

Business Valuation Notes

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Daubert Hearing

APPRAISER FILE KEEPING UPHELD

Keep Opinion Support

A recent court ruling has affirmed a valuation expert's right to keep a tidy file, not being forced to keep every worksheet or draft prepared during an engagement, while refusing to have experts who had done so from being excluded under a *Daubert* hearing.

MBVG President Randall Schostag said, "The ruling is important because most of the work an appraiser does is in contemplation of potentially going to court to defend the findings. When closing the working files after a case is finished, the appraiser typically tosses away the non essential papers which accumulate during the analysis and report writing, including 'candy wrappers' and other, doodling, scraps, and notes. Our training is very clear that the essential 'must keep' paperwork is that which pertains to our conclusions and the manner in which they were derived."



Schostag

The question of a valuation expert's file maintenance was raised in the matter of the University of Pittsburgh, plaintiff, versus David W. Townsend; CTI

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Developing Practical Valuation Methods...

ACADEMIC RESEARCH SUPPORTS PRACTICE

Academic research is raising doubt about multiple regression analyses of economic variables to ascertain intrinsic value for a security pricing while advanced discounted cash flow models driven by economic driver variables produce better measures due to back test results and tracking errors.

MBVG President Randall Schostag said, "This isn't black box stuff. It has direct implications for valuing private companies and especially for those portfolios of securities, both private and public: hedge funds or individuals with larger holdings."

The question of modeling has been raised by the Practitioner Demand Driven Academic Research Initiative (PDDARI), a joint effort of the Financial Management Association International (FMA) and practitioner professional associations such as the Chartered Financial Analyst's Society of Chicago, Illinois. PDDARI is facilitating the development of research for practitioners and encouraging interaction between the practitioner and academic communities.

MBVG Principal Rawley Thomas is PDDARI chairman, PDDARI has launched a 'Request for Academic Re-

search' for *Cross Sectional Analysis of Return, Risk and Attribution*, an initiative drafted by the CFA Society of Chicago.

Included in early results, Andrew McElheran, Hewitt Associates, has requested "...any existing empirical models..." which demonstrate "...the degree of correlation that a given financial metric or set of metrics might have to shareholder value creation." He noted that he has built some multiple regression models to test this questions, "...but thus far I am not getting interesting R-squareds for any of the analyses."

MBVG believes the early results important because appraisers generally and the securities industry in particular have relied on models using multiple linear regression techniques for assessing the pricing of publicly traded securities.

Schostag said, "PDDARI is early in evaluating various methods being used for publicly traded securities, but even now it's clear that some accepted methods must be reconsidered."

Schostag noted although the methods of evaluating intrinsic value of publicly traded common stock and the to appraise privately held common stock have been developed in two separate



Thomas

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Daubert Hearing

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Molecular Imaging; and CTI Pet Systems, Inc., Defendants, in the Tennessee United States District Court, E.D., No. 3:04-cv-291. Judgment was rendered March 30, 2007.

Defendant has moved the court to exclude testimony of plaintiff's experts based on spoliation and destruction of evidence. The defendants contended that the appraisers (and plaintiff's counsel) admittedly destroyed copies of emails and previous drafts of their reports. Defendants argued that as a result of this spoliation, the defendants were unfairly prejudiced and denied the opportunity to cross-examine the experts as to counsel's contributions to the expert reports.

Plaintiff argued that before subpoenas were served and shortly before their depositions, "...there was no outstanding discovery request asking for the drafts of any expert reports, and that no documents were destroyed once the subpoenas were served." Plaintiff also argued that email communications and draft reports are not evidence and raised inherent issues of privilege and work product. Finally the plaintiff argued the defendants had the opportunity to fully depose the experts and had not suffered any prejudice.

The court noted that under *McDaniel v. Transcender, LLC*, 119 Fed. Appx 774, 782, 6th Cir, January 31, 2005, "Spoliation is the intentional destruction of evidence that is presumed to be unfavorable to the party responsible for the destruction." The court stated that such findings and appropriate sanctions are 'determined by state law', in this case Tennessee. The court found that, "This inference arises, however, only where the spoliation was intentional, fraudulent, and done with a 'desire to suppress the truth.'

In the ruling the court observed that it did not interpret Rule 26(a)(2) of the

Federal Rules of Civil Procedure to impose an 'affirmative duty' upon an expert to preserve 'all documents,' particularly draft reports, and stated that the defendants had not cited any support for such a 'sweeping obligation.'

Part of the defendant's problem in the matter may stem from their own sweeping request. The court noted that defendant's request sought production of "...all documents provided to or by you to, revised by, relied upon, or otherwise used in consultation with or as a basis for consultation with, any expert witness..." Concerning this 'awkwardly worded request', the court said, "the Court finds that this request, served well over a year prior to the date that any expert disclosures were required to be made, to be an unreasonable request, essentially imposing a continuing obligation on a party to disclose any document from an expert - whether it be a letter or a draft report - as it is received through the consultation process. Such a requirement would virtually nullify the expert disclosure deadline established by the Court," they wrote.

The court did find that plaintiff's counsel acted improperly when it destroyed emails in light of pending discovery requests, but did not find it was done with any fraudulent intent. Therefore, it also did not impose any sanctions on counsel.

The court wrote that it "...declines to impose such harsh sanctions as the wholesale exclusion of an expert for an infraction of this nature. For the foregoing reasons, Defendant's Motion to Exclude Expert Testimony Based on Spoliation of Evidence is DENIED."

Schostag said that while this is not new law and that though it was decided in a Tennessee court, the findings should give comfort to experts and counsel about file keeping. "As an expert witness, there are plenty of issues which must be considered," Schostag said. "Anything which can reduce the uncertainty is welcome."

SETTING TAXABLE DATE: WARRANTS WHEN ISSUED OR EXERCISED?

The United States Tax Court has determined in a case filed this month that warrants which were issued for service should have been taxable in the year and at the value the warrants were at when issued rather than in the year and at the value when the warrants were exercised.

That conclusion was entered May 8, 2007, by the US Tax Court (128 T.C. No. 13) in the case of *Kevin B. Kimberlin and Joni R. Steele, et. Al., versus Commissioner of Internal Revenue (Internal Revenue Service)*.

MBVG President Randall Schostag said the decision is worth examining to assess in what instances it may be used and if it will be the basis for similar cases where such warrants have resulted in huge tax liability for other tax payers.

In 1995 warrants were issued to the petitioners, Kimberlin and Steele, for acting as agent in the sale of a client company's preferred stock to investors in a private placement. In 1997 the petitioners exercised the warrants. The IRS subsequently sent petitioners a notice of deficiency to taxes due, declaring that income from the warrants was taxable for the 1997 year and citing Section 83 of the Internal Revenue Code.

The tax court held, however, that the use of the 1997 value was in error, that the fair market value on the date of the grant in 1995 reflected the correct value which had been transferred in connection with the services rendered, and that the earlier date should, therefore, have been used.

"We at the Minnesota Business Valuation Group have been approached in the past by stock brokers - investment bankers - who may have suffered from a similar situation," Schostag said. "Because the brokers provided services very early in developmental growth of

PDDARI

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worlds, MBVG has been trying to assimilate academic theory of both communities.

Replying to McElheran, Thomas said, "In my experience multiple regression is the wrong technique to identify firm economic drivers of stock price levels and changes. Multiple linear regression produces less than satisfactory results because it fails to separate multicollinearity of the independent variables and fails to recognize the non-linearities in the relationships.

"The lack of an underlying theory of economic discounted cash flow makes their approach like data mining to find reduced forms of relationships. Findings are unstable across firms and through time."

In layman's terms, these multiple regression models use numbers which proxy for DCF effects and fail to use direct data from real value drivers: cash economic return for investors and related real growth rate, size, leverage, dividend policy, trading costs, and excess cash.

"Many existing models are trying to include a whole series of economic and other measures simply because the measures are available," Thomas said. "The fact is models have not focused on the dominant economic drivers which contribute to the real value which investors seek. The creators either have not been grounded in valuation theory or have otherwise avoided using the value drivers correctly in their models. Furthermore, the modeling has failed to incorporate critical empirical back testing to validate the findings across the universe of public companies for a decade with the fewest degrees of freedom."

The request for *Cross Sectional Analysis of Return, Risk and Attribution* by the Chicago CFA Society is principally designed to achieve a ranking and fundamental indexing for a comprehensive analysis of portfolios over time. The goal is to determine not only the return

characteristics, but also use the return distributions to measure risk in the investment process and identify the key drivers to both return and risk. MBVG welcomes readers' input and will forward questions or observations to PDDARI.

MBVG has been engaged in a three-year development effort to develop a way to value the securities of large portfolios with multiple holdings of private and public securities so that valuations of those portfolios can be achieved on a timely basis and with costs which are less than would be required using conventional valuation methods.

"The price to value a single company's equity using procedures now generally accepted by the Uniform Standards of Professional Appraisal Practice or USPAP may range from \$8,000 to \$20,000," Schostag said. "The Financial Accounting Standards Board or FASB and the SEC are now considering requiring hedge funds to have periodic appraisals of their holdings. Imagine the cost to the portfolio companies if required to use present methods which are accepted in a court of law."

WARRANTS

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some firms, there was little in the way of cash which the client companies could use to pay the brokers. Brokers accepted warrants in lieu of cash. Where companies were successful and the broker exercised the warrants, the full amount was due and payable as a tax liability at the time of exercise, even if the broker had not sold any of the shares acquired by the exercise."

Schostag observed by the time brokers were aware of the tax due, the share prices may have declined so the sale of all of the shares did not cover the income tax. "In one case, this forced a taxpayer into bankruptcy," Schostag said. If the warrants were taxable at the time of issue rather than later at the time of exercise,

Schostag believes the tax impact would have been minimal and the taxpayer would not have suffered the significant financial loss.

"At MBVG we are not lawyers," Schostag said. "We try to follow important case decisions for our clients. Any final determination must be evaluated by competent legal counsel."

In the Kimberlin / Steele case, Judge Foley said the warrants had a readily ascertainable fair market value in both 1995, the date of grant, and 1997, the date of exercise. However, Judge Foley determined that 1995, the grant date, was when the petitioners had constructive receipt of income: dividend, return of capital, or capital gain.

The firm issuing the preferred stock which was sold was Ciena Corp, a Delaware corporation formed to develop and market dense wavelength division multiplexing systems for long-distance fiber optic telecommunications networks. Ciena planned several private stock offerings and a subsequent initial public offering.

Through a wholly-owned investment company (INNO), Kimberlin raised capital for Ciena, beginning in 1993 when it raised \$190,000 in seed capital and a \$300,000 letter of credit. Subsequently Kimberlin agreed to attempt to raise \$3 million to \$5 million in a private placement offering. In exchange for this undertaking, Spencer Ventures was to receive a cash commission of 10% and stock warrants, exercisable at \$5 per share for five years.

Ciena did not use Spencer Trask, however, but pursuant to part of the private placement agreement, a court subsequently ruled that Ciena must issue warrants to Spencer Trask. In 1997 Ciena held its initial public offering. In 1998 Spencer Trask filed an amended return for 1995 reporting \$13,500 of income relating to receipt of the warrants. In 2005 the IRS notified Spencer Trask of a deficiency for 1997, saying that the warrants received resulted in \$43,950,000 of taxable income as opposed to \$13,500.

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