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ROUTE TO:

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Financing Issues

Money is Cheap But It's Hard to Get

"Now that money is cheap, why is it so hard to get?" is a common question in the M&A world – especially among financial buyers. The reality of today's marketplace is: interest rates are low; the economy appears to be improving although this may be suspect because information seems to be changing on a daily basis; and deal flow seems to be picking up but the quality of the deals may be somewhat average. Many are convinced that the better deals are on the sidelines until sellers can achieve their expectations.

Lenders are also providing insights into the financing of transactions. The same observations discussed here generally apply to refinancing of businesses as well. Generally, lenders are:

- More focused on asset-based loans in today's market than on cash flow loans;
- Looking more closely at the coverage ratios;
- Not willing to take the risks that they once did, thereby making it more difficult to close the deal;
- Insisting on outside appraisals of the actual assets they are lending against to further verify the underlying value. These appraisals can dictate the loan amount;
- Typically lending at some percentage of orderly liquidation value which further depresses the ability to get a deal done.

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If you consider those financial buyers that are insisting on receiving the same returns that were available during the 90's bull market in the context of the current lending environment, you will understand what is happening in the marketplace. So, what are the options for getting a deal done in today's market?

- Put more real equity in the deal;
- Ask the seller for better terms or finance more of the deal; and/or
- Work with lenders to get more of a stretch piece if cash flow is strong. Some lenders might be able to stretch up to 10% to 15% of an asset-based deal if they are comfortable with the asset quality.

What can we expect going forward? In addition, lending should loosen up because of the availability of money but probably not at the late 90s and early 2000 levels. Deal flow should also pick up as expectations adjust to the reality of the current marketplace. There is money available from lenders and equity groups have money. If sellers can come to terms with the current reality, equilibrium will return to the marketplace and deals can get done. ♦

Divorce Engagements and Valuation Terms

With the evolution of mediation requirements, divorcing parties and their advisers are discovering the importance of early involvement by a qualified valuation professional. Defining the engagement and understanding the requirements of the work product is crucial. Unfortunately, there may be a lack of understanding as to what a "valuation" is. In fact, there are different products and services that may fit the need (see Table 1 on page 4). Report documentation, analytical procedures and assumptions, and fee structure can be greatly affected by the nature of the chosen product or service. For the purpose of this article, we will focus on "limited appraisals" and "valuations or full appraisals."

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Darrell V. Arne Future Speaking Engagements

Maximizing the Value of the Closely Held Company

11/11/02 International Business Brokers Assn.
Los Angeles, CA

Advanced M&A Tax Strategies and Deal Structures

11/12/02 International Business Brokers Assn.
Los Angeles, CA

Succession Planning: Exit Strategies for the Privately Held Company

11/07/02 American Institute of CPAs
Souix Falls, SD

12/05/02 American Institute of CPAs
Jackson, MS

Descriptions of the courses offered
by Darrell Arne can be found
on our website

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Case Law Update

Dunn v. Commissioner

(Docket No. 00-60614, 5th Cir.)

Background. In August 2002, the 5th Circuit Appellate Court reversed and remanded a 2000 Tax Court decision regarding the *Estate of Beatrice Dunn* (TC Memo 2000-12). Beatrice Dunn's estate owned almost 63% of the Dunn Equipment Company ("Dunn"), a family owned, privately held, heavy equipment rental facility. The Tax Court made an extensive valuation analysis. The Tax Court concluded that the decedent's 63% block of stock gave her operational control, but did not give her the power to compel liquidation or

merger. This required a 66.67% block under Texas law. The Tax Court concluded that the decedent could not likely garner votes to obtain that super majority and also concluded that the process of liquidating would be long and expensive. Therefore, liquidation was not imminent. The Appellate Court did not find any error in the lower Court's findings thus far.

The Tax Court's valuation analysis included an earnings-based value (\$1.3 million) and asset-based value (\$7.9 million). The asset-based value included a 5% factor for built-in capital gains liability, not the actual rate of 34% Dunn would have incurred. The Court weighted the earnings-based approach 35% and 65% to the asset based approach. The Tax Court then assigned a 22.5% discount, consisting of 15% for lack of marketability and 7.5% for lack of super-majority control. The Tax Court's valuation conclusion was \$2.74 million, versus \$1.64 million by the Estate and \$4.43 million by the Commissioner. The Appellate Court was only asked to review the appropriate discount to apply to the value of the assets of Dunn to account for built-in tax liability and the relative weights to apply to each valuation measure.

Appellate Court Decision. In previous cases, the Tax Court has deemed appropriate a discount to reflect the built-in capital gains tax liability. The Appellate Court found the Tax Court's conclusion that a buyer of operational control of Dunn would not seek a discount to reflect built-in tax liability, absent the buyer's intent to liquidate, to be fundamentally wrong. The Appellate Court indicated that "as a matter of law, the built-in tax liability of this particular business' assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of the Company." Therefore, the discount should be 34%. The 5th Circuit also indicated that the Tax Court's consideration of the likelihood

of liquidation was flawed. The Appellate Court indicated that when applying the asset-based valuation method, it must be assumed that all assets will be sold, noting that the earnings approach considers value if the assets are retained.

The Appellate Court agreed with the Tax Court's determination that the likelihood of liquidation was minimal. The Appellate Court notes, that given the Tax Court's analysis, the earnings approach should be weighted more. The Appellate Court indicated that this is reversible error.

On remand, the Tax Court is instructed to give the earnings-based value a weight of 85%, and the asset-based approach 15% weight. The Tax Court must apply a 34% discount to the asset based conclusion to reflect the built-in capital gains. After calculating the pro rata value of the Estate's 63% share, a 22.5% discount for lack of marketability and lack of super-majority control is appropriate. ♦

Hackl v. Commissioner (118 T.C. 14)

Background. In the mid-1990s, AJ Hackle and his wife, Christine, purchased two tree farms, a 3,813.8 acre tract in Putnam County, FL and a 7,771.88 acre tract in McIntosh County, GA. They formed Treeco, LLC to provide the following: liability protection for members; protection of assets inside the LLC from members' creditors; pass-through income tax treatment; and centralized management for the operation of the family tree farming business. The Hackls intended for the tree farming business to be operated in such a way as to acquire and manage plantation pine forests for long-term income and appreciation for them and their heirs and not to produce immediate income. Records indicated that they operated their business consistently with this intent.

In December 1995, AJ and Christine Hackl transferred 500 voting and 700 nonvoting units in Treeco to each of their eight children and to the spouse of each child. At that time, each donee executed an acceptance of the Treeco Operating Agreement. The Hackls reported the 1995 gifts of Treeco units on timely filed gift tax returns and treated the gifts as qualifying for the annual exclusion of section 2053(b). The Hackls continued their gifting of Treeco units after purchasing a third property in early 1996. However, Commissioner disallowed the annual exclusions claimed for their 1996 gifts.

Decision. The issue before the Court was whether the gifts qualified for the annual exclusion provided by Section 2503(b). The question to be answered was whether the transfers constituted gifts of a present interest. The Court determined that the Treeco units represented future, not present, interests and did not qualify for the annual exclusion.

The Court stated that a gift qualifies for the annual exclusion if the donee receives "an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom." While the donees received outright possession of the Treeco units, they did not receive present economic benefit of those units. Therefore, the units are not present interests because the donees have no means of transferring their ownership to a transferee who would then have no right to become a member or participate in the business. Clauses in the operating agreement precluded conference of the use, possession, and enjoyment of the property. Therefore, the annual exclusion did not apply. ♦

Corporate Reform Update

Sarbanes-Oxley Act

With much fanfare, Congress passed and the President recently signed new securities legislation (Sarbanes-Oxley Act of 2002) meant to curb weaknesses in laws, regulations, and oversight believed to have contributed to the recent spate of less than admirable disclosures of corporate accounting and governance shortcomings. Experts seem somewhat divided as to whether the legislation is momentous or merely mundane, although the legislation's full impact awaits the promulgation of rules by the SEC and the Accounting Oversight Board. Accountants and accounting firms bear the brunt of the legislation, as about half of the bill is devoted to the new Accounting Oversight Board and auditor independence issues.

The Accounting Oversight Board is given seemingly broad authority to adopt standards governing attestation procedures, audit quality control, and auditor ethics, responsibilities formerly performed by committees of the American Institute of Certified Public Accountants. However, the Accounting Oversight Board can incorporate standards previously adopted by other professional organizations into its rules.

The auditor independence regulations stiffen the rules adopted by the SEC in 2001, as indicated in the following chart that compares the new securities act to the SEC's rules. The most significant new limitations on non-audit services appear concentrated in the areas of systems design and implementation and internal audit services. Accounting firms apparently escaped a requirement to rotate clients every few years. Instead, the firm must replace the engagement partner after five years.

Section 301 of the new legislation is devoted exclusively to audit committees, which provides that the audit

committee has direct responsibility for the appointment, compensation, and oversight of the auditing firm.

Section 204 also applies directly to audit committees. It provides that the auditor must report to the audit committee regarding (i) the critical accounting policies used; (ii) alternative accounting treatments discussed with management, their financial effect, and the treatment preferred by the auditor; and, (iii) communications with management, such as management letters or schedules of unadjusted differences. The legislation also requires that the company must disclose whether one audit committee member is a "financial expert," possessing significant knowledge regarding accounting and internal control matters.

From the legislation, it is unclear what level of "due diligence" the audit committee must conduct to properly carry out its oversight responsibilities. The act gives the audit committee latitude to retain legal counsel or other advisors to assist in conducting its duties. For instance, if the auditor discusses several alternative accounting treatments with management, would the audit committee need to retain a second accounting firm to concur with the selected accounting treatment? While the legislation references auditors and their work product, what responsibility does the audit committee have with respect to other financial disclosures by the company? Given the legislation's core focus on investor protection, do these disclosures need to be evaluated for transparency?

Sections of the legislation concerning corporate officers focus more on exacting new or tougher penalties for malfeasance, rather than creating large-scale revisions, as for accounting firms. Chief executive officers and chief financial officers must certify financial statements in a form paralleling a standard audit opinion; that is,

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Corporate Reform Update

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the company's financial statements "present fairly, in all material respects" its financial position and results of operations. In addition, Section 1001 of the Act recommends that the federal income tax return of a corporation be signed by the chief executive officer of such corporation, which may subject the chief executive officer to other potential tax penalties if a fraudulent tax return is filed.

Given the recent events concerning noted public companies, many people are nervous. This corporate responsibility legislation is an attempt to calm the markets. We note that the vast majority of firms and people that are addressed by this Act are reputable and concerned with what is best for their clients and their employees.

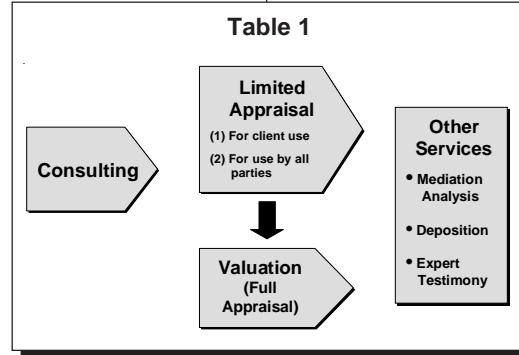
Give us a call if you have valuation or other transaction advisory needs. We serve our clients' best interests first with the highest standard of service and level of professionalism. ♦

Divorce Engagements and Valuation Terms

(Continued from Page 1)

Limited Appraisal. A limited appraisal is "the act or process of determining the value of a business, business ownership interest, security, or intangible asset with limitations in analyses, procedures, or scope."^{*} Limited appraisals can substantiate value but are not typically styled a "valuation." Because in many cases limited appraisals do not require an on-site inspection, extensive industry and market research, or detailed documentation, they can save time and expense. However, limited appraisals can be elevated to a valuation (or full appraisal) when formality and completeness is needed for the Court or in response to the scope of an opposing expert's work.

Valuation (Full Appraisal). A valuation is "the act or process of determining the value of a business, business ownership interest, security, or intangible asset."^{*} A valuation requires, among other things, an on-site visit with company management, extensive industry and economic research, and collection and analysis of all information expected to be relevant to the valuation.



The valuation process involves defining the engagement, collecting and analyzing financial and business information, researching relevant valuation data, developing the valuation, and communi-

cating the result via an agreed upon level of documentation and/or testimony. We encourage divorce attorneys to be rigorous in selecting valuation experts. If you have any questions about the services we provide, please do not hesitate to call us. ♦

^{*} *International Glossary of Business Valuation Terms*, 2001.

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