New York Court's Fair Value Award in Shareholder Oppression Case Deducts Present Value of Built-In Gains Tax

By Peter A. Mahler*

Murphy v. U.S. Dredging Corp., 2008 NY Slip Op 31535 (May 19, 2008) (unpublished)

The Eleventh Circuit's reversal last year of the tax court's decision in *Jelke v. Commissioner* (see the January 2008 *BVU*) represents a tipping point in the evolution of case law—beginning with the tax court's 1998 *Estate of Davis* decision—toward 100% discounts for built-in capital gains in valuing holding company assets. At least, that appears to be the case for estate and gift tax purposes in the appraisal of a C corporation under the fair market value (FMV) standard.

But what of shareholder oppression and dissenting shareholder cases involving application of a statutory fair value (FV) standard? Typically, the appraisal or buyout statute requires FV appraisal of the company on a going-concern basis as opposed to *Jelke*'s "arbitrary assumption" of liquidation on the date of death. Can the redeeming company or purchasing shareholder nonetheless seek a discount for built-in gains?

These questions were recently addressed in a post-trial valuation decision by Justice Warshawsky of the New York Supreme Court (the state's trial-level court) in *Murphy v. U.S. Dredging Corp*. The court's decision—to deduct the present value of built-in gains tax assuming a nineteen-year holding period—rejects the assumption of liquidation on the valuation date in favor of a reasonably foreseeable liquidation date based on evidence of the controlling shareholders' actual intent. In so ruling, the court reconciles the FV standard's stated purpose, to protect minority interests against majority overreaching, with economic market reality that would lead a hypothetical purchaser to demand—and the hypothetical seller to give—a tax discount based on non-speculative liquidation plans.

The Facts in *Murphy*

U.S. Dredging Corp. (USD) was formed in 1934 and owned by the families of its three founders. When USD ceased dredging operations in 1973, it owned valuable waterfront properties in Brooklyn, New York and Jersey City, New Jersey. USD sold the Jersey City property in 2001. In 2005, USD sold its Brooklyn property to the IKEA chain for $31.25 million. The bulk of the sale proceeds was invested in replacement commercial properties in tax exempt §1031 exchanges (under §1031, the exchange of certain types of "like-kind" property may defer the recognition of capital gains or losses due upon sale, and hence defer any capital gains taxes otherwise due), which deferred $11.6 million in capital gains taxes on the two sales. Major retailers under long-term triple net leases operated the replacement properties.

In 2006, a 36.77% shareholder faction petitioned for judicial dissolution of USD on the grounds of oppression, alleging that the controlling shareholders withheld distributions while enriching themselves and their children with excessive salary and pensions. USD elected to purchase the petitioners' shares. After the parties failed to agree on the buyout price, the matter went to trial to determine the fair value of the shares as of February 13, 2006.

Same approaches, much 'different values'

Both USD's expert, and the petitioners' expert used the adjusted book value (net asset) method and the discounted future cash flow (DCF) approach to value the shares. That's where the similarity ended, as the court noted, "each expert weighted the two approaches differently and reached different values as to each area."

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The primary difference with respect to the net asset approach was treatment of built-in gains. USD's expert deducted 100% of the $11.6 million deferred capital gains tax on the 2001 and 2005 sales to arrive at a company value of approximately $15 million, to which he applied a 15% discount for lack of marketability (DLOM) to arrive at a value of $12.8 million.

The petitioners' expert deducted approximately $3.4 million in gains tax representing present value, assuming liquidation in the year 2024, to arrive at a company value of $24.8 million. He applied no DLOM.

The two experts' DCF values were even further apart, due primarily to their differing analyses of USD's working capital. The corporation's balance sheet on January 31, 2006, showed $16.2 million in current assets. The question for the court became whether any of this was excess working capital, and therefore a non-operating asset.

The petitioners' expert determined $14.1 million of this was a non-operating asset and included only $2.1 million in working capital into his calculations. He used the DCF Model to determine the present value of the future cash flows from 2006-2025 to be $6.0 million, to which he added $14.1 million in non-operating assets, resulting in a value for the corporation's equity of $20.1 million. In contrast, USD's expert claimed the $14.1 million to be working capital and determined the value of the corporation's equity to be $11.4 million.

After making adjustments for a DLOM and a January 2007 dividend payment, the petitioners' expert's fair value was $16 million, and USD's expert's fair value was $8.7 million.

The petitioners' expert weighted his net asset value 45%, and his DCF value 55%. He explained that the long-term nature of USD's real estate and mortgage financing transactions made giving more weight to its expected long-term cash flow, rather than its highly encumbered assets, more appropriate. USD's expert gave the two approaches equal weight; however he also testified that he would assign 85% weight to his DCF value if the court did not deduct 100% of the built-in gains tax in the net asset valuation. Based on these weightings, the petitioners' expert and USD's expert concluded that the value of the petitioners' 36.77% stock interest was approximately $8.14 million and $3.76 million, respectively.

Prior case law directs the court

The court began by noting that the New York statutes providing for appraisal rights and for elective purchase in dissolution proceedings use the term "fair value" without offering a definition, but that the case law has defined it generally as what a willing purchaser, in an arm's-length transaction, would offer for the corporation as an operating business. The court observed that, while case law recommends consideration of each of the three basic valuation approaches, net asset value (cost) is generally the approach most applicable in evaluating real estate and investment holding companies such as USD. Also, New York law generally supports application of a DLOM while prohibiting minority discounts.

Turning to the discount for built-in gains, the court, after referencing *Davis*, stated:

> Though we are not in Tax Court, and a Fair Value calculation...is not identical to the procedure of Tax Court...it is clear from the evidence that no liquidation was or is contemplated by [USD] in our case and thus a 'liquidation' or semi-liquidation scenario is not appropriate when dealing with the [built-in gains] tax.

The court agreed with the petitioners' expert's assumption of a nineteen-year holding period based, in part, on the following factors:

1. Historically, USD made long-term property acquisitions, i.e., it held the Jersey City and Brooklyn properties for thirty-six and twenty years, respectively, before selling;
2. The specific §1031 exchange properties acquired by USD were the "type

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of investments" which reflected long-term investment goals;

3. The possibility of converting to an S corporation gave the majority "tremendous incentive" to hold the property for at least ten years in order to avoid gains tax;

4. A willing buyer would not expect to deduct the entire gains tax.

Since the deduction of the entire tax would mean the payment of the tax at the time of sale, the court asked, "Why would such [a] buyer buy into this type of [REIC] if the corporation is going to sell [its] assets as soon as you buy?"

The court's opinion cites what appears to be the only previous New York decision on gains tax and fair value, in *Matter of LaSala* (Feb. 6, 2003), where that court rejected a deduction for built-in gains taxes. The court states that while the court "agrees with the logic" of *LaSala*:

> ...under these circumstances with the [built-in gains] representing such a large portion of corporate assets it appears that a willing purchaser would expect to deduct the present value of the [built-in gains] tax along with a percentage for lack of marketability.

The court deducted the $3.4 million present value of the gains tax liability and applied a 15% DLOM to arrive at a net asset valuation of the company of approximately $18 million; the petitioners' interest came to $6.7 million. Regarding the amount of working capital, the court found the petitioners' expert's working capital assumption to be "incorrect," and determined that a logical amount of working capital to be $6.45 million. Accordingly, the court directed both parties to recalculate their income approach calculations, and promised a final decision "giving appropriate weight to the two different methodologies" (i.e. reconciliation).

A new course for built-in gains deductions?

Murphy may well be the first decision permitting a deduction for built-in gains under a FV standard. While its precedential value may be limited by its unusual facts and circumstances, *Murphy* merits close study by appraisers and lawyers called upon to value C corporations with built-in gains, as it could be a harbinger of a new trend by the courts, particularly as the FV standard becomes more prevalent.

Legal & Court Case Update

Insolvency of Hedge Funds Turns on Book Value versus 'Fair Valuation' of Debts

***Waller v. Pidgeon*, 2008 WL 2338217 (U.S. Dist.) (June 5, 2008)**

Must debts be valued at book value, or can they be treated similarly to assets, and adjusted to a "fair valuation" for purposes of determining insolvency? These are the questions the U.S. District Court (N.D. Texas) considered in this opinion, which may well impact both state and federal solvency cases.

Closely related entity holds debt

The plaintiff in this case was the receiver (a person appointed to take possession of an insolvent company's accounts and property by order of the court) for four closely related entities: two hedge funds, and the two partner organizations that served as investment advisors to the funds. The defendant had invested $4 million in one of the funds (Dobbins Partners) over the course of four years. Over the same time period, he received significant redemption payments, totaling nearly $5 million. A final payment of $650,000 was made to the defendant on December 27, 2002.

The entities declared bankruptcy on December 31, 2002, and the plaintiff subsequently sued to recover the $650,000 payment as a fraudulent transfer. Under the Texas fraudulent transfer

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statute, the fund would be entitled to recover the payment if the fund was insolvent on the date of the transfer or became insolvent as a result. The plaintiff believed that, due to a fraudulent overstatement of the fund's value, Dobbins Partners was insolvent as early as September 30th, 2002.

The parties actually stipulated to most of the facts at trial: the fair value of the assets of the fund was approximately $4.95 million as of December 31, 2002, and the book value of its liabilities was roughly $8.9 million. However, more than $6.8 million of that liability amount was owed to the other Dobbins hedge fund. The plaintiff argued that because the book value of the fund's liabilities exceeded the fair value of its assets, the fund was insolvent, and the $650,000 transfer to the defendant must be recovered. The defendant, in contrast, believed that "the court should adjust liabilities to a fair valuation by deducting related-party transactions" between the two funds. In essence, the defendant argued to reduce Dobbins Partners' $6.8 million in debts owed to $2.08 million. With this adjustment, the fund's assets would have exceeded its debts, and the transfer would stand.

Analyzing the parties' arguments under the Texas statute, the court narrowed its discussion to the "simple" issue of whether it was required to value a debtor's liabilities at book value, as the plaintiff contended.

Does the law 'compel' book value of debts?

To support his position, the plaintiff pointed to the language of the statute itself, and its definition of "insolvency," as well as the "similarly worded" text of the Bankruptcy Code. He also argued that applying the fair valuation standard to debt was "inconsistent with the broad definition of 'debt,' as interpreted by several courts."

While the majority of the court's opinion focuses strictly on legal issues involving statutory construction and interpretation, the court rejected the plaintiff's arguments. Neither the legislative intent behind enactment of the statute, nor subsequent judicial interpretations supported a finding that "compel[led] the conclusion that debts can *only* be valued at book value" and could never be adjusted.

> ...although the [Texas statute] definitions of insolvency at issue here would *permit* debts be valued at book value, they do not *command* that they be valued at book value (emphasis in original).

Accordingly, the court dismissed the plaintiff's claims. The court declined to make any findings specific to the valuation of the fund's liabilities, but it was clearly concerned with the close relationship between the funds, with one holding the debt for the other. It remains to be seen whether courts interpreting the U.S. Bankruptcy Code will similarly find a "fair valuation" of debts to be permitted.

Legal & Court Case Update

Goodwill, Appraiser Preparedness Take Center Stage in Valuation of Insurance Agency

***Statham v. Statham*, 2008 WL 2357353 (Louisiana)(June 11, 2008)**

While the debate and jurisdictional divide of whether personal goodwill, enterprise goodwill—or both—should be subject to division in divorce cases, Louisiana places itself firmly in one camp with this latest decision to focus on the distinction.

Experts differ 'substantially' on goodwill

After thirty-five years of marriage, the Stathams filed for divorce. The main issue in dispute was the value of the husband's business, an established insurance brokerage company. Both parties presented expert valuation testimony at trial.

The husband's expert assigned a total fair market value to the company of about $220,000, from which he subtracted just under $13,000 for

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Goodwill, Appraiser Preparedness

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business assets (such as accounts receivable, furniture, and fixtures). The expert classified the remaining value—$207,000—as goodwill, 90% of which was personal. The expert determined the percentage of personal versus enterprise goodwill based on the husband's "personality," the relationship with, and loyalty of, his customers, and the percentage of his business he received from referrals. His opinion was further bolstered by testimony from a former partner of the husband, who described the husband's "personal relationship" with his clients. With only 10% classified as divisible enterprise goodwill, the expert's total value for the company was $34,000, $13,000 for tangible assets and about $21,000 for enterprise goodwill.

The wife's expert, in contrast, calculated the company's fair market value using 2005 data, which was nearly two years old at the time of trial. His final valuation was $310,766 (the court's opinion does not go into further details regarding the expert's valuation). The wife's expert had "failed to assess" a value for goodwill; rather, he testified that the husband's expert's "assignment of 90 percent to personal goodwill was unreasonable," and he characterized any method used to calculate personal goodwill as "at best, subjective."

The trial court accepted the husband's expert's valuation calculations, and the wife appealed.

Court finds guidance in state statute

On appeal, the wife argued that the trial court erred in finding her expert's valuation less credible simply because of the less-recent data which he used. She pointed to the company's consistently steady cash flow from 2005 through the date of trial.

In Louisiana divorce cases, the distinction between personal and enterprise goodwill—and whether it should be included in a marital estate—has been codified (currently, the only state to have done so). The statute permits (but does not require) the court to include value of any goodwill attributable to a business, so long as it is not "attributable to any personal quality of the spouse." The appellate court again noted that the husband's expert used the statute in his determination and division of goodwill, while the wife's did not.

The court deferred to the trial court's acceptance that the husband's expert's analysis was more thoroughly prepared, timely, and credible. Finding no error, the higher court upheld the decision.

Legal & Court Case Update

Plaintiff Sues Law Firm After Questionable Advice, Seeking Lost Future Profits

***Cal-City Construction, Inc. v. Wilson, Elser, et al*, 2008 WL 2191141 (California)(May 28, 2008) (unpublished)**

While the "reasonable certainty" standard of determining lost profits is generally accepted by the courts, what evidence may be sufficient to establish that certainty is often fact—and case—specific. This unpublished case from the California Court of Appeals sheds light on when an argument for future lost profits may be an uphill battle.

When it rains, it pours

The plaintiff—a California-based construction company—was the successful bidder on separate, but closely-connected projects to build two schools (Belmont 2 and Belmont 3) for the Los Angeles School District (District), for which the plaintiff was to be paid approximately $6.52 million combined.

Delays on Belmont 2, both man-made and natural, quickly made the project's completion tenuous: engineering problems, a nearly three-month rainy season, and the discovery of "black, sticky soil" at the site (which the plaintiffs wanted to test for contamination, but were not allowed by the District) all led to the plaintiffs eventually

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Plaintiff Sues Law Firm

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being "thrown off" of the job by the District. On Belmont 3, the situation wasn't much better. Because of new, stricter regulations implemented by the District, the plaintiff was unable to have its forms requesting preliminary payments approved, despite submitting them three times. Further, excavation progress was hindered by the presence of several dozen concrete blocks, for which neither the District nor the plaintiff wanted to pay to have removed.

The plaintiff retained the defendant law firm to advise and advocate on its behalf with the District. The plaintiff's goal was to return to the Belmont 2 project, and to receive its payments on the Belmont 3 project. The attorney, however, advised the plaintiff to "walk off" the Belmont 3 job, which it did. Despite repeated demands by the District to return, the attorney advised the plaintiff to "stay the course." Eventually the plaintiff sued the District for breach of contract, and the District sought to recover the cost of completion, on both projects.

Immediately before trial, the attorney began to have second thoughts about the case, and advised the plaintiff that the claims arising out of the Belmont 3 "walk-off" were unwinnable. Although he still believed in the Belmont 2 case, the attorney stated bluntly that he was "not going to try [the] case." This led to the plaintiff agreeing to "settle on unfavorable terms" with the District, which included a payment of $520,000, and an agreement to not bid on any District projects for five years.

Because of the termination from Belmont 2, the walk-off from Belmont 3, and the settlement, the plaintiff was in a "terrible position," and had an extremely difficult time "getting bonded" for future projects. Eventually, the plaintiff brought a legal malpractice suit against the defendant, and sought to recover more than $13 million in damages arising from the settlement and lost future profits. A jury awarded the plaintiff $941,000 in damages (related in part to the "adverse settlement" with the District), and another $1.72 million in lost profits, and the defendant appealed both parts of the award.

Lost profits award 'speculative and uncertain?'

While the appellate court easily found grounds to uphold the $941,000 in damages, the lost profits award was more troubling to the court.

The plaintiff's expert was a forensic accountant who testified regarding the general damages, as well as the lost profits on "future projects." He first calculated lost profits which were a direct result of the plaintiff's five-year ban on District projects. By analyzing the number of District projects the plaintiff had been awarded over the previous two-and-a-half years (an average of 2.7 projects per year), and the average worth of those projects ($2 million each), he was able to determine an "average annual value" to the plaintiff of $5.4 million. Lost profits as a result of the five-year ban came to approximately $3.24 million, based on the average profit margin, per project.

Regarding non-District projects—or "projects of interest"—the expert found that the plaintiff was the successful bidder on roughly 11.33% of the jobs on which it had bid. He then calculated an average gross margin of 12.18% for the periods during which the plaintiff was unable to secure adequate bonding, and therefore could not bid on potential projects. Multiplying the total value of the "project of interest" contracts by the rate of successful bidding, and then by the average gross margin, the expert arrived at an additional lost profits figure of approximately $7.47 million. (In a footnote, however, the court noted a miscalculation on the part of the expert, where he had failed to include the 11.33% successful bid rate. Accounting for this, the court found the correct calculation to instead be approximately $2.38 million.)

The defendant's expert, by contrast, had used a 6% profit margin to determine lost profits, by simply "subtracting expenses from revenues" on a historical basis, an approach which the plaintiff's expert found inappropriate. Part of his criticism was based on the terms of the Belmont 2 contract itself, which called for a "set profit."

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Plaintiff Sues Law Firm

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On review, the higher court articulated that a plaintiff must establish future lost profits "with reasonable certainty as to both their occurrence and extent," and specific to this construction context, "the likely net profit [the company] would have realized on lost business."

Working its way through a long line of sometimes contradictory cases involving construction and contracting companies similar to the plaintiff, the court determined that lost profits could not be recovered due to the plaintiff's loss of bonding, as a matter of law, due to their "speculative and uncertain" nature. Although it upheld the $941,000 damages award, the court reversed the jury's award of lost profits in its entirety.

Legal & Court Case Update

Are Damages Opinions Based 'Almost Exclusively' on Management Opinions too Unreliable?

***U.S. Salt, Inc. v. Broken Arrow, Inc.*, 2008 WL 2277602 (U.S. Dist.)(May 30, 2008)**

A basic principle of the valuation profession is that valuation conclusions must be supported by sound data, and independent analysis, and that claims of lost profits cannot be overly speculative. This opinion from the U.S. District Court (Minnesota) illustrates how unreceptive the courts may be when a damages claim fails in each of these areas.

Damages claim relies on management projections

The plaintiff—a producer of a product called "solar salt"—brought a breach of contract claim against the defendant for an alleged violation of an agreement to ship salt. The liability of the defendant was quickly decided by the court in a pretrial summary judgment proceeding. The court then scheduled a special hearing on damages, for which both parties submitted "voluminous trial materials." The plaintiff, in particular, relied heavily upon its valuation expert to establish its lost profits for "solar salt" which the plaintiff suffered as a result of the defendant's breach. The defendant challenged the admission of the expert's testimony under *Daubert* and the appropriate Federal Rules of Evidence.

The plaintiff's expert's initial lost profits calculations were $1.8 million; however, he later revised his damages amount in a subsequent report downward to a range of $600,000 to $1.06 million (the court's opinion offers no details regarding the expert's valuation, or what caused him to revise his numbers). The court noted that the expert "relied almost exclusively on the assumptions and estimates provided" by the owner of the plaintiff company.

Articulating the applicable legal standard, the court stated:

> Although the law does not require mathematical certainty in the proof and calculation of lost profits, it requires evidence of definite profits *grounded upon a reasonable factual basis.* (emphasis in original)

'Unsupported assumptions' lead to expert's exclusion?

The court had little trouble finding that the expert's reports contained "very little analysis and were riddled with unsupported assumptions." In fact, when asked in a prior deposition whether he had done "anything to verify" whether the information and projections relied upon were accurate, the expert answered quite frankly: "Not that comes to mind."

Without an independent, objective opinion on the part of the expert, the court found that the management's estimates were "nothing more than optimistic projections."

> And [the expert's] wholesale acceptance of [management's] projections without any verification of these estimates or any independent market analysis is simply too speculative to submit to a jury.

Accordingly, the court excluded the plaintiff's expert's lost profits damages testimony, and without any damages evidence to present, the court dismissed the plaintiff's claims.