Value Management Inc.

The Business Valuation Specialist

Issues & Updates

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Did Ballmer Overpay for the LA Clippers?

"When you look at tech companies with no earnings and huge valuations and a lot of downside, the Clippers look like a really well valued team to me," says Steve Ballmer in a video interview on Bloomberg about his $2 billion purchase of the NBA team. Many critics say the price tag was too high.

In a blog post devoted to the Clippers deal, Dr. Aswath Damodaran (Stern School of Business, New York University) estimated the value at $1.61 billion under a set of simplifying assumptions. He also makes an interesting point concerning his hypothesis on "acquisition hubris," where acquirers overpay due to ego and pride. He says: "While the desire to acquire glamorous assets and pay ego premiums may be clearly visible in sports franchise acquisitions, they are not restricted to them." He adds: "If Steve Ballmer is overpaying for the Clippers, he is at least overpaying with his own money. When, as CEO of Microsoft, he paid $8.5 billion for Skype, it was Microsoft stockholders who were put at risk from overpayment."

Some people believe that "all boats could rise with the tide," meaning the values of other teams could increase as a result of the Clippers deal. Others, however, think this is a special case of facts and circumstances.

Can Bert the Hippo Pass the Smell Test?

According to a report in the *Hollywood Reporter*, CBS has been sued in federal court over copyright infringement concerning a puppet, Bert the Hippo. Bert gained popularity on the show "NCIS" and is famous for emitting bodily sounds associated with too much intestinal gas.

Bert and his antics got to be so famous that CBS started selling the puppet online. The manufacturer, Folkmanis Inc., is the plaintiff in the case and claims that it was the original creator of Bert and holds the exclusive rights.

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VMI Highlights

VMI will be a conference sponsor at the Pennsylvania Bar Association's Family Law Section Winter Meeting. The conference takes place on January 16 -18 in Lancaster, PA.

VMI was a conference sponsor at the PA Bar Institute's 21st Annual Estate Law Institute on November 19-20th.

If you are interested in having one of our analysts give a business valuation related presentation to your firm or at a conference, please contact Susan Wilusz at smw@valuemanagementinc.com or at 215.343.0500.

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The plaintiff was working with CBS on a special edition of Bert (with a spiked collar) when CBS allegedly made a deal with a Chinese toy company to make an unlicensed version of the gassy critter. Folkmanis is suing for $733,000 in lost profits from the defendant's sale of the phony toy.

According to the report, a CBS spokesperson made this comment: "We believe this to be a flatulent abuse of the legal system, and we intend to clear the air on this matter immediately."

Tax Court Can't Pull a Discount Out of Thin Air

When valuation experts use discounts, they must be substantiated. That goes for the Tax Court as well.

In *Estate of Elkins v. Commissioner*, 2014 U.S. App. LEXIS 17882 (5th Cir, Sept. 15, 2014) (overturning *Estate of Elkins v. Commissioner*, 2013 U.S. Tax Ct. LEXIS 6 (2013)), a decedent owned fractional interests in valuable paintings. His estate took a fractional ownership discount for lack of control and marketability and offered valuation reports and testimony of three expert witnesses as proof. The IRS took the position that no discount was allowable but offered no evidence. The Tax Court concluded that a nominal discount of 10% should apply but also offered no evidence to back up that percentage.

The case was appealed to the 5th Circuit. In its ruling, the appellate court rejected both the IRS's and the Tax Court's findings on the discount. The court said that the discounts determined by the estate's experts "are not just the only ones proved in court; they are eminently correct." The estate was therefore entitled to a refund of more than $14 million.

Significant Shift in Fair Value Audit Deficiencies

Auditors continue to stumble over fair value measurements, but they are now having trouble with different issues, a new report reveals.

Over 40% of all audits inspected by the Public Accounting Oversight Board in 2012 had deficiencies, and the number of fair value measurement (FVM) deficiencies made up about 25% of all audit deficiencies, according to the third annual "Survey of Fair Value Audit Deficiencies" from Acuitas, an Atlanta-based consultancy firm.

The report notes that there's a shift in the sources of FVM deficiencies. In 2012, insufficient testing of financial instruments caused 87% of FVM deficiencies, but that percentage dropped to 55% in 2012. Business combinations are now the source of 45% of FVM deficiencies in 2012, up from 9% in prior years. Also, failure to assess risk and failure to identify or test internal controls caused a significant increase of FVM and impairment deficiencies. Risk assessment and control deficiencies caused 41.2% of the FVM deficiencies and 50% of impairment deficiencies cited by the PCAOB in 2012.

Stunning Personal Goodwill Amount Triggers Lawsuit

How do you rationalize a $12 million personal goodwill claim when you already receive compensation for signing a consulting and noncompete agreement? This was the issue explored in a recent ruling in a dissenting shareholder case (*Potok v. Rebh*, 2014 Phila. Ct. Com. Pl. LEXIS 318 (Sept. 16, 2014)).

An advertising company was embroiled in a five-year litigation with a competitor over the legality of the competitor's business practices, which threatened to ruin the company. One week into trial, the company accepted the competitor's settlement offer.

The competitor insisted on buying only the company's assets, not its stock, and wanted to eliminate the risk of future competition from the company or its four officers. In return, it offered $29.5 million on a "take-it-or-leave-it" basis. This amount was not based on any prior valuation of the company's assets.

The buyer specified that none of the money should be allocated toward the settlement. It required the company and the four officers to execute a noncompete agreement and also entered into one-year consulting agreements at $1,000 per month for each of the individuals. Based on the buyer's instructions, the CEO of the company had to allocate the proceeds to the following categories: (1) retailer contracts; (2) inventory; (3) noncompete agreements; and (4) consulting agreements.

The CEO's valuation assigned $13 million to cover the value of the company's assets and inventory, over $4.45 million to cover the defendants' noncompete agreements, $48,000 to cover the consulting agreements, and $12 million to cover the four officers' "personal goodwill." A true-up from an appraisal firm did not occur until some eight months later. At trial, the appraiser explained he was not allowed to create any new categories and was "solving back" to the purchase price. Under his analysis, the retailer contracts were worth only $9.3 million and the noncompetes only about $3 million. This left $16.7 million to cover the defendants' personal goodwill. The CEO ultimately adopted his figures.

The plaintiff, on behalf of the minority shareholders, sued the officers, who were majority shareholders in the company, alleging self-dealing. According to the plaintiff's expert, the company had little, if any, value, at the time of the transaction. Consequently, the noncompete and consulting agreements from the four defendants were worthless. The entire $29.5 million purchase price was in effect payment for settling the lawsuit and belonged to the company, the expert said.

The court agreed that there was no meaningful valuation. It also agreed that the deal was not an arm's-length transaction in an open and unrestricted market. However, in light of the potential the company had to offer to certain synergistic buyers, it was reasonable for the buyer to pay $13 million for the retailer contracts. This amount belonged to the company, the court determined. It also was reasonable for the defendants to be compensated for their consulting agreements and the noncompetes.

But the court flat out rejected the 40% allocation to personal goodwill. Considering the company's financial situation, it would take a lot to convince a fact finder that it is appropriate for the CEO to award himself and the other officers an additional $12 million because "they worked so hard and deserved it," the court said. It found the personal goodwill agreements "stunning in that it is not clear that anything is being sold." It rejected the idea that personal goodwill could serve as a "plug" figure. The defendants were unjustly enriched by the $12 million allocation for personal goodwill, the court concluded, and ordered them to pay the amount to the company.

Harsh Ruling Due to Faulty Value Allocation in a Merger

In *Cavallaro v. Commissioner*, 2014 Tax Ct. Memo LEXIS 189 (Sept. 17, 2014), taxpayers who built a successful business relied on estate planning professionals to effect a transfer of wealth that would minimize their tax liability. The resulting merger of two family businesses led to an IRS deficiency notice alleging the couple was liable for making a $46 million gift to their sons.

In 1979, the taxpayer husband and wife founded a company, Knight, which built custom tools and machines. Eventually, the husband and a son used Knight resources to develop a unique machine, CAM/ALOT, and formed another company, Camelot, to take the product to market. The taxpayers' three sons owned Camelot in equal parts. Knight built the machines and financed the operations of both businesses. The two companies worked out of the same building and shared payroll and accounting services. When the taxpayers hired a major accounting firm for tax advice, the latter prepared tax returns that claimed R&D tax credits for Knight, based on work Knight engineers had done.

In 1994, the taxpayers also retained a well-known law firm for estate planning purposes. Initially, the accountants and the lawyer had differing ideas as to which entity owned the technology and how to pass that value down to the three sons. The attorney set out to construct a narrative in which the value transfer from Knight to Camelot started at the time Camelot was incorporated. When told that real events did not bear out this story, the attorney said that in any history one had "to squeeze a few embarrassing facts into the suitcase by force." Eventually, the accountants fell in line and the professionals structured a merger based on the premise that no gift tax was due because, on the merger date, Camelot already owned the CAM/ALOT technology. In 1995, the petitioners accepted a 19% interest in the new entity, while the three sons claimed the remaining 81% in equal measure. Effectively, Camelot was valued at four times the value of Knight. Six months later, the merged company was sold for $57 million in cash.

Fifteen years later, the IRS issued a deficiency notice claiming the premerger Camelot had zero value and the merger resulted in a roughly $23 million gift from each parent to the sons.

The issue in Tax Court was whether the petitioners agreed to an unduly low interest in the merged company and the sons received an unduly high interest. The court considered valuation testimony from three experts. The taxpayer's two experts relied on the assumption that, at the time of the merger, Camelot owned the value of the technology. They valued the merged entity between $70 million and $75 million and Knight's portion of that value between $13 million and $15 million. In contrast, the IRS's trial expert assumed Knight owned the technology. He concluded the merged entity was worth $64.5 million. He determined that 65% of that value belonged to Knight, that is, $41.9 million. As a result, the IRS conceded some ground and lowered the gift amount to $29.6 million.

The court found that Knight owned the technology and the merger was not an arm's-length transaction. Because the taxpayers' valuations were based on the wrong assumption, there was no evidence to counter the IRS valuation.

Devoid of Goodwill, Corporation Escapes Income Tax Liability

Bross Trucking, Inc. v. Commissioner, 2014 Tax Ct. Memo LEXIS 109 (June 5, 2014) commands attention because of its thorough discussion of personal versus corporate goodwill. The case explores the nature of goodwill as property that is transferrable and the tax consequences resulting from the transfer.

The family business' umbrella included Bross Trucking, which the taxpayer founded in 1982. In the late 1990s, Bross Trucking became the target of audits and investigations by a number of government agencies. Fearing the effects of negative attention and a possible shutdown of the business, the taxpayer and his three sons met with an attorney to discuss the best way to ensure the family business had a suitable trucking provider. They decided to form a new company, ostensibly to ensure a clean regulatory slate. The new company was majority owned by the sons, who had had no involvement in Bross Trucking, and it provided more services than Bross Trucking did. The taxpayer played no role in managing the new company.

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In 2011, the Internal Revenue Service sent Bross Trucking a notice of deficiency, claiming the latter had distributed an appreciated intangible asset to the taxpayer for which the company should have recognized gain for 2004 under IRC Section 311(b)(1). The alleged total amount of liability, including accuracy-related penalties, was over $2.6 million.

The outcome of the case turned on what "regime" of goodwill was in play: personal goodwill or corporate goodwill. "A business can only distribute corporate assets and cannot distribute assets that it does not own," the court stated, referencing *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 18 (1998). By extension, it cannot distribute intangible assets that the shareholders own individually. Such was the case here, the court found.

Even assuming Bross Trucking once had corporate goodwill, it had lost most of it by the time of the alleged transfer due to various regulatory infractions. Under threat of losing the trust and patronage of customers, the taxpayer decided to establish a new entity. If trade names and trademarks are the embodiment of goodwill, the court said, this action showed that any transferred corporate goodwill was not valuable and may in fact have been detrimental to the new company. According to the court, the reputational situation was "the antithesis of goodwill."

Nearly all the goodwill Bross Trucking had was attributable to the personal ability of the taxpayer, the court determined. The company's customers chose to do business with Bross Trucking only because of the efforts of the taxpayer. Critically, the taxpayer did not transfer his personal goodwill to Bross Trucking, the court continued to say. It had no employment contract with the taxpayer and had no right to his future services. It also had no noncompete and could not expect to benefit from his personal goodwill once he left the business.

In sum, the court found that, since Bross Trucking had no corporate goodwill and no right to the taxpayer's personal goodwill, it did not transfer goodwill to the taxpayer and, therefore, was not liable for income tax related to it. Since the taxpayer did not transfer corporate goodwill to his sons, he was not liable for gift tax.

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