Munroe, Park & Johnson, Inc.

Business Valuation and Securities Analysis

BUSINESS VALUATION NEWSLETTER

Vol. 14 No. 2 San Antonio, Texas Fall 2014

Discount for Lack of Control May Increase Based on Recent Court Decision

In a 6-3 opinion, the Texas Supreme Court ruled in *Ritchie v. Rupe* that minority shareholders can no longer turn to the court to force closely-held corporations to purchase their shares.

In this case, the plaintiff, Ann Rupe, inherited 18% of the shares in Rupe Investment Corp. (RIC) from her husband, Buddy Rupe. Mr. Rupe, who died in 2002, was a descendant of the founder of RIC and a board member. RIC was a family-owned holding company with $150 million in sales and assets in excess of $50 million. After inheriting the interest, Ann Rupe requested that her shares be redeemed. An offer of $1 million was initially made and later increased to $1.7 million. Ms. Rupe refused the offer and hired a broker to sell her interest. However, RIC declined to meet with prospective purchasers.

> *…the statute does not authorize courts to order a corporation to buy out a minority shareholder.*
>
> Texas Supreme Court

In 2006, Mrs. Rupe filed suit against the corporation's board of directors and RIC. She alleged that they engaged in oppressive conduct and breached their fiduciary responsibilities by refusing to buy her shares at fair value, denying access to RIC's financial statements and refusing to meet with potential third party purchasers.

In 2014, the Texas Supreme Court determined that RIC's conduct was not oppressive under Texas law and overturned the ruling by the Dallas Court of Appeals which required RIC to buy her shares for $7.3 million. The ruling stated that it would only recognize a shareholder oppression claim under section 11.404 of the Texas Business Organizations Code and that the only remedy for shareholder oppression is the rehabilitative receivership statute, not a buy-out of the minority shareholder. Furthermore, the Court pointed out that shareholders should protect themselves before buying minority interests by negotiating shareholder agreements that contain buy-sell, first refusal or redemption provisions that reflected their mutual expectations and agreements. It appears the Court was not concerned that the plaintiff in this case inherited the 18% interest and therefore did not have the ability to protect herself by negotiating a shareholder agreement.

Shortly after the *Ritchie* decision, the Supreme Court overturned another finding of oppressive conduct based on the same grounds in *Cardiac Perfusion v. Hughes*. In that case, the trial court found the defendant engaged in shareholder oppression and ordered "the equitable remedy" of a judicially mandated buyout. Relying on *Ritchie*, the Supreme Court overturned the trial court's decision and remanded. Again, the Court noted that a minority shareholder may not recover equitable relief through a shareholder oppression action, and echoed that rehabilitative receivership was the only available remedy for shareholder oppression in Texas.

The landmark decision of *Ritchie v. Rupe* raises concerns that it will become increasingly difficult for minority shareholders of closely-held corporations to successfully bring claims of oppressive conduct to court in Texas. Experts have speculated that this could reduce investments in venture capital deals and increase discounts for lack of control for minority shareholders in closely-held corporations in Texas. The rights and remedies set forth in shareholder agreements will continue to be of paramount importance in determining the value of minority interests in closely-held corporations in the State of Texas.

Goodwill Considerations in Appraisals

Every once in a while, an extreme case comes along that highlights the consideration of goodwill at a greater magnitude than is normally encountered. In the recent case of *Estate of Franklin Z. Adell vs. Commissioner* (TC Memo 2014-155), the tax court's ruling was based on whether the goodwill of the company involved was personal or commercial, to what extent it impacted the value of the Estate and the demonstration of the business valuation report to prove its position.

The initial value of the Estate of $9.3M, by the appraiser's admission, failed to take into account a limit on fees payable to the company owned by the Estate, STN, which was a cable up-linking company whose only customer was a broadcasting network owned by Kevin Adell, the son of the decedent. The fee cap was considered to be directly connected to the personal goodwill of STN's sole employee, who also happened to be Kevin Adell. While Kevin was employed by STN, he had no employment contract or non-compete agreement. Four years later, an amended return was filed by the Estate which claimed the worth of STN to be $0. The IRS returned with a value of $92.2M which led to Tax Court. The IRS amended its valuation, taking into account the personal goodwill and determined a lower value of $26M on the premise of retaining the son as an employee of STN. The taxpayer appraiser's revised valuation resulted in a value of $4.3M. Although the court sided with the Estate, the appraiser's initial value of $9.3M was upheld which some view as a flawed decision due to the handling of personal goodwill.

When valuing a business that has goodwill, it is important to properly identify whether it is personal or commercial. In order to do so, one must first understand the differences between the two and their impact on the profitability of a company. Personal, or professional, goodwill relates to the experience, skills, ability, contacts and reputation of one or more individuals within a business. Its value is intrinsic to the individual(s) without whom it would not exist. Personal goodwill is not transferable in some states, and the impact results in a reduction of profits to the business if the individual(s) leaves the company. Conversely, commercial goodwill, or enterprise goodwill, is tied directly to the business itself. The reputation of the business, not an individual, drives repeat business or draws new business. This type of goodwill is sustainable despite who owns the company or services its clients, and therefore is transferable.

Conscious consideration must be given to the impact of goodwill on the value of an entity. The concern with the court's decision to uphold the initial valuation of STN was that its value was based on a historical cash flow which was overstated due to non-enforcement of the fee limit agreement. Ultimately, Kevin's business relationships resulted in higher payments made to STN than was required. Essentially, the first appraisal failed to take into full consideration the impact of personal goodwill on the projected future profits of STN. However, the appraiser's revised value for STN of $4.3M, which was based on a liquidation approach, was rejected by the court due to the failure of the revised report to clearly demonstrate any error in the initial determination of value or to sufficiently prove the second value to be more appropriate. The *Estate of Adell* substantiates the need to clearly identify goodwill and provide an appropriate explanation supporting its impact on profitability and the appraised value.

Throughout the appraisal process, one way to approach the identification of goodwill as personal or commercial is to utilize objective factors. Some of the factors to be considered include how customers, both new and repeat, are generated; whether the focus of advertising is on a key individual or company based; the defining elements of profit allocation; the depth and organizational structure of owners and managers; and, the utilization of employment and non-compete agreements. In addition to objective indicators, another tool involves the contemplation of a hypothetical sale of the company under its current characteristics. Considering the ability of the company to continue to generate similar profits after a change of ownership or key personnel can help objectively identify personal versus commercial goodwill.

Although this case is an extreme example regarding the impact of personal goodwill, the takeaway from the case is that by fully taking into account the impact of goodwill on the future profitability of a company, writing a report which logically supports the value and providing clear reasoning that leads to the conclusion, a practitioner can help to mitigate a potential challenge of the valuation. If an error is made in the impact of personal goodwill, an amended appraisal is a valid option as long as it clearly demonstrates the initial error, explains the material impact of the goodwill and supports the adjustment.

Munroe, Park & Johnson, Inc.

Changes to Goodwill Impairment

In the Financial Accounting Standards Board (FASB) update as of January 2014, the guidance for ASC 350 will provide an accounting alternative for existing goodwill and new goodwill recognized for non-public companies with an annual year end after December 15, 2014. (Early adoption is permitted.) For those private companies that choose to adopt the alternative, the changes will significantly affect the accounting for goodwill.

Under current Accounting Standards Codification ("ASC") 350, *Goodwill and Other Intangible Assets,* a company is divided into one or more reporting units, and a separate goodwill impairment test is performed annually at the reporting-unit level. If the carrying value exceeds the fair value, then there is an indication of potential goodwill impairment. The total amount of impairment is measured in the second step ("Step 2"). Under Step 2, the level of goodwill impairment is measured by performing a purchase price allocation. Following are the three key changes to ASC 350.

1. **Amortize goodwill.** A non-public company may now elect to amortize goodwill over 10 years. A company may use less than 10 years if they can demonstrate that another useful life is more appropriate. The existing carrying balance of goodwill will be amortized over its remaining useful life, not to exceed 10 years, for the entire year in the year of adoption. Entities electing to use a shorter life should have sufficient analysis to support the useful life assigned, which will often include:

    - Identification of the cash flow specific to the goodwill.
    - Discussion of the interaction of cash flows specifically identified with the goodwill and other reporting units of the entity and why they are included/excluded from the analysis.
    - How the estimated useful life was determined.

2. **Testing for impairment.** Goodwill only needs to be tested for impairment if there has been a triggering event. Upon the occurrence of a triggering event, a company may assess qualitative factors to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If it is more likely than not, the company will need to calculate the fair value of the reporting unit and compare it to the carrying value.

3. **Goodwill impaired.** If goodwill is impaired, a company does not need to do a purchase price allocation to quantify the goodwill impairment. The impairment is calculated by comparing the fair value of the reporting unit to its book value. The difference is the goodwill impairment. The goodwill impairment loss cannot exceed the reporting unit's carrying amount of goodwill.

After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill will be its new accounting basis, which must be amortized over the remaining useful life of the goodwill. The subsequent reversal of a previously recognized goodwill impairment loss is prohibited.

If the alternative is adopted, there is currently no guidance for transitioning back to the current standard. Therefore, adoption may not be appropriate for companies considering a public offering in the future. If a company goes public, the need to go back and restate as if goodwill was not amortized may come into play. The Financial Accounting Standards Board (FASB) has an active project considering whether to also change the accounting for goodwill in public and not-for-profit companies.

Meeting the Burden of Proof

The Estate of Frederic C. Kohler (the "Estate") held a 14.5% stock interest in the Kohler Company, a privately-held manufacturer of plumbing fixtures, gas engines, generators and other products. The Estate valued this stock at $47 million on the tax return. The IRS believed that the stock was worth $145 million.

In T.C. Memo 2006-152, United States Tax Court *"Kohler et al. v. Commissioner,"* the judge expressed a number of "grave concerns" about the valuation presented by the IRS expert. The court questioned the IRS expert's credentials by noting that he was not a member of the American Society of Appraisers (ASA), and stated that the expert's report was not submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP). This was due to the IRS expert's failure to provide the customary USPAP certification, which assures readers that the appraiser has no bias regarding the parties, that no other persons besides those listed provided professional assistance and that the conclusions in the report were developed in conformity with USPAP.

On the other hand, the two experts presented by the Estate were both accredited as senior appraisers in business valuation by the ASA. Additionally, the court found that the experts for the Estate provided a thoughtful, credible report which strongly supported the value the Estate reported on its tax return. As a result, the judge gave no weight to the conclusion by the expert for the IRS and ruled that the IRS had not met its burden of proof. The court adopted the value reported on the estate tax return and rejected the entire tax deficiency assessed by the IRS.

The case of *Kohler et al v. Commissioner* presents the importance of consistency, clarity and conformity in a valuation. If the experts for the Estate had neglected to present a proper appraisal, and the IRS had adequately supported its burden of proof, the value of a 14.5% stock interest in the Kohler Company could have been $98 million higher which would have increased the tax and penalty burden on the Estate.

Munroe, Park & Johnson, Inc.
18402 US Hwy. 281 North, Suite 216
San Antonio, Texas 78259
210-545-7332
www.mpjonline.com

The firm focuses on providing consulting in the areas of business valuation and acquisitions.

- Estate and Gift Tax Valuations
- Family Limited Partnerships
- Litigation Support
- Shareholder Disputes
- Buy/Sell Agreements
- Sale of Privately-Held Companies
- Purchase Price Allocation
- Goodwill Impairment
- Common Stock Options
- Promissory Note Appraisals

Business Valuation Newsletter is published and provided free of charge on a quarterly basis. The articles in the newsletter are written by the principals in the firm and are for informational use only. This publication does not constitute legal, tax, accounting or valuation advice. Those seeking advice should solicit professional assistance.