PERKINS & CO
Let's get there

BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

Contacts:

Keith H. Meyers, CPA, ABV, CFF
Shareholder
503.221.7579
kmeyers@perkinsaccounting.com

Peter Kwong, CPA, ABV, CFF
Shareholder
503.221.7541
pkwong@perkinsaccounting.com

Lisa J. Goecke, CPA, ABV, CFF
Shareholder
503.221.7510
lgoecke@perkinsaccounting.com

Paris Powell, CPA, ABV, CFF
Business Valuation Manager
503.221.7564
ppowell@perkinsaccounting.com

What's in a Name?

What better way to start off than by talking about "What's in a Name?" – a tradename to be specific. In a recent litigation engagement, my firm was asked to rebut the report of another expert claiming damages for infringement of tradename for a restaurant. Let's say that the name of the defendant's restaurant chain was "Danny's Real Good Eats." Let's also say that the plaintiff's chain was called just "Real Good Eats."

Real Good Eats is a multi-state chain, and Danny's Real Good Eats is a regional chain that operates in only one state. Beside the obvious issue as to whether the term "real good eats" is generic and in the public domain, the real issue for us as a rebuttal expert was to examine the efficacy of the arguments used by the expert for the plaintiff in determining damages.

Both parties agreed that the defendant's restaurants operated at a loss during the period of purported infringement, so an award based on profits was not appropriate here. Therefore, the plaintiff's expert was left with the application of a reasonable royalty to the asserted infringing revenue for determination of damages. The determination of the reasonable royalty rate is where the plaintiff's expert's report fell short.

In reviewing the "guideline" companies that plaintiff's expert used, it became apparent that none of the guideline companies were retail restaurants. Instead, all of the guideline companies were either wholesalers to the restaurant industry or producers of products used by the restaurant industry.

The cost and profit structures of these companies are different from a restaurant. Therefore, in this case it was not appropriate to use those other companies as comparables to determine a reasonable royalty rate to be applied to a retail restaurant.

The plaintiff's expert also applied the principles of the *Georgia Pacific* case to determine a reasonable royalty rate. That case applies to patent infringement and not necessarily to trademark infringement.

The lesson to be learned in all of this is that as an expert it is important that you have a clear understanding of what it is you are analyzing and assessing in either valuation or determination of damages. A guideline company or a guideline asset or transaction (royalty) must not be exact, but it should be reasonably similar. It is an elementary mistake to compare companies in a completely different line of business in the determination of a reasonable royalty rate when other companies that are more similarly aligned to the specific industry are available. If you were valuing a retail company using a guideline company method, you would usually not use companies who are wholesalers and manufacturers as guideline companies when guideline retailers exist. The same principles apply in the intellectual asset arena.

By R. James Alerding, CPA/ABV/CFF, ASA, CVA
Clifton Gunderson, LLP, Indianapolis, IN

Are Stock Options Marital Assets Subject to Equitable Distribution?

As any good expert knows, "It depends!"

Was the Stock Option Acquired During the Marriage?

This is usually one of the first questions asked when determining the classification of assets. Marital assets are typically those acquired from the date of marriage to the date of filing, or any other appropriate date as determined by the court, given the specific facts of that case. Some alternate dates to consider are the date of separation, date of trial, or an agreed upon valuation date.

Obvious Situations

Generally, if an option is granted and vested during the marriage, which means that it is exercisable and cannot be cancelled, the option will most likely be viewed as a marital asset subject to equitable distribution. If an option is acquired by post-filing efforts, then it is probably a non-marital asset. If the option is not vested on the date of filing, which means that it is not exercisable and could be lost due to subsequent events, it will likely be viewed as a separate non-marital asset of the employee spouse.

Not So Obvious Situations

- What if the options were granted prior to the marriage, were unvested at the date of marriage, and vested during the marriage?
- What if the options were granted prior to the marriage and are not vested at the date of filing?
- What if the options were granted during the marriage and are not vested at the date of filing?
- What if the options were granted during the marriage for past performance prior to the marriage?
- What if the options were granted after the date of filing for past performance during the marriage?

It is for these not so obvious situations that an expert should be engaged to assist the attorney in determining if the option is a marital asset.

What Was the Primary Purpose of the Option Award?

The critical question with regard to the classification of a stock option is whether the primary purpose of the grant was in recognition for past services or as an incentive for future services. The answer to this question is almost never apparent or plainly evidenced. It is fact-specific and often requires substantial discovery.

Only after this question is answered can the court attempt to determine what portion of the stock options is a marital asset. The

attorney should be intimately involved in this process, as this calculation varies depending on the local case law. There is no universal formula used to apportion options between marital and non-marital property. Certainly, our tasks would be easier if a universal formula or rule existed, but Family Courts are courts of equity and are case-specific. No one formula could contemplate every unique fact pattern. Certain issues must be left to the judge's discretion.

Formulas

One method used to apportion options is a coverture formula or time rule. This formula initiated in California, a community property state, and evolved over the years. Initially, the numerator was the number of months between the hire date and the date of filing; the denominator was the number of months between the hire date and the vesting date. It was later modified to give greater consideration to the increase in stock value and again to give greater consideration to the vesting date of the options. Finally, the court decided that no single formula can be applied to every situation.

Applying a coverture formula does not circumvent the necessity of considering the employee's past or future efforts in lieu of simply analyzing the date of employment, date of marriage and date of the grant. When using a coverture formula, the marital portion of the options increases as the fraction approaches unity. This formula allows and promotes manipulations in favor of either spouse by simply altering the numerator, the denominator, or both, to fit the circumstances. Numerous scenarios can be generated by altering the variables such as the dates of employment, the grant date, the vesting date, the exercise date, etc. The formula will need to be altered to fit the case law in the local jurisdiction. The courts are given discretion to design a distribution scheme that will achieve the most equitable results, given the facts and circumstances at hand.

A coverture formula is not the only method of apportioning stock options. Some courts use a multi-tiered approach. This approach also focuses on the number of shares granted for past services and the number of shares granted for future services. Past services are marital. Future services are subject to a coverture fraction. The numerator is the number of months from the grant date to the date of filing and the denominator is the number of months from the grant date to the date of vesting.

After the court reaches a determination as to what fraction is marital, then the challenge becomes assigning a value to that marital asset.

What You Need to Know

Although the facts and circumstances of each case are unique, here are some of the essential facts required to assist in determining if a stock option should be classified as a marital asset:

1. Primary purpose of the grant
2. Date of marriage
3. Date of employment
4. Date of grant
5. Date of vesting
6. Date of expiration
7. Date of filing of DOM or alternate valuation date

Where You Will Find What You Need to Know

The information gleaned from this documentation is important in supporting a position about whether the grant is for pre- or post-filing efforts.

1. Stock Option Plan
   a. Why established?
   b. Reason for grant?
   c. References to past service, incentive for future
2. Evidence of award to employee
3. Personnel file of employee
   a. Evidence of past performance worthy of option
   b. Evidence of future value to company
4. Employment contracts
5. Minutes of meetings when options are discussed
6. SEC filings, if applicable
   a. Stock option prospectus
7. Direct testimony of officers of the company

By L. Gail Markham, CPA/ABV/CFF, CFP® and Toni Sparkman, M.S., CP, FCP, FRP, CDFA™ — Markham Norton Mosteller Wright & Co., Fort Myers, FL

Expert Tip

The critical question with regard to the classification of a stock option is whether the primary purpose of the grant was in recognition for past services or as an incentive for future services.

Terminology

Below is an excerpt of terms specific to this article.

Stock option – A right issued by a company to an employee to buy a given amount of shares of company stock at a stated price within a specified period of time.

Grant date – The date the option was offered to the employee.

Vesting date (exercisable date) – Options usually vest on a particular date after which the employee can exercise the option and receive a share of stock.

Expiration date – The date the option expires.

Exercise date – The date the stock is purchased by the employee.

Exercise price (strike price) (option price) – The price the employee pays for one share of stock under the plan; the fixed price at which the option is exercisable.

FEATURED CASE

CITATION

Estate of Erma V. Jorgensen, Deceased; Jerry Lou Davis, Executrix and Co-Trustee; Gerald R. Jorgensen, Co-Trustee, Petitioners, v. Commissioner of Internal Revenue, Respondent. No. 09-73250. United States Court of Appeals, Ninth Circuit. Argued and Submitted April 13, 2011 — Pasadena, California. Filed May 4, 2011.

OVERVIEW

The Ninth Circuit Court of Appeals affirmed a Tax Court determination that values of assets transferred to two family limited partnerships ("FLP") were includable in the Decedent's estate under § 2036(a) of the Internal Revenue Code.

THE FACTS

The Tax Court determined that transfers of assets owned by Erma V. Jorgensen ("Decedent" or "Ms. Jorgensen") to FLPs were includable in her taxable estate. In particular, the Decedent's ignoring of partnership formalities (such as bookkeeping, meetings, meeting minutes, and the separation of personal and partnership assets), retention of benefit of the transferred property, and lack of non-tax reasons for partnership formation were cited by the Court.

On appeal, the Estate argued that although § 2036(a) applies in this case, the amounts paid out by Ms. Jorgensen should be considered *de minimis* or be limited to the actual amount accessed by the Decedent. The Ninth Circuit Court disagreed. In particular, it cited *Strangi v. Commissioner*, 417 F.3d 468, 477 (5th Circuit 2005) and *Estate of Bigelow v. Commissioner,* 503 F.3d 955, 964, 970 n.6 (9th Circuit 2007), both of which ruled that funeral expenses paid from partnership accounts indicated an agreement that the decedent would enjoy personal access to partnership funds.

The Appellate Court further noted that although Ms. Jorgensen only accessed $90,000 herself, she could have accessed more had she so chosen. That ability indicated an agreement that Ms. Jorgensen enjoyed a personal right to what should have been partnership assets.

CONCLUSION

As a result of the preceding, the Appellate Court affirmed the Tax Court's decision.

By Chris D. Treharne, ASA, MCBA, BVAL and John Walker
Gibraltar Business Appraisals, Inc., Longmont, CO

TAX COURT CASE TAKEAWAY

The Tax Court decision provided estate planning practitioners a guide book on how to doom the use of an FLP as an effective planning tool. More specifically, the co-mingling of assets, non-existent record keeping, poor management by general partners, legal counsel's failure to educate the clients, and failure of clients to understand the duties required of them undermined the taxpayer's arguments in this case. The Ninth Circuit affirmed the Tax Court's ruling in full.