VALUE MANAGEMENT INC.

Investment Banking + Valuation Services

ISSUES + UPDATES

1ST QUARTER 2025

What Happens When You Don't Read the Documents

***Ajay Endeavors, Inc. v. Divvymed, LLC*, 2025 U.S. Dist. LEXIS 9189; 2025 WL 239035 (Jan. 17, 2025)**

Two physicians invested in complex convertible debt instruments related to an online pharmacy. Despite the complexity, the doctors never read the investment contracts, which limited their upside. Not being satisfied with the proceeds they received on the sale of the pharmacy, they sued the pharmacy, its parent company, and its founder claiming entitlement to several million dollars more than they received. The court found they acted unreasonably by not reading the documents and awarded summary judgment in favor of the defendants. It is important for investors to know the terms of their investments. An investor should seek legal and/or professional advice on the terms of an investment.

U.S. Appellate Court Affirms Vacatur of Jury Award— Witness Should Not Have Been Allowed to Testify

***Endless River Techs., LLC v. TransUnion, LLC*, 2024 U.S. App. LEXIS 32270; 2024 FED App. 0530N (6th Cir.) (Dec. 18, 2024)**

The U.S district court denied the defendant's motion to exclude the testimony of Dr. Malec, who had used an unreliable valuation, during the trial. The jury awarded the plaintiff $18.3 million in damages. Post-trial, the defendants filed a motion for judgment as a matter of law, challenging Endless River's recovery on multiple grounds. The district court granted the motion and vacated the award. In so doing, it pointed out that the report and testimony of Dr. Malec was speculative and based

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VMI Highlights:

Value Management Inc. is a proud sponsor of the Pennsylvania Center for Employee Ownership. The PaCEO's mission is to raise awareness of employee ownership in the state of Pennsylvania. Please reach out if you are interested in learning more.

Ed Wilusz will be speaking at the National Center for Employee Ownership's annual conference in Salt Lake City, UT later this month. His topic is, "When Things Change: Addressing ESOP Financial and Business Issues in Challenging Times."

If your firm is interested in having VMI give a presentation on business valuations and/or mergers & acquisitions, please contact Susan Wilusz at smw@valuemanagementinc.com.

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on projections from management that Malec had not vetted and were unreliable. The appellate court affirmed the vacatur of the jury award. Once again, this pointed out that projections from management cannot be taken at face without some vetting as to reliability. The trial court also determined, among other things, that Dr. Malec's testimony was not relevant to the damages nor was it reliable and his testimony was therefore stricken under Rule 702.

Proposed Regulations for Tax Valuations

The IRS has issued proposed regulations that would make changes to Circular 230 strengthening the agency's ability to penalize or disqualify appraisers who do tax-related valuations.

Circular 230 contains the rules for certain tax professionals who can practice before the IRS, and it hasn't been changed for 10 years. Most of the proposed revisions involve tax professionals (e.g., CPAs, tax return preparers, attorneys, enrolled agents, and the like). The proposed regulations were published Dec. 26, 2024, in the Federal Register. Comments were due February 24, and that was also the deadline for requests to speak at a public hearing, which will be on March 6[1].

Of particular interest to the business valuation community is Paragraph L. Entitled "Appraiser Standards." This section, among other things, uncouples determinations of appraiser misconduct, noting that "[a]n appraiser's conduct may be disreputable or fail to conform to appraisal standards even when the IRS has not assessed a penalty or when no penalty under the Code is applicable." Further complicating the situation is the statement that:

> Proposed §10.61, under new subpart D, would require appraisals submitted in an administrative proceeding before the IRS to conform to the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation or the International Valuation Standards (IVS) promulgated by the International Valuation Standards Council. Proposed §10.61 would thus ensure that appraisals submitted in an administrative proceeding generally conform to broadly applicable standards without requiring strict compliance with such standards.

Back in 2020, the IRS slipped through changes that eliminated the appraisal review process under which IRS personnel trained in valuation did the reviews. There was no notice given of the change, no comment period, and no public hearing. After eliminating the process, IRS agents with no valuation experience could review appraisals to determine whether a Sec. 6695A penalty should apply. The agency got an earful about the change from the valuation community, but the new process is still in place. And, with this new proposed change, there should be heightened concern about inexperienced IRS agents reviewing valuations.

Appraisers who fail to meet the standards through willful, reckless, or grossly incompetent conduct could face disqualification under the new rules. The commentary to the proposed regulations says that an appraiser "may show adherence to USPAP standards [or IVS we presume] when issuing the relevant appraisal," which will be considered as a defense in determining whether an appraiser has engaged in conduct that may trigger disqualification.

Another change says that the IRS can determine appraiser misconduct even though the agency has not assessed a penalty—or when no penalty is even applicable.

[1] *federalregister.gov/public-inspection/2024-29371/regulations-governing-practice-before-the-internal-revenue-service.*

Results of Purchase Price Allocation Study

Stout has released its Purchase Price Allocation (PPA) Study, based on an analysis of 130,417 filings and 5,203 transactions, highlighting the valuation of intangible assets and goodwill as a percentage of enterprise value. This review of 10-K and 10-Q filings examines key components of purchase price allocation, including goodwill, intangible assets, and contingent consideration, offering benchmarks to evaluate the strategic allocation of intangible

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When is the Right Time to Sell the Business?

Timing can be critical to successfully selling a business. Raising questions about when to sell and understanding the issues early in the process is key to developing a successful sale strategy.

1. Is it the right time for the business owners to sell?
    - o Why do they want to sell and what do they hope to achieve? Are their objectives reasonable?
    - o Are the owners prepared for the sale process and post-transaction life?
2. Is it a good time for the company to be sold?
    - o Are current conditions and performance positive relative to its recent history? Are they sustainable?
    - o Is the company ready to be presented and transferred to a buyer? Are its books in order and its skeletons explainable?
3. Are there any noteworthy timing issues in the company's industry or market?
    - o What's going on now and how will the outlook impact the company and/or its sale?
    - o Are there opportunities or obstacles involving schedules or deadlines?
4. Are there qualified buyers interested in the company when it is ready to be sold?
    - o Would there be a better time for the buyers to transact? Why?
    - o Who are the buyers and what could impact their ability to purchase?
5. Is the timing right in the economy to support the desired transaction?
    - o Is funding available for buyers around the time of the purchase?
    - o What factors will/could impact the deal and for how long will they last or when will they change?
6. Considering that the sale process can take 8 to 18 months to complete, is there time to get the deal done?
    - o Can the owners stay on track, and will business and industry conditions be sustained?
    - o Are there any expected or suspected changes in the economy that could impact the deal, and will buyers still be in the position to close the deal?

So, when is the right time to sell the business? Is there a good time or a bad time? Are there better times and worse times to sell? The answers to these questions are found in an assessment and an understanding of the circumstances specific to the situation at hand. The key to optimizing timing in a business sale is to start a conversation with professionals about selling the business well in advance of the sale.

Considering selling? We are glad to discuss owners' goals, pricing, timing and other key issues. Confidentially contact Andrew Wilusz at: amw@valuemanagementinc.com

Common Factors Impacting Price

The price paid for a business is the meeting of minds between the buyer and seller. Buyers view certain factors as a potential negative that will cause a downward adjustment to value. Sellers would do well to bolster pricing by addressing low-hanging pricing pressure possibilities.

- Dependence on Owner/Key Person
    - o Can the business run without you? If not, delegate, delegate, delegate, or hire and train a replacement, or cross-train others so that they can handle your duties.
    - o Buyers will scrutinize the ***reasons for*** and ***sustainability of*** current revenue and earnings to ensure that they will have the right people needed to get the job done after the transaction.

- Customer/Client Concentrations
  - o A low number of customers or a large percentage of business attributable to relatively few clients may be a pricing issue for buyers because of the perceived risk associated with losing clients.
  - o The quality of the clients, and the length and the quality of the relationship with the customers can mitigate buyer concerns.
- Inadequate and/or Inaccurate Company Records
  - o Trust is needed for buyers to proceed with a purchase. Company documents must be understandable and accurate, especially financial statements.
  - o Operating manuals for the company and/or Standard Operating Procedures (SOPs) are also helpful in reducing risk to the buyer. Buyers want to verify that they get what they are paying for, and that they know how it all works!
- Problems with Management and/or Employees
  - o Lack of managerial depth or ineffective managers negatively impacts buyers pricing perceptions.
  - o High employee turnover or poor relations with employees creates concern for buyers.

Reducing risks (or perceived risks) to the buyer strengthens a seller's pricing profile and puts them in a more favorable negotiating position.

Add-Ons Add Up in 2024

An "add-on" (also known as a "tuck-in") is a term referring to a small business purchased by a strategic buyer or a private equity group making the acquisition to add the business on to an existing, larger company that they own. Put simply, add-ons are add-on acquisitions. The buyer's strategy is often to integrate the relatively smaller add-on into the larger company (known as a "platform") to expand and/or enhance operations and to create and/or benefit from potential synergies. Combining the resources and capabilities of platforms and add-ons can lead to operational efficiencies, cost savings, revenue growth, and hopefully increased profit margins.

In 2023 and 2024, private equity groups in the middle market haven't been as aggressive in pursuing platform purchases. Private equity buyers have been put off by much, including: additional cost and risk associated with higher interest rates, more challenging debt markets, less available debt coverage for platform deals, market condition unknowns, concerns about wars in Europe and the Middle East, and political and economic uncertainty in the U.S. (including 2025 tariff activity). Consequently, many private equity buyers have opted for add-ons, which typically require less or no additional debt. Overall, add-ons are believed to be less expensive and easier to execute than platform purchases.

Because middle market private equity groups targeted smaller companies and more add-ons in 2024, GF Data[1] added a new size category for small transactions with total enterprise value ("TEV") of between $1 million and $10 million. In the first three quarters of 2024, GF Data analyzed 81 such small deals and reported that they traded on average at 5.5x trailing twelve-month ("TTM") EBITDA. Additionally, they found that 75 percent of the smallest TEV deals were add-ons which traded at an average of 5.7x TTM EBITDA.

For all 350 deals reported to GF Data in the first three quarters of 2024 having TEV between $1 million and $500 million, the sale price averaged 7.1x TTM EBITDA. GF Data found that nearly 54% of transactions analyzed were add-ons. This compares to 38% of deals in 2023.

Private equity add-on acquisitions increased in 2023 and 2024, and the relative percentage of add-ons compared to platforms increased notably in 2024. The shift in private equity focus to add-ons makes sense given the current investment atmosphere created by the numerous buyer risk and cost concerns stated above. Unless conditions change for private equity buyers, there is ample reason to believe that add-ons will continue to add up in 2025.

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[1]*GF Data collects information on private-equity sponsored M&A transactions ranging from $10 million to $500 million in enterprise value, as reported by more than 320 active contributing firms.*

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assets. Key findings include:

- For Q4 2023 transactions, goodwill represented 47.5% of enterprise value on average, demonstrating its growing significance in M&A valuations;
- Less than a quarter (23.3%) of Q4 2023 transactions included contingent consideration, averaging 15.7% of enterprise value, indicating an increasing trend toward performance-driven M&A negotiations; and
- Goodwill as a percentage of enterprise value increased in several sectors, including energy, healthcare, industrials, and information technology, underscoring its role in value determination across industries.

Transfers of Decedent's Properties by Nephew Shortly Before Death Were Not a Bona Fide Sale for Adequate and Full Consideration

***Estate of Anne Milner Fields v. Comm'r, T.C. Memo 2024-90; 2024 Tax Ct.* Memo LEXIS 92 (Sept. 26, 2024)**

The decedent's great nephew, Bryan Milner, using power of attorney, implemented an estate plan about a month before the decedent's death. The transfers made were not a bona fide sale for adequate consideration. The timeline cast significant doubt on the nephew's avowal that he was motivated for any purpose other than reducing estate tax.

On May 20, 2016, a month before Anne Milner Fields' death, Milner established AM Fields Management LLC (serving as the general partner) and AM Fields LP. Milner transferred approximately $17 million of Fields' assets to AM Fields LP in exchange for limited partner interest, while AM Fields Management contributed a nominal amount ($1,000) for its general partner role. Fields retained only about $2.15 million in assets outside the partnership after these transfers.

In early May, Fields' health was in rapid decline. She suffered a heart attack and other complications that left her needing intensive care. Her doctor certified her condition as terminal in early June, and she was placed in hospice care shortly afterward. Fields passed away on June 23, 2016.

After Fields' death on June 23, 2016, an appraisal valued her 99.9941 percent limited partner interest at $10.8 million, reflecting significant discounts for lack of control and marketability. The estate filed a tax return with this valuation, but the IRS challenged the plan under section 2036(a), arguing that it included retained interests and was structured to reduce estate taxes. The estate tax liability was calculated at $4.6 million.

Following Fields' death, Bryan Milner initiated probate proceedings in Texas, where he was appointed executor of her estate. Under her will, Fields left cash bequests totaling $1.45 million and a noncash bequest of 6,000 shares of North Dallas Bank & Trust stock.

The court examined whether Fields retained rights or interests in assets she transferred to AM Fields LP under section 2036(a), which could necessitate including these assets in her taxable estate.

The court considered whether Fields retained economic benefits from the assets by examining her financial situation after the transfer. The assets outside of AM Fields (about $2.15 million) were insufficient for the cash bequests and expected estate tax liabilities. Thus, the court inferred an implied agreement that AM Fields' assets would cover her expenses and obligations if needed. This was later confirmed when Milner made posthumous distributions to satisfy bequests and tax obligations.

The court concluded that Fields' retained interests in AM Fields assets aligned with section 2036(a), potentially affecting her estate's taxable value.

In the conclusion regarding section 2036(a), the court determined that the transfers of Fields' assets to AM Fields LP did not qualify as bona fide sales for adequate and full consideration. The court found that the formation of AM Fields lacked a substantial, nontax purpose and was instead motivated primarily by an intent to reduce estate taxes.

It noted that the purported nontax reasons for the partnership's creation were unsupported, as Fields was in declining health, had little financial need for asset protection, and retained control over her transferred assets through Milner, her agent and general partner.

As a result, under section 2036(a), the value of the transferred assets was included in Fields' gross estate for tax purposes.

The court further assessed whether the estate was liable for an accuracy-related penalty under section 6662(a) for substantial understatement or negligence. The IRS argued that the estate's reporting errors met the criteria for negligence or substantial understatement, justifying a 20% accuracy-related penalty. Specifically, the estate's valuation of Fields' limited partnership interest was significantly lower than the IRS' assessment, leading to an underpayment.

The court concluded that estate did not meet its burden of establishing that it "actually relied in good faith on [an] adviser's judgment" (Neonatology Assocs., P.A.), so it did not meet its burden of establishing reasonable cause. The court held the estate liable for the penalty under section 6662(a) and (b)(1).

Earnouts in M&A Deals Are Up Significantly

The inclusion of earnouts in private-company deals increased significantly in 2023, with nearly one-third of nonlife sciences deals containing an earnout provision, a 50% increase from the prior year, according to the SRS Acquiom "2024 M&A Deal Terms Study." Historically, earnouts have been most prevalent in the life sciences sector, but now they are becoming increasingly common across all industries, the study found. Also, the amount of contingent consideration tied to earnouts "ticked up slightly," from 30% of the closing payment in 2022 to 32% in 2023.

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