expert properly accounted for it.

Trial court supported its decision with detailed findings. Overall, the trial court adopted the valuation by the wife's expert ($1.27 million), without adjustment. It also detailed its findings regarding the analysis of goodwill value by the wife's expert and why the court chose to accept his valuation as opposed to that of the husband's. These comprehensive fact-findings permitted the Court of Appeals to affirm the $1.27 million valuation in all respects.

Case name: *Cox Enterprises, Inc. v. News-Journal Corp.*
Citation: 2007 U.S. App. LEXIS 29533
Court: United States Court of Appeals
State/Jurisdiction: 11th Circuit Federal
Date of decision: December 21, 2007
Judge: Birch
Experts: Owen D. Van Essen (plaintiff); Robert E. Duffy (defendant)
SIC: 2711 Newspapers: Publishing, or Publishing and Printing (except Internet newspaper publishing)
Type of action: Dissenting Shareholder, Damages, Conversion

The News-Journal Corp. (NJC) is a closely held Florida company that publishes a daily newspaper (*The News-Journal*), the 11th largest independently owned newspaper in the country, as well as several local shopping guides. Cox Enterprises owns 17 daily newspapers throughout the Southeast and has owned a 47.5% interest in NJC since 1969.

Beginning in the 1960s, NJC created several artistic and cultural nonprofit endeavors. Not only did NJC provide substantial financial support to these cultural entities, but also management between the two was inextricably intertwined. Throughout the 1990s, NJC consistently contributed over $1 million to these entities, including paying $13 million for the naming rights to a new performing arts center. After discovering the naming rights agreement—and similar "business" expenses that exceeded allowable charitable contributions—Cox sued for fraud, waste, and mismanagement. Pursuant to Florida statute, NJC elected to purchase Cox's shares at fair value. The parties disputed this amount and sought judicial appraisal of the shares.

Expert valuations diverge by $200 million. Both sides presented expert valuation testimony at trial. Cox's expert was a partner at a firm that has appraised over $10 billion worth of newspaper transactions in its 25-year history and more than 50% of U.S. newspaper sales in the past decade. Prior to joining the firm, the expert owned and managed a daily newspaper. The trial court found him "plainly qualified."

The expert began by establishing the fair market value (FMV) of NJC as a "going concern." He used a comparable sales analysis, measuring NJC in relation to the purchase prices of comparable newspapers. He also compared NJC's EBITDA margin to the average operating margin of 11 publicly traded newspapers. NJC's operating margin was 9.3%; the comparable companies operated at an average margin of 28.3%. Due to this data, the expert normalized NJC's margin to 28.3%.

Further, he selected seven transactions involving comparable newspapers based on 50 different measures—including growth, circulation, financial metrics, and market characteristics. After excluding two outliers, he calculated the average purchase price-to-revenue ratio (4.1:1) and purchase price-to-EBITDA ratio (14.4:1) of the comparables. In a "slight departure from his standard approach," he adjusted his multipliers downward to account for NJC's higher-than-average capital expenditures and a possible reduction in its growth rate. The expert performed a similar analysis for NJC's primary shopping guide and arrived at a total fair market value for NJC holdings of $306 million. Cox's 47.5% interest totaled $145.35 million.

As a check on this approach, the expert conducted a discounted cash flow analysis, using a projected growth rate of 6% and the normalized operating margin of 28.3%. Under this method, he valued NJC at $289 million.

By contrast, NJC's expert was an experienced and accredited appraiser, albeit without a specific practice in valuing newspapers. The district court found him qualified, although "appreciably less so" than Cox's expert.

NJC's expert also valued the company as a "going concern," although he relied on a definition (by NJC's general counsel and board member) that assumes a company will operate in the future exactly as it has in the past, including maintaining its operating margins. NJC's expert also relied exclusively on a DCF analysis. His future cash flow estimates predicted that NJC would operate for roughly 2.5 years at its present EBITDA margin of approximately 12%, then increase to roughly 18.3% (based on the company's performance from 1998 to 2002). Using the Gordon growth model and applying a capitalization rate of 10%, the expert projected future cash flow of $82 million. After discounting this to present value, he added a $4.4 million tax shield related to depreciation and applied a 20% discount for lack of marketability. His final estimated value of NJC was $61.9 million, with Cox's share worth $29.4 million.

Focus on 'reasonably prudent' management. The trial court adopted the comparable sales analysis by Cox's expert, finding the method more accepted in the financial community and protective of minority shareholders. Notably, the court rejected NJC's definition of a "going concern," explaining that it would "create an incentive for those with control over corporations to violate fiduciary duties … and drive down the value of minority shares." Instead, the court assumed that a company will be managed in a "reasonably prudent manner going forward," regardless of how it may have been run in the past.

The court also rejected the methodology—including application of discounts—that Cox's expert used, saying that it would "reward wrongdoing by permitting NJC to purchase Cox's shares at a bargain price." However, it adjusted Cox's expert's operating margin from 28.3% to 24.8% to reflect the average margin of comparable independent newspapers. It assessed NJC's total fair market value at $272 million, with the fair value of Cox's share equaling $129.2 million. NJC appealed the court's definition of "going concern"; its use of fair market value in its calculation of fair value; and its normalization adjustment. Cox also appealed, arguing that the court should have further adjusted its fair value to account for $31 million in mismanagement and corporate waste.

When is FMV a measure of fair value? The 11th Circuit Court of Appeals acknowledged that "fair value" and "fair market value" are not synonymous; neither are they "mutually exclusive." While fair market value often accounts for the effects of an impending sale or merger, statutory fair value (under applicable Florida law) does not. When such "potentially distorting corporate actions are not at issue," the Court explained, then fair market value may serve as an estimate of fair value. In this case, NJC was a viable, marketable corporation that would command "an attractive price on the open market." In the absence of any imminent sale or other "distorting" corporate action, the fair market value/comparable sales analysis by Cox's expert was "most appropriate."

Similarly, the appropriate definition of "going concern" in valuation contexts requires an appraiser to exclude any consideration of a potential merger or liquidation. The Court also agreed that a valuation should assume the subject business will be managed according to the "reasonably prudent" definition. NJC claimed that it was incorrect to assume the company could perform at the same financial level as the comparable newspapers, but the Court disagreed. The trial court's normalization of its operating margins "better approximates the value of the corporation as a 'going concern,' or a reasonably prudently managed business."

Finally, the Court found that, while not specifically addressing waste in his valuation, Cox's expert did "effectively adjust for any impact [that] previous waste or mismanagement would have had on the value of the shares through normalizing the operating margin." To adjust further would have effectively double-counted the mismanagement, and the Court affirmed its exclusion.

Case name: *Ackerman v. Ackerman*
Citation: 2006 Cal. App. LEXIS 2056
Court: Court of Appeal, Fourth Appellate District
State/Jurisdiction: California
Date of decision: December 27, 2006
Judge: Rylaarsdam
SIC: 8011 Offices and Clinics of Doctors of Medicine (except mental health specialists, HMO medical centers, and ambulatory surgical and emergency centers)
Experts: James Christensen (husband); Glenn Mehner (wife)

Ackerman reminds appraisers that in reasonable compensation cases, salary surveys are relevant only to the extent they account for professionals similarly situated to the subject practitioner.

One survey too big, other too small. The Ackerman husband was a successful plastic surgeon practicing in the highly affluent Newport Beach, Calif., community. When the Ackermans divorced, the only significant property issue became the value of goodwill in the husband's professional practice. Although both party experts used the capitalization of excess earnings method, each relied on different professional compensation surveys—and neither turned out to be very satisfactory to the trial court.

The wife's accountant, Glenn Mehner CPA-PFS (D&M Capital Management Inc.; Costa Mesa, Calif.), had relied on a survey by the Medical Group Management Association (MGMA) because he believed it the most comprehensive, containing breakdowns by region, as well as specialty and years in practice. Mehner chose the Pacific region, which encompassed the Western states. Based on this data, he calculated reasonable annual median compensation to be $291,000 and $355,000 at the 75th percentile.

The husband's expert, James Christensen (affiliation unknown), used American Medical Association (AMA) data for four years prior to the divorce to calculate total revenue for self-employed surgeons as well as their professional expenses and net income; he then calculated net income as a percentage of total revenue. As a "sanity check," he applied this percentage to the husband's gross revenue to calculate the husband's reasonable compensation as a percentage of his gross compensation. In addition, in answer to the trial court's request, Christensen conducted an informal survey of local plastic surgeons, revealing an average of $551,000 per year, slightly more than Christensen's ultimate conclusion of $515,000 for the husband's reasonable compensation.

Court applies its own quality control. But both surveys were problematic. The MGMA data encompassed too wide an area; the trial court was troubled by relating a national survey of physicians in the Western states to a plastic surgery practice in Newport Beach, where the per-capita discretionary income (upon which plastic surgery relies) "is remarkably different … than in such places as Pocatello, Idaho … or Little Rock, Arkansas."

Similarly, the trial judge had difficulty accepting the compensation statistics for employees in the AMA survey because "it 'just boggles the mind' to think anyone making as much money as [the] husband would work for an employer and receive 'a third of what he was actually making.'" As a result, the informal survey of local practitioners might have provided the sole source of a "quality control check."

Instead, the trial court applied its own quality control, observing that the husband had made substantial income based on his particular talent, training, and expertise as a self-employed professional and because he had a "special reputation in the community." Given the court's "common sense" view of the husband's track record, it determined his reasonable compensation to be $544,000 per year.

When the wife asked how it had reached this number, the court explained that the compensation data from both surveys were not "sufficiently fine-tuned and honed to our area here to be particularly valuable." Moreover, neither party had presented a vocational or compensation expert, "a medical head hunter or economist," who would have been more familiar with the Newport Beach market and could have supplemented the survey data.

Nevertheless, the trial judge had not picked its final number "out of the air," but had grounded it in the "curbstone" of the methodology used by the husband's expert, and as such, his common-sense finding was confirmed on appeal.

Case name: *Eckelkamp v. Beste*
Citation: 315 F.3d 863, 2002 U.S. App. LEXIS 27175
Date of decision: December 31, 2002
Country: US
State or Federal: Federal
State/Jurisdiction: Missouri
Court: United States District Court
Experts: Daniel Callanan (for Eckelkamp), Everett Matthews (for Beste)
Type of action: Breach of Fiduciary Duty
Judge: Murphy
SIC: 3714 Motor Vehicle Parts and Accessories (except truck and bus bodies, trailers, engine and engine parts, motor vehicle electrical and electronic equipment, motor vehicle steering and suspension components, motor vehicle brake systems, and motor vehicle transm)

This is an action for breach of fiduciary duty under the Employee Retirement Income Security Act (ERISA).

Facts

Plaintiffs were employees and former employees of Melton Machine and Control Co. They brought this action against Melton, its employee stock ownership plan (ESOP), and four officers of the company. Plaintiffs alleged that defendant officers, who manage both Melton and the ESOP, breached their fiduciary duties "by overcompensating themselves and by failing to obtain accurate annual appraisals of Melton stock."

Valuation Evidence

In 1986, the ESOP purchased Melton from the owner for $1.4 million, or $14,000 per share. Everett Matthews performed the annual appraisals of the company's stock. In 2000, Matthews appraised the value per share at $109,000.

Plaintiffs presented the report of their expert, Daniel Callanan, who stated that the annual appraisals consistently undervalued the company. He calculated that the actual value per share was over $200,000.

Trial court findings. The trial court did not specifically refer to *Daubert* in its analysis of Callanan's report, but it "rejected his methodology and concluded that his opinion was of no value and therefore insufficient to create a genuine issue of material fact."

Regarding Callanan's overcompensation analysis, the trial court found several flaws in his methodology. Callanan premised his analysis on comparisons to executive compensation at companies that in many ways, were not comparable to Melton. Many of the companies used for comparison were publicly held, none had achieved Melton's 20% annual rate of growth, and some were not even profitable. He also did not visit the Melton facility, interview his employees, research the job duties of executives at the comparison companies to ensure that their jobs were actually comparable to those of the individual defendants, or consider the fact that much of their compensation was paid in the form of bonuses contingent on Melton's performance. The trial court also found flaws in Callanan's appraisal methodology.

It criticized his use of a 10% "control premium" in his appraisal. That premium was what he calculated a hypothetical buyer might pay to obtain control of the company, but there was no evidence that the company appeared likely to be sold. Callanan also increased his valuation by $450,000 to reflect an amount previously paid in dividends. The district court concluded that this was a form of double counting by Callanan because already distributed dividends were being used to increase the value of the employee ESOP accounts. Callanan also increased his valuation to account for savings that would accrue if the compensation of the individual defendants were reduced. The district court questioned this methodology because there was no indication that Melton's compensation policies would change and value added as a result.

Holding on appeal and rationale. The court of appeals noted that the trial court thoroughly examined Callanan's methodology and determined that it was unreliable. After carefully examining the trial courts record, the court of appeals concluded that the trial court did not abuse its discretion in rejecting Callanan's report and opinion. Since the plaintiffs produced no other evidence to show the defendant's breach of fiduciary duty, the trial court did not err in granting summary judgment on that claim.

Case name: *Friedman v. Beway Realty*
Citation: 87 N.Y.2d 161
Date of decision: December 7, 1995
Country: US
State or Federal: State
State/Jurisdiction: New York
Court: Supreme Court
Type of action: Dissenting Shareholder
Judge: Levine
Experts: Kenneth McGraw (for respondent)
SIC: 6512 Operators of Nonresidential Buildings (except stadium and arena owners)

Counsel for appellants: Gerald A. Novack, Alan S. Brodherson, New York, N.Y.
Counsel for respondents: Milton S. Gould, Steven E. Levitsky, New York, N.Y.
Judges: Judges Simons, Titone, Bellacosa, Smith, and Ciparick concur; Chief Judge Kaye taking no part
Opinion by: Levine

The petitioners are minority stockholders in nine family-owned close corporations, each of which had as its sole asset a parcel of income-producing office, commercial, or residential real estate in New York City. In 1986, the board of directors and the requisite majority of stockholders of each corporation voted to transfer all of its property to a newly formed partnership. Petitioners voted their shares against the transfers and, pursuant to Business Corporation Law § 623, timely elected to exercise their appraisal rights and receive the "fair value" of their shares in each corporation. When the corporations failed to offer to purchase their shares, petitioners commenced this proceeding to have a judicial determination of the fair value of the shares (see Business Corporation Law § 623 [h]).

In the first phase of a bifurcated valuation trial, the Supreme Court determined the net value of the leasehold interest in an office building held by one of the family corporations, a decision not now disputed. The parties then stipulated to the net asset values of the remaining corporations. It is undisputed that, based on the percentages of each petitioner's stockholdings in the nine corporations, her proportionate share of the aggregate net asset values of all nine corporations was $15,200,833.

The second phase of the trial was devoted to a determination of the fair value of the petitioners' shares in the nine corporations, given the net asset values previously fixed. At the conclusion of the trial, the Supreme Court rejected the testimony of the petitioners' expert, who had essentially arrived at his opinion of fair value by simply applying the petitioners' fractional corporate stock ownership to the aggregate corporate net asset values. The court reasoned that this approach ignored the effect of the lack of marketability of the corporate stock and "valued these shares as if petitioners were co-tenants in the real estate rather than corporate shareholders."

Instead, the Supreme Court adopted the net asset-based valuation methodology employed by Kenneth McGraw, the corporations' expert. McGraw's technique was, first, to ascertain what the petitioners' shares hypothetically would sell for, relative to the net asset values of the corporations', if the corporate stocks were marketable and publicly traded, and, second, to apply a discount to that hypothetical price per share to reflect the stocks' actual lack of marketability. As to the first step in this valuation process, the Supreme Court accepted the comparability of one group of publicly traded shares suggested by McGraw, that is, of real estate investment trusts (REITs). McGraw suggested that REITs shares traded primarily in direct relation to each REIT's net asset value, and, hence, the mean discount between REIT net asset values per share and REIT stock prices (which McGraw found was 9.8%) could be applied to determine what the petitioners' stocks were worth if they were marketable. Thus, McGraw opined that the hypothetical value of the dissenters' shares here, if marketable and publicly traded, would be 9.8% less than their net asset value per share.

For the second step in McGraw's valuation process, he applied a discount to reflect the illiquidity of the petitioners' shares, i.e., that a potential investor would pay less for shares in a close corporation because they could not readily be liquidated for cash (see *Matter of Seagroatt Floral Co. [Riccardi]*, 78 N.Y.2d 439, 445-446). The primary unmarketability discount recommended by McGraw was 30.4%. According to McGraw, that figure represented the mean reduction in price per share when ordinarily publicly traded shares in "comparative" corporations became unregistered and thus, restricted shares, which could only be sold in private placements. The corporations' expert then exacted an additional 14.6% discount in the value of the shares, which he based upon the existence of restrictions on transfer contained in stockholder agreements covering the shares of all nine corporations.

Although the Supreme Court approved of the net asset valuation methodology of the corporations' expert as a generally valid approach to determining the fair value of the petitioners' shares, it found various flaws in McGraw's evaluation and modified the values accordingly. First, the court eliminated the initial 9.8% discount from each petitioners' share in the aggregate net asset value of the corporations. The court based this upon McGraw's testimonial concession that the discrepancy between the net asset value per share and the price per share in the REITs actually represented, for the most part, the minority status of the REIT shares traded. Thus, the court reasoned, to reduce the petitioners' share of net asset value by 9.8% would in effect impose a discount based upon the petitioners' status as minority stockholders, a result the court concluded violated New York precedents (citing *Matter of Raskin v. Walter Karl, Inc.*, 129 A.D.2d 642, 514 N.Y.S.2d 120; *Matter of Blake v. Blake Agency*, 107 A.D.2d 139, 486 N.Y.S.2d 341, lv denied 65 N.Y.2d 609).

Second, the Supreme Court rejected McGraw's rationale for the imposition of a second unmarketability discount of 14.6% based upon stockholder agreement restrictions as factually "unpersuasive." Finally, the court found that McGraw's 30.4% unmarketability discount actually included "a minority interest factor which is implicit in any minority stock holding." Consequently, the court considered it necessary to eliminate that factor from the value equation. It did so by reducing the 30.4% discount by 9.4%, which the court regarded as the discount McGraw had testified reflected the minority status of the shares traded in comparable REITs.[1] Thus, the Supreme Court only applied

1 As earlier described, the actual mean minority discount McGraw derived from his REIT study was 9.8%, not the 9.4% the court applied to reduce McGraw's recommended unmarketability discount. None of the parties to this appeal has raised any objection

a 21% discount for unmarketability against each petitioner's proportionate share of the aggregate net asset value of the corporations, resulting in a fair value determination of each petitioner's total stock interests of $2,008,682.

The Appellate Division affirmed for the reasons stated by the Supreme Court.

I

The corporations' primary argument for reversal is that the Supreme Court erred as a matter of law in refusing to take into account in its fair value determination the financial reality that minority shares in a close corporation are worth less because they represent only a minority, rather than a controlling interest. Although the corporations' argument may have validity when corporate stock is valued for other purposes, it overlooks the statutory objective here of achieving a *fair* appraisal remedy for dissenting minority shareholders. Mandating the imposition of a "minority discount" in fixing the fair value of the stockholdings of dissenting minority shareholders in a close corporation is inconsistent with the equitable principles developed in New York decisional law on dissenting stockholder statutory appraisal rights (a position shared by the courts in most other jurisdictions) and the policies underlying the statutory reforms giving minority stockholders the right to withdraw from a corporation and be compensated for the value of their interests when the corporate majority takes significant action deemed inimical to the position of the minority.

Several principles have emerged from our cases involving appraisal rights of dissenting shareholders under Business Corporation Law § 623 or its predecessor statute: (1) The fair value of a dissenter's shares is to be determined based on their worth in a going concern, not in liquidation, and fair value is not necessarily tied to market value as reflected in actual stock trading (*Matter of Fulton,* 257 N.Y. 487, 492). "The purpose of the statute being to save the dissenting stockholder from loss by reason of the change in the nature of the business, he [or she] is entitled to receive the value of his [or her] stock for sale *or its value for investment*" (Id., at 494 [emphasis supplied]); (2) the three major elements of fair value are net asset value, investment value, and market value. The particular facts and circumstances will dictate which element predominates, and not all three elements must influence the result (*Matter of Endicott Johnson Corp. v. Bade,* 37 N.Y.2d 585, 587-588, 376 N.Y.S.2d 103, 338 N.E.2d 614); (3) fair value requires that the dissenting stockholder be paid for his or her *proportionate* interest in a going concern, that is, the intrinsic value of the shareholder's economic interest in the corporate enterprise (*Matter of Cawley v. SCM Corp.,* 72 N.Y.2d 465, 474, 534 N.Y.S.2d 344, 530 N.E.2d 1264); (4) by virtue of the 1982 amendment to Business Corporation Law § 623 (h) (4) (L 1982, ch 202, § 9), fair value determinations should take into account the subsequent economic impact on value of the very transaction giving rise to appraisal rights, as supplemental to the three basic value factors (net asset, investment, and market values); and (5) determinations of the fair value of a dissenter's shares are governed by the statutory provisions of the Business Corporation Law that require equal treatment of all shares of the same class of stock (*Matter of Cawley,* supra, at 473).

based upon this discrepancy.

Further, contrary to the corporations' contention here, there is no difference in analysis between stock fair value determinations under Business Corporation Law § 623 and fair value determinations under Business Corporation Law § 1118. The latter provision governs the rights of minority stockholders when the corporation has elected to purchase their interests, also at "fair value," following their petition for corporate dissolution under Business Corporation Law § 1104-a for oppressive majority conduct. The corporations' opposing argument is that considerations of the oppressive conduct of the majority stockholders enter into fair value considerations conducted under Business Corporation Law § 1118; therefore, the cases decided under that section are distinguishable and not authoritative for fair value considerations under Business Corporation Law § 623. The corporations' position in this regard is untenable because their basic underlying assumption—that oppressive majority conduct enters into the court's fair value equation under section 1118—is in error. As we stated in *Matter of Pace Photographers* (Rosen) (71 N.Y.2d 737), once the corporation has elected to buy the petitioning stockholders' shares at fair value, "the issue of [majority] wrongdoing [is] superfluous … [f]ixing blame is material under [Business Corporation Law] § 1104-a, but not under [Business Corporation Law §] 1118" (Id., at 746; see also, *Matter of Seagroatt Floral Co.*, 78 N.Y.2d at 445, supra).

Thus, we apply to stock fair value determinations under section 623 the principle we enunciated for such determinations under section 1118: that, in fixing fair value, courts should determine the minority shareholder's proportionate interest in the going concern value of the corporation as a whole, that is, "what a willing purchaser, in an arm's length transaction, would offer for the *corporation* as an operating business" (*Matter of Pace Photographers [Rosen]*, 71 N.Y.2d at 748, supra, quoting *Matter of Blake v. Blake Agency*, 107 A.D.2d at 146, supra [emphasis supplied]).

Consistent with that approach, we have approved a methodology for fixing the fair value of minority shares in a close corporation under which the investment value of the entire enterprise was ascertained through a capitalization of earnings (taking into account the unmarketability of the corporate stock), and then fair value was calculated on the basis of the petitioners' proportionate share of all outstanding corporate stock (*Matter of Seagroatt Floral Co.,* 78 N.Y.2d at 442, 446, supra).

Imposing a discount for the minority status of the dissenting shares here, as argued by the corporations, would, in our view, conflict with two central equitable principles of corporate governance we have developed for fair value adjudications of minority shareholder interests under Business Corporation Law § 623 and 1118. A minority discount would necessarily deprive minority shareholders of their proportionate interest in a going concern, as guaranteed by our decisions previously discussed. Likewise, imposing a minority discount on the compensation payable to dissenting stockholders for their shares in a proceeding under Business Corporation Law § 623 or 1118 would result in minority shares being valued below that of majority shares, thus violating our mandate of equal treatment of all shares of the same class in minority stockholder buyouts.

A minority discount on the value of the dissenters' shares would also significantly undermine one of the major policies behind the appraisal legislation embodied now in Business Corporation

Law § 623: the remedial goal of the statute to "protect minority shareholders 'from being forced to sell at unfair values imposed by those dominating the corporation while allowing the majority to proceed with its desired [corporate action]'" (*Matter of Cawley v. SCM Corp.*, 72 N.Y.2d at 471, supra, quoting *Alpert v. 28 William St. Corp.*, 61 N.Y.2d 567-568). This protective purpose of the statute prevents the shifting of proportionate economic value of the corporation as a going concern from minority to majority stockholders. As stated by the Delaware Supreme Court, "to fail to accord to a minority shareholder the full proportionate value of his [or her] shares imposes a penalty for lack of control, and unfairly enriches the majority stockholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder" (*Cavalier Oil Corp. v. Harnett*, 564 A.2d 137, 1145 [Del]).

Furthermore, a mandatory reduction in the fair value of minority shares to reflect their owners' lack of power in the administration of the corporation will inevitably encourage oppressive majority conduct, thereby further driving down the compensation necessary to pay for the value of minority shares. "Thus, the greater the misconduct by the majority, the less they need to pay for the minority's shares" (Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Evaluation of Minority Shares*, 65 *Notre Dame L Rev* 425, 487).

We also note that a minority discount has been rejected in a substantial majority of other jurisdictions.[2] "Thus, statistically, minority discounts are almost uniformly viewed with disfavor by State courts" (Id., at 481). The imposition of a minority discount in derogation of minority stockholder appraisal remedies has been rejected as well by the American Law Institute in its Principles of Corporate Governance (see 2 ALI, Principles of Corporate Governance § 7.22, at 314-315; comment e to § 7.22, at 324 [1994]).

II

We likewise find no basis to disturb the trial court's discretion in failing to assign any additional diminution in value of the petitioners' shares here because they were subject to contractual restrictions on voluntary transfer. As we noted in *Matter of Pace Photographers (Rosen)*(supra), a statutory acquisition of minority shares by a corporation pursuant to the Business Corporation Law is not a voluntary sale of corporate shares as contemplated by a restrictive stockholder agreement, and, therefore, "the express covenant is literally inapplicable" (71 N.Y.2d at 749). Nor is there any reason to disturb the Supreme Court's award of prejudgment interest.

III

While we have concluded that the Supreme Court correctly applied the legal doctrines respecting fair value determinations of dissenting minority stockholders' shares in the instant case, we find error in the court's calculation of the unmarketability discount that must be applied here. As

2 E.g., *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477, 486, 154 Cal. Rptr. 170; *Cavalier Oil Corp. v. Harnett*, supra, at 1144 (Del); *Hickory Cr. Nursery v. Johnston*, 167 Ill. App. 3d 449, 521 N.E.2d 236, 239-240, 118 Ill. Dec. 168; *Eyler v. Eyler*, 492 N.E.2d 1071 (Ind); *Woodward v. Quigley*, 257 Iowa 1077, 133 N.W.2d 38, 43, mod 257 Iowa 1104, 136 N.W.2d 280; *Matter of McLoon Oil Co.*, 565 A.2d 997, 1004-1005 (Me); *Rigel Corp. v. Cutchall*, 245 Neb. 118, 511 N.W.2d 519.

previously explained, the Supreme Court generally adopted the net asset valuation approach of McGraw, the corporations' expert, and his two-step evaluation process. However, the court added back the 9.8% discount McGraw took in the first step of that process because the court concluded that it actually represented a minority discount. Then, when it reached the second step of the evaluation process, the court removed what it regarded as the same minority discount from the 30.4% unmarketability discount McGraw applied at that stage. Thus, the Supreme Court added back McGraw's minority discount twice, once in each of the stages of the process. Apparently, this was based upon the court's erroneous finding that McGraw arrived at the 30.4% discount by analyzing privately transacted sales of stock "with restrictive sale provisions and [McGraw] found that they exhibited a median discount of 30.4 percent *relative to net asset value*" (emphasis supplied). The Supreme Court further reasoned that, because the sales McGraw analyzed were of minority shares, his unmarketability discount also must have contained an element of reduced value because of their minority status. The evidence in the record does not support the foregoing conclusions. In actuality, McGraw did not arrive at the 30.4% discount by comparing shares with "restrictive sale provisions" to their net asset values. He calculated the unmarketability factor by comparing the purchase prices of registered, publicly traded *minority* shares in comparative corporations to the purchase prices of *the same class of minority shares* in the same corporations that were unregistered and, therefore, not publicly traded, but purchased under trading restrictions in private placements. Because McGraw in his calculations always compared the prices of a marketable set of minority shares to the prices of a set of minority shares when the same stock was unmarketable, the difference in prices of the shares did not contain any additional minority discount element and the discount was solely attributable to the difference in the marketability of the shares in the same stock.

Thus, the Supreme Court erred in removing a nonexistent minority discount element from the reduction in value of the petitioners' shares McGraw attributed to their lack of marketability. It is unclear, however, as to whether the Supreme Court would have accepted in full McGraw's 30.4% discount as a proper reflection of diminution in value due to unmarketability had the court been aware that it did not also reflect a reduction in value due to the shares' minority status. Because of this uncertainty, the matter must be remitted to the Supreme Court for a new determination of the appropriate discount for unmarketability of the petitioners' shares and a recalculation of fair value when that discount is applied to the proportionate net asset value of the petitioners' stockholdings in the nine corporations.

Accordingly, the order should be reversed, without costs, and the matter remitted to the Supreme Court for further proceedings in accordance with this opinion.

Judges Simons, Titone, Bellacosa, Smith, and Ciparick concur; Chief Judge Kaye taking no part.

Order reversed, etc.

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