



CA NEWS BRIEF

Volume 09, Issue 4
*Special Interest
Articles:*

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- Pension Protection Act of 2006
- Court Rules Evidence Submitted by "Expert" is Insufficient
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COURT RULES THAT MARITAL DEBT SHOULD NOT BE OFFSET BY BUSINESS GOODWILL

In RE the Marriage of Lance, No. 6-1073/06-0638, Court of Appeals of Iowa, originally filed on February 14, 2007. After thirteen years of marriage and three children, the Lances filed for a divorce. Among the assets that were to be divided were the family home and a business, Lance Refuse. Lance Refuse is a one-man sanitation business. The original trial judge awarded the home to Mrs. Lance and the business to Mr. Lance. In addition, the judge ruled that Mrs. Lance would be responsible for approximately 84% of an outstanding home equity loan. The proceeds of the loan were used for home improvements, business expenses, credit card debt and the purchase of a boat. Mrs. Lance also received 61% of the gross assets from the marriage. Upon appeal, Mrs. Lance argued that her portion of the debt should have been offset because the client list and goodwill associated with Lance Refuse were income producing assets. Judge Mahan of the Appeals Court ruled that Mrs. Lance's argument was "without merit and not supported by the record" because Mrs. Lance did not present an expert witness or any type of appraisal indicating value, or potential income stream associated with the client list or goodwill of Lance Refuse.

If you or your client are preparing for a divorce proceeding involving the value of a business, be sure to present proper support documentation. For appraisal assistance, please call us.

IRS ADDS NEW PROVISION TO PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 was passed by Congress and signed into law by President Bush. It is hundreds of pages long and buried inside is Section 1219 which adds a new section 6695A to the Internal Revenue Code. 6695A is designed to halt taxpayers who use inaccurate appraisals to avoid paying income taxes, by imposing severe penalties on appraisers who prepare inaccurate valuations. 6695A affects not just professional valuation firms but also business owners who use the old "bar napkin" valuation method when gifting stock to family members and others.

Suppose that a machine shop owner decides, for estate planning purposes, to gift company stock to his wife and children. One evening he visits his favorite neighborhood watering hole and uses the back of a napkin to figure out the value of his shares. (Believe it or not, this method is still used by some). Thanks to 6695A, the IRS would consider the machine shop owner to be an appraiser under the Internal Revenue Code. If the owner's valuation differs from true fair market value by 50% or more, he is subject to fines, audit and much more. Worst of all, the IRS can easily tell when a valuation is prepared by an amateur because *a copy must accompany the gift tax return.*

PENSION ACT (CONT'D)

Whether you are a business owner, CPA, attorney or a financial advisor, don't get caught by 6695A, call us for an accurate fair market valuation and avoid this very real pitfall.

COURT RULES EVIDENCE SUBMITTED BY "EXPERT" IS INSUFFICIENT

M&A Technology, Inc. ("M&A") v. IValue Group, Inc. ("IVG") and Ross, No. 08-08-00022-CV, Court of Appeals of Texas, Eighth District, El Paso, August 12, 2009. In the original case, the 44th District Court of Dallas County, Texas ruled in favor of IVG/Ross and awarded \$3.0 million in actual damages plus \$6.0 million in exemplary damages to M&A.

IVG, a start-up technology company, hired an expert witness to support its claim of damages. The expert was a partner in a firm that provided economic consulting, forensic accounting and valuation services. The expert also possessed a Bachelor's and Master's Degree in Accounting and held a doctorate of jurisprudence. He has served as an adjunct professor at several universities, speaks nationally and has been published numerous times on the issue of damages. The expert used three methods to value IVG's damages; a Market Method (\$3.5 to \$4.8 million), an Income Method (\$2.6 million) and a Cost Method (\$1.4 to \$1.8 million). The Income Method used was a Discounted Cash Flow analysis of future income streams. The expert conducted his Market Method by using multiples of gross revenues from similar businesses and applying those multiples to forecasted revenues. The Cost Method estimated what it would cost to rebuild IVG.

In writing the Court's opinion, Judge Rivera found that IVG was a start-up business without any historical revenues or earnings and therefore, revenue and income forecasts were "pure speculation". The Court stated that "revenue forecasting, as in a lost income analysis, must be based on objective facts or data and established to a reasonable certainty." Therefore the values provided by the expert, using the Income and Market Methods, were deemed to be "incompetent" and were rejected. The value determined using the Cost Method did not support the jury's award of \$3.0 million in actual damages and was therefore not ruled upon.

When choosing an appraiser to serve as an expert witness, look beyond the "surface" qualifications and make sure that your expert has the proper credentials from one or more of the three business appraisal organizations (American Society of Appraisers, Institute of Business Appraisers or National Association of Certified Valuation Analysts). For valuation assistance from qualified appraisers, call us.

COURT RULES IN FAVOR OF FLP

A wealthy Texas widow, utilizing financial and legal advisors, formed a family limited partnership ("FLP") which was to be funded using \$250 million in bonds. Within days of signing the papers, and before funding could take place, the widow passed away. Her advisors, believing that because funding did not take place before death, ceased their efforts. A year later, *Church v. U.S.*, 2000 WL 206374 (W.D. Tex.), was decided in favor of an FLP, even though the principle

*Expert witnesses should
be properly
credentialed.*

FLP (CONT'D)

died just prior to funding. Because of the favorable ruling in *Church*, the advisors completed the transfer of assets into the FLP and claimed an estate tax refund for the amount of its discounted values.

The federal district court in *Keller v. U.S.*, 2009 WL 2601611 (S.D. Tex.) approved the FLP. In addition, the court discounted the FLP's assets for lack of marketability and lack of control at a combined rate of 47.5%. The court, in its August 20 ruling, discredited the government's undiscounted appraisal. It found that the government's appraisal violated the fair market value (FMV) standard by considering real (rather than hypothetical) buyers and sellers, and by speculating as to subsequent events. The court found that the planner's careful and detailed efforts to establish the FLP coupled with the decedent's clear intent to transfer the \$250 million in bonds prior to her death established a legitimate purpose and adequate consideration.

If you or your clients require credible appraisal services, please call us.

Detailed planning and clear intent are necessary for a successful FLP.

MAXIMIZING VALUE

In our last issue, we pointed out that owners willing to sell their business needed to pay attention to improving discretionary cash flow and maximizing their company's value drivers. In this issue, we will discuss some other areas which can improve value.

During the valuation process, an appraiser usually has to determine a company's Discount Rate. The Discount Rate is the required rate of return that an investor would demand, based on risks associated with the income stream under consideration, to induce him to make the investment. Obviously, the greater the uncertainty, the greater the amount of risk and the higher the risk, the less an investor is willing to pay for something.

One of the risk components used to determine the Discount Rate is the Company Specific Risk Premium. There is no objective source of data to properly reflect the specific risk premium of a particular company. The appraiser must use his judgment and experience to quantify this factor. Some of the elements used to determine a company's risk premium can include depth of management and quality of management. Most small companies will not have a lot of depth in management. Usually they are highly dependent upon one key person, the owner. However, larger companies can and do have other key personnel who can greatly assist a new owner during his learning period. In either case, the appraiser will also be looking at the quality of those individuals as well as the overall management of the company being valued. The appraiser can be asking himself: Does the business have adequate management to achieve the business goals? Does management have written goals to achieve? Does management have proper internal controls in place to help attain these goals?

As an owner, you need not only to assess your management team but also place yourself in a potential owner's shoes and evaluate your management processes. In addition to the normal factors that increase value, companies obtaining higher prices usually have other characteristics in common, including: written annual forecasts/budgets; periodic review of actual results to forecasted results (with appropriate corrective actions); written policies and procedures; written job descriptions for key personnel;

Increase your Company's value through organized management techniques.

MAXIMIZING (CONT'D)

written limits for authority and responsibility set forth for the management team. Having these key items in place, will help to reduce a company's specific risk premium. Remember, the more organized a company's management processes are, the more likely a buyer will pay an owner's asking price.

If you are considering selling your business and need assistance in identifying and improving your company's value drivers, please give us a call. We have staff members who are qualified to assist you in this area, as well as provide you with a credible valuation of your business.

SBA ISSUES SOP50-10(5)(B)

The U.S. SBA has updated its primary policy document related to "change of ownership" loans which require the services of *independent* and *qualified* business appraisers. SOP50-10(5)(B) has an effective date of October 1, 2009 and has 1) elevated the goodwill cap to \$500,000 and 2) allows preferred lenders to fully process even greater amounts of goodwill when the combined equity totals 25% or more of the purchase price.

The specific situations requiring independent business valuations include loans involving "related" parties (parents to children) or a total loan amount greater than \$250,000 (less the portion attributable to real estate and equipment). Readers interested in more detail can go to <http://www.sba.gov> and enter SOP into the search engine.

For *independent* appraisals by *qualified* business appraisers, call us.

*SOP50-10(5)(B)
increases goodwill cap.*

CA APPRAISER HIGHLIGHTS

THIRD PARTY HASSLES

CA's sister company (Advanced Business Brokers, Inc.) recently announced the successful sale of Total Choice Communications, one of the largest Sprint Cell Phone distributors in Texas. The founders of Total Choice commended ABB for their expertise in valuing the business and putting together a marketing package that properly represented the business. Keeping this information confidential while the business was being marketed was a major concern of the founders, as they did not want customers, suppliers and the general public to be aware of a pending sale. This was an especially difficult sale due to all the third parties that were involved in the transaction: accountants and attorneys for both sides; eight landlords; Sprint management; employee benefit plan administrators; a payroll service; and, assignees of contracts for phone systems and equipment leases. Any one of these parties could have caused the whole deal to fall apart. For example, one of the landlords wanted \$4,000 just to assign the existing lease to the buyer. Fortunately, Jeff Jones, President of ABB, was able to communicate with all involved parties and get the deal done to everyone's satisfaction.

If you or a client needs assistance in selling their business, please call us. Our organization is more than just appraisers.

If your business sale is complicated, make sure you have experienced assistance.

HISTORICAL FARMER'S MARKET VALUED

Certified Appraisers, Inc. was contracted by Farmer's Market Association Of Houston, Texas, Inc. an evaluation of their eighteen acre plus facility at 2526 Airline Drive in Houston. The function and use of this appraisal was to provide the management with value considerations regarding a proposal to purchase the subject Company and the related real estate.

The Farmer's Market Association Of Houston, Texas, Inc. was originally formed in 1942 by local farmers who began the operation on four acres of land they had acquired. In 1942, when the market opened as a cooperative, it was supplied by local German, Italian and Japanese farmers. By the 1980s, Hispanic vendors and buyers began frequenting the market, and today 90 percent of the customers are Hispanic. By 1989, the farmers market had become a meeting place for Hispanic vendors and their customers. No major or controlling interests in the Company have been transferred since its inception.

The Company's farmer's market is Houston's **largest** market for fresh produce. It leases buildings and warehouse space to third party vendors for specific contract terms, which generally provide for beginning of monthly rental payments. Vendors sell produce raised in Mexico, California, Florida, and the Rio Grande Valley.

The completeness and accuracy of Certified Appraisers analysis was considered invaluable by Farmers Market in making the decision to pass on the offer to purchase.

If you or client owns unique commercial property and requires an accurate appraisal, call us.

Bio of the Author:

Jack Bell holds a Bachelors Of Science in Business Administration from Tennessee Technological University as well as a Real Estate Course (Core Courses) Completion Certificate from East Tennessee State University. He is a designated member of: The American Society of Appraisers (ASA), and The International Association of Assessing Officers (IAAO). Jack holds the following professional licenses: Texas State Certified General Real Estate Appraiser, Texas Real Estate Broker, State of Texas Senior Property Tax Consultant.

Jack has appeared as an expert witness in numerous commercial real estate valuation and assessment appeals lawsuits. Other activities include: Life Member - Houston Livestock Show and Rodeo
Current Member - The Napoleonic Alliance.

*Historical commercial
real estate valuation
helps owners decide not
to sell.*

VALUATION OF A COVENANT NOT TO COMPETE

INTRODUCTION

In valuation cases involving partial ownership interests, the standard of value to be utilized, the size of the ownership interest, and the related discounts must be considered in reaching a final opinion of value. When the assignment

COVENANT (CONT'D)

calls for valuing an ownership interest on a Fair Market Value basis, the effective and supportable use of Discounts For Lack of Control and Lack of Marketability must be analyzed and applied. When the assignment calls for valuing an ownership interest on a Fair Value Standard, it usually means valuing the interest on a pro rata basis of total company value unless other factors dictate a discount. The Standards of Value relating to Fair Market Value and Fair Value assume a willing seller who would sign a normal covenant not to compete. In the event the seller is not willing to sign such an agreement, a discount would typically be required to account for this unusual circumstance.

Whether a buy/sell agreement calls for fair market value or fair value, the assumption is that the seller will sign a covenant not to compete. In the event the seller is unwilling to sign a covenant not to compete or will only sign a limited covenant that would allow the seller to compete in certain aspects of the business, such as a Non-Piracy Agreement, buyers are not willing to pay the same value as if there were a complete covenant not to compete.

This article will describe the process of valuing a covenant not to compete or the lack thereof. No consideration has been given to other discounts such as lack of marketability or lack of control which would determine the fair market value of the subject ownership interest on a minority ownership basis.

DISCOUNT FOR LACK OF A COVENANT NOT TO COMPETE

The concept of Fair Market Value assumes a willing seller who will do all the things necessary to facilitate the sale of a business or partial ownership interest therein, and a willing generic buyer who expects to be able to obtain and maintain the tangible and intangible assets being acquired. A normal consideration in most all merger and acquisition transactions is for the selling entity to enter into a Covenant Not To Compete within a specified territory for a specified length of time to protect the buying entity from potential loss of customers, employees, and future business. In the event the seller violates the terms of the covenant, a monetary penalty and/or reduction in the price paid for the entity can be assessed by the Courts.

If the terms of the covenant not to compete are reasonable, and if the seller is truly being compensated for giving up his/her right to forego opportunities that would place him/her in competition with the purchaser, then the payment allocable to the covenant constitutes ordinary income to the seller, and the buyer is entitled to amortize the cost of the covenant over the life of the agreement.

Valuation Methods

The value allocated to the covenant must reflect economic reality. In making this determination, the courts have looked to the same factors as those listed in the discussion of the economic reality test.

The value of the covenant to the purchaser comes from the increased profitability and the likelihood of survival of the newly-acquired enterprise that the covenant affords. The value to the seller, on the other hand, is measured by the opportunities foregone to reenter a particular market for a given period.

One method to value a covenant is the compensation-based approach. Under this method, the covenantor's (seller's) average compensation (including salary, bonuses, and benefits) is calculated, this amount is projected over the life of the covenant, and a discount rate is applied to adjust the figure to present value. This method measures the loss of earnings anticipated by the seller as a result of his forbearance from competing in the specified market.

In some complex buy-sell agreements, however, a court may find the

In the event the seller is unwilling to sign a covenant not to compete, buyers are not willing to pay the same value as if there were a complete covenant not to compete.

COVENANT (CONT'D)

compensation-based approach too simplistic. Valuation texts, in discussing covenants not to compete, refer to a second method which values what the buyer acquired: protection of the continued profitability of the business from the seller's hostile use of his or her contacts in the market.

This method calculates the present value of the economic loss to the buyer on the assumption that the seller reentered the market. Such an approach was sanctioned by the Tax Court in *Ansan Tool and Manufacturing Co. v. Commissioner*, T.C. Memo. 1992-121, where the compensation-based method was determined inadequate for the unique arrangement between the taxpayer and the seller in a stock buyout.

There are situations where the same parties execute both a covenant not to compete and an employment contract. Both agreements need to be evaluated carefully because their provisions may overlap, and thus, so may their values. An employment agreement may convey similar benefits and cover the same time period as a covenant not to compete, and arguably its value is not separate and distinct from the value of the covenant.

Any consideration paid for a bonafide covenant not to compete forms the cost basis of a fixed-life, depreciable intangible asset. However, a covenant not to compete is not amortizable unless the objective facts show that (1) the covenant is genuine, i.e., it has economic significance apart from the tax consequences, (2) the parties intended to attribute some value to the covenant at the time they executed their formal buy-sell agreement, and (3) the covenant has been properly valued.

MEASUREMENT OF ECONOMIC IMPACT ON BUSINESS VALUE DUE TO SELLER'S ABILITY TO COMPETE:

Whenever there are more than one owner of a business, the parties should enter into a Buy-Sell Agreement that sets forth the terms and conditions upon which a member may sell their ownership interest. The buy/sell agreement should cover what is known as the 4 D's being divorce, death, disability, and dissolution. Each of these scenarios involves the sale of an ownership interest. The buy/sell agreement should address issues such as the standard of value to be utilized, who has the right to buy the ownership interest, whether or not the entire ownership interest can be sold, whether a partial ownership interest can be sold, and the procedure for obtaining a valuation of the ownership interest. Under any standard of value, except for some form of liquidation value, the seller will be required to sign some form of a covenant not to compete or at least the valuator will make that assumption. However, when it is known that the seller is not willing to sign a covenant not to compete, then the valuator is faced with valuing the ownership interest given this provision.

The value of a covenant not to compete or the lack thereof can be determined by measuring the economic impact on the business during the period of the covenant. Texas courts have generally restricted covenants not to compete to no more than five years on the basis of not wanting to prevent a person from being able to earn a living at their chosen profession for long periods of time. Furthermore, covenants are limited to the market area in which the business is currently doing business and/or to those customers and clients being served by the subject business. The measure of impact on future earnings for the next five years can be determined as follows:

- Develop a Discount Rate for the lack of a covenant not to compete that reflects the risk factors of a seller reentering the market place and competing with the subject Company resulting in economic damages.

COVENANT (CONT'D)

- Forecast future earnings for the specified period covered by the covenant not to compete.
- Determine the present value of future earnings for the subject Company for a period equal to the term of the covenant not to compete.
- Apply the Discount Rate for Lack of A Covenant Not to Compete to the present value of the forecasted earnings.

In a recent appraisal assignment, a partner owning a 45 ownership interest in a high technology firm manufacturing measuring devices for the petrochemical industry has announced to the two other partners that he wanted to sell his ownership interest. Per the terms of the buy/sell agreement, the partners hired Certified Appraisers, Inc. to determine the value of the company. The terms of the buy/sell agreement call for the ownership interest to be valued based on the standard of value known as Fair Value, meaning pro rata of total company value, by an independent valuation expert.

The company and then the remaining partners had first right of refusal to purchase the ownership interest. In the event that the company nor the other partners choose to purchase the ownership interest, then the departing partner has the right to sell to a third party. We were initially hired to conduct the appraisal of the business. Before the appraisal report was completed, the selling partner left the firm and joined another firm who is in a similar industry and could certainly benefit from the knowledge and experience of the departing partner, much to the surprise of the remaining partners. None of the partners had signed a covenant not to compete and the departing partner stated that he had no intention of signing one. We were then asked to determine the value of the subject ownership interest given the knowledge that the departing partner will not sign a covenant not to compete.

We had to determine the potential economic impact the departing partner can have on the revenues and profits of the company and then translate this impact into a dollar amount which is then used to discount the pro rata value of the departing partner's ownership interest. Knowing that a covenant not to compete is only enforceable for five years, the key is to determine the impact on company earnings for a five year period of time. Thus, a five year forecast of earnings is made discounted to present value using the company's cost of capital as the surrogate discount rate. Then it was necessary to develop a discount rate applicable to the forecasted earnings which results in the forecasted economic damages.

The original appraisal shows the pro rata value of the 45% ownership interest to be \$720,000. The economic damages were forecasted to be \$491,000, resulting in a final opinion of value for the subject ownership interest being \$229,000. This resulted in being a 68.2% discount from the pro rata value of the ownership interest.

While the process seems straight forward, the actual analysis and development of the economic damages for a lack of a covenant not to compete should be conducted by an experienced business appraiser who is well versed in these methodologies and founded in the economic reality of the market place.

Bio of The Author:

Jeff Jones is President of Certified Appraisers, Inc., where he manages the firm's multidiscipline appraisal practice that includes valuation of businesses, machinery & equipment and real estate. As President of Advanced Business Brokers, Inc. he and his staff have been involved in the sale of over one thousand small and midsize businesses since 1976.

COVENANT (CONT'D)

He frequently testifies in depositions and courts of law as an expert witness on business valuation litigation matters. His clients include closely held companies, publicly held companies, financial institutions, the IRS and other governmental agencies.

Jeff is the co-editor of two books published by John Wiley & Sons: "Handbook of Business Valuation" and "Mergers and Acquisitions Handbook For Small and Midsize Companies".

Jeff holds a Masters Degree from Pepperdine University. He is licensed by the Texas Real Estate Commission and the Texas Securities Commission. He is a designated member of the American Society of Appraisers (ASA); the Institute of Business Appraisers (CBA); Texas Association of Business Brokers (BCB); and is a Fellow of the International Business Brokers Association (CBI).

APPRAISING CUSTOM MADE TOOLS

It happens with some frequency that the appraisal of machinery and equipment involves rather specialized and custom fabricated equipment for the manufacture of one-of-a-kind tools. This is especially true of the petroleum industry and, in particular, the equipment required for the exploration for or the production of oil and gas. Custom equipment used in such manufacture can involve grinders, mills, EDMs, lathes and the like.

Custom made manufacturing equipment is like other metalworking equipment except designed for unusual length, diameter or weight of the work piece as is not available in the normal metalworking equipment marketplace. The appraiser must be aware that custom equipment is, by definition, different from standard equipment, but must be also aware that normal engineering costs cannot be allocated over the production of multiple machines. Thus, the cost approach is important for realistic valuation of such specialized equipment. Much specialized equipment built for single applications has extremely high cost and is most usually "farmed out" to a custom builder to control costs and accounting. Therefore, the acquisition expense of custom equipment is a valuable indicator of original value. It is further the responsibility of the appraiser to recognize the technology utilized in comparison to technology associated with later manufacture.

Obsolescence depreciation can be difficult to assign. A machine that works with plastics, such as polyurethane, will show considerably less wear over time than one that works with steel or ductile iron, or, even worse, with high-carbon steel or carbide. Such machines, regardless of type, will display considerable wear, loose slides, gearing, adjusting mechanisms and general tolerances, almost regardless of age. Grinders are especially vulnerable.

Bio of the Author:

Russell Knapp has been engaged in the appraisal of Machinery & Equipment, Structures and Fabrications, and Holdings since the 1980s. Educated at The University of Texas-Arlington, he has held significant posts in Cost Analysis of various equipments in Europe, Asia and the U.S. As Machinery & Equipment Appraiser for Certified Appraisers, Inc. he has undertaken appraisal assignments throughout the United States and Mexico. His experience includes all types of manufacturing machinery, inventory, shop accessories, office furniture and fixtures and other related assets. He has four grown children and resides in the greater Houston area.

Certified Appraisers, Inc. is unusually qualified to appraise businesses, commercial real estate, practices, and machinery and equipment. Your inquiry is maintained in confidence and qualified personnel are always assigned to address your specific needs. Call for a confidential discussion of your appraisal needs.

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About Our Organization...

Certified Appraisers, Inc. is a multi-faceted appraisal firm specializing in the valuation of closely-held businesses, intangible assets, lost profits and economic damages, machinery & equipment, and commercial and residential real estate. Certified Appraisers, Inc. is headquartered in Houston and founded in 1988.