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Appraisal Malpractice: It's About Standards, Not the Ultimate Value

Development Specialists, Inc. v. Weiser Realty Advisors LLC, 2012 U.S. Dist. LEXIS 8666 (Jan. 24, 2012)

After more than 150 years in existence, the "storied" international law firm Coudert Brothers began to falter in 2005. In winding up the firm's affairs, the equity partners contemplated selling its New York practice to another large commercial law firm, Baker & McKenzie.

At the time, Coudert was paying below market rent for several floors in a midtown Manhattan office building and subleasing portions of the space, the profits from which it was obligated to split with the landlord. With the pending sale, the Coudert partners engaged an appraisal firm to value the remaining eight-year interest in its office lease.

Appraiser complied with USPAP. In determining the fair market rental rate for the office space, the appraisal firm relied on several factors, including the strength of the midtown Manhattan rental market, the condition of the building, and macroeconomic trends in New York City. It then deducted its subletting costs (i.e., its actual rent) from the projected cash flows from the Coudert space before adding the risk-adjusted profits from any subleases and reduced the total net expected cash flows to present value. Overall, the appraisal firm determined that the fair market value of the law firm's "leasehold position" was worth $18 million as of Sept. 1, 2005.

In its report, the appraisal firm certified that its techniques complied "with the Uniform Standards of Professional Appraisal Practice" (USPAP) as well as the Appraisal Institute's Code of Professional Ethics. The appraisers also acknowledged that at the time of the report, Coudert was looking to merge with or be acquired by another law firm, which would assume the lease.

Nearly a year later, Coudert filed for bankruptcy. The plan administrator subsequently sued the appraisal firm, claiming that it failed to perform its appraisal "with due care in light of commonly accepted appraisal standards." The defendants retained the valuation firm of Duff & Phelps to review the September 2005 report.

To preface his review, the defendants' expert explained that the USPAP standards "are generally considered the quality control standards applicable for appraisal analysis in the United States, including real property." The expert ultimately concluded that the defendants had followed these standards in valuing the Coudert leasehold and applied "credible and adequately reliable valuation methods … relative to the intended use, and users, of the appraisal report."

Plaintiff's expert cites Rev. Ruling 59-60. For its part, the plaintiff retained a forensic accounting expert from a litigation, business valuation, and tax consulting firm to review the defendants' original report and prepare her own calculated value of the Coudert lease. She also prepared a rebuttal to the Duff & Phelps report. Unlike the Duff & Phelps expert, however, the plaintiff's expert was not a certified real estate appraiser.

In her first report, the plaintiff's expert said that the cash flow projections used by the defendants in their original appraisal were "mathematically correct," but their valuation did not "produce the entire economic benefit" of the leasehold interest because it did not factor in the potential sale or refinancing of the building.

In fact, the landlord sold the subject office building in 2006, one year following the Coudert sale, for nearly $999 million. By taking the annualized 4th quarter 2005 income projections (used by the defendants in their original appraisal) and dividing it by a capitalization rate based, in part, on the price garnered by the landlord's sale of the building in 2006, the plaintiff's expert determined the "hypothetical sale price" that the landlord would have been willing to pay for

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the Coudert leasehold position. Adding that price to the defendants' original discounted cash flows, the expert calculated that the total value of the Coudert lease as of September 2005 was at least $31 million.

The expert subsequently submitted her rebuttal report, in which she criticized the original appraisal for assuming that smaller office spaces in Manhattan typically lease for smaller rents than larger spaces. Instead, she stated that as of July 2005, there were an 8% vacancy rate in the midtown Manhattan rental market and limited opportunities for larger tenants to rent "high floor, well-configured, well-appointed space," so any space would have rented at a higher price. She used this assumption to add $3 per square foot to the original net rents calculated by the defendants, which she said would yield an extra $387,000 per year, for a present value of approximately $18.2 million, using the defendants' 4.5% discount rate.

However—as the defendants pointed out—the plaintiff's expert did not indicate how the extra $386,000 per year for each of the remaining eight years on the Coudert lease could possibly yield more than $18 million. Nevertheless, in her rebuttal report, the expert determined that the defendants' DCF analysis should have yielded a value ranging from $36 million to $39 million, not $18 million.

More problems with the rebuttal report. In her rebuttal report, the plaintiff's expert used a different capitalization rate than in her primary report (5.5% instead of 5.25%), but didn't explain the change. As for her own independent report, the expert stated that it was not an "appraisal report" and did not need to utilize the USPAP standards.

"Such an approach, different than that used by other experts in the industry, without known validation in the industry literature and connected to existing data only by the ispe dixit of the expert, is not reliable," the court held. Further, neither the expert nor the plaintiff offered any evidence to dispute Duff & Phelps's expert testimony regarding the commonly accepted professional standards for valuing leaseholds such as Coudert's. On this basis alone, the court excluded the expert's testimony and her reports.

In determining the defendants' motion for summary judgment, the court noted that in stating a claim for malpractice, the plaintiff needed to show that the defendants departed from the accepted standards of appraisal practice and that such departure caused its losses. Although the defendants put forth sound expert evidence that their appraisal methodologies complied with applicable standards, the plaintiff did not, the court explained.

In sum, the plaintiff's expert's "divergent" opinion, detached from any professional standard, failed to raise a triable issue of fact regarding the reasonableness of the defendant's appraisal, the court held, and dismissed the case.

Are We Still Confused About Goodwill?

Courts across the U.S. still struggle to determine and divide goodwill in divorce cases—particularly in those jurisdictions that follow the majority rule and require making a distinction between personal goodwill (nondivisible) and enterprise goodwill (divisible). "Or is it the valuator who is confused?" asked presenters Sharyn Maggio (Maggio & Co.) and Miriam Mason (Mason Black & Caballero) at the recent AICPA/AAML National Conference on Divorce in Las Vegas.

Some appraisers might consider Maggio lucky; she practices in New Jersey, which does not recognize the distinction. "It's all divisible," Maggio said, "but I work with one practitioner who insists that with respect to a highly skilled professional, there is no goodwill: It's all personal." Other states' courts have agreed, relying on an inverse argument. For example, in a Missouri decision, the husband claimed he was a key employee in his seven-man roofing business, but the court declined to reduce its value by any personal goodwill, finding the husband didn't provide the highly skilled professional services that would qualify.

Some courts have determined that all professional goodwill must be salable to be divisible, as evidenced by a noncompete; still others preclude the appraiser from assuming the presence of a noncompete. Notably, in Gaskill v. Robbins (2009), the Kentucky Supreme Court held:

> While fair market value of [the wife's practice] anticipates what a willing buyer would give a willing seller, the fictional sale must be viewed as a "fire sale," meaning that it must be valued in its existing state. This precludes factoring in a nonexistent

non-compete clause, as there is no requirement that [the wife] enter into one other than as a possible negotiated term of a real sale.

The Gaskill court also required that any goodwill value "must" have a rational basis in accounting principles and "should avoid speculation and assumptions as much as possible." This language is a "little disconcerting," Maggio said. BV appraisers have to make assumptions, particularly regarding goodwill. "But courts don't like it," she added, noting that Gaskill is a "must read" case, no matter where you practice. In fact, this year the case came up again after another trip through the courts, and the appeals court affirmed the previous decisions.

DLOM Applicable in Valuing Pharmacy on Divorce

Taylor v. Taylor, 2012 N.C. App. LEXIS 304 (March 6, 2012)

For 20 years of their marriage, the parties owned and operated a hospital pharmacy. During their divorce, each retained experts to value the business. After considering the three traditional valuation approaches (income, market, and asset), both experts agreed that a capitalization of earnings method would best value the business, but they disagreed on certain data and assumptions.

Same valuation approach yields different results. For instance, the husband's expert relied on only two years of earnings to value the pharmacy at $211,000. By contrast, the wife's expert relied on five years of earnings, which he said was "the typical number of years used for business valuation." He also used a higher capitalization rate than the husband's expert (the appellate court opinion does not specify the rates used by either expert). He believed the higher cap rate was appropriate based on the three specific risk factors: 1) the husband had become disabled, leaving the wife as the "key person" to run the business; 2) the pharmacy's contract with the hospital had a termination clause; and 3) there was a relatively short term remaining on the contract.

As a final step, the wife's expert applied a 20% discount for lack of marketability (DLOM) due to the costs and difficulty of finding a buyer for the business. Overall, his calculations resulted in a value of $107,350.

The wife's expert is right on all counts. The trial court agreed with the wife's expert's valuation, noting that it most appropriately reflected the fair market value of the business, based on the traditional "willing buyer/ willing seller" definition. The husband appealed.

The husband argued that "his expert [was] correct in his valuation of the business and that [the wife's expert was] wrong," in response to which the appellate court pointed out that credibility of expert testimony is within the discretion of the trial court.

The husband then claimed that the trial court erred by applying a marketability discount to the value of the business, but his argument "overlooked" a North Carolina case, Crowder v. Crowder, 556 S.E.2d 639 (2001), which specifically upheld the application of a DLOM in valuing a marital business, "if substantiated by the evidence," as it was here. The appellate affirmed the $107,350 value for the pharmacy.

Best Practices for Financial Experts and Attorneys

The community of business valuation professionals has opened a discussion on determining how to identify and enforce shared best practice standards for their profession, which is perceived as having significantly less infrastructure than, for example, accounting.

The endeavor faces roadblocks. A few of them are:

- Valuation standards are different depending on context.
- Unlike procedures at FASB and elsewhere, there isn't a common methodology for exposure drafts established in business valuation.
- Multiple professional associations and groups are working independently, with only rudimentary communication and no collaboration.
- There's no clear enforcement arm or communication method through the certifying associations to get members to follow best practices once they're agreed upon.

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Where to start in the face of these challenges? One suggestion is for all the organizations to recognize the AICPA's IPR&D guide and TAF's Contributory Assets advisory as best practices. For the future, a working group might recommend adoption of other best practices documents as they develop.

Other suggestions include stiffer qualification standards, including mandating an undergraduate degree, possibly even with a quantitative focus. Though many in the profession note a caveat to this requirement: Professional experience will always be of primary importance.

Similarly, the business valuation credentials available, while good designations, cannot replace the critical need for professional experience. Not to mention the fact that clients are often more confused by the certifications than anything else. As to whether there ought to be specialist certifications for particular niche focuses, the value has yet to be determined.

There is a place, of course, for continuing education, and this is already reasonably well-served by the certifying organizations.

Whether or not there ought to be an enforcement process, once standards and best practices are in place, is still under consideration.

Over 20 Reasons Your ESOP Clients May Need a Fairness Opinion

An article by Mercer Capital in Valuation Matters provides a comprehensive FAQ on fairness opinions in ESOP transactions. Among the most important is a list of over 20 ESOP transactions that might trigger the need for a fairness opinion—a good reminder for ESOP specialists and their clients. "Despite the breadth of the listed circumstances, there are many other situations which likely accompany ESOP transactions and transactions of ESOP owned companies," the article advises. Any ESOP-related financial transaction "should be thoroughly reviewed from the financial perspective of the ESOP. The transaction process, evolution, negotiations, and other factors that comprise the event (and any circumstances) should be systematically analyzed and documented within the fairness opinion." Download the article at: http://mercercapital.com/index.cfm?action=page.item&id=1024&utm_source=Mercer+Capital+Newsletters&utm_campaign=224591a857-Value_Matters_2012_023_21_2012&utm_medium=email.

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