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Tax Court's Adjustment to Reasonable Compensation 'Dizzying and Arbitrary'

Menard v. Commissioner, 2009 WL 595587 (C. A. 7)(March 10, 2009)

The CEO of The Home Depot was paid $2.8 million in salary in 1998. The CEO of Lowe's received $6.1 million (neither including bonus). Yet when the CEO of the nation's third largest retail home improvement chain, Menards, posted roughly $20.6 million in salary (including bonus), the IRS stepped in and disallowed $19 million as a corporate deduction. The reason: The IRS claimed that it was a disguised dividend.

The Tax Court applied a unique formula. The CEO, John Menard, founded the Wisconsin-based Menards hardware stores in 1962. He worked six or seven days a week, up to 16 hours a day, and was involved in every detail of company operations. Under his management, revenues grew from $788 million in 1991 to $3.4 billion in 1998. The company's return on shareholder equity in 1998 was 18.8 percent. By contrast, Home Depot returned a 16.1 percent return on investment that year, and Lowe's rate of return was lower.

Menard owned all the voting shares in the company and 56 percent of the non-voting shares. He was paid a modest base salary and a portion of a profit-sharing plan; in 1998, he earned $157,500 and $3 million from these sources. A bonus program, adopted by the board of directors in 1973, for his "commanding" management role, awarded him an additional 5 percent of company earnings (before taxes) at the end of each year. In 1998, the 5 percent bonus yielded the CEO an additional $17.5 million, conditioned on the IRS allowing its deduction from corporate income.

At trial the IRS not only persuaded the Tax Court that the bulk of the CEO's compensation was excessive, but that because it was conditional and paid at year's-end, it was also intended as a dividend, especially since the company didn't pay formal dividends to other shareholders.

As to the "excess," the Tax Court found that any compensation above $7.1 million for Menard was too much. The court used its own unique formula to arrive at this conclusion:

1. Divide Home Depot's return on investment (16.1 percent) by its CEO's salary ($2.84 million);
2. Divide Menard's return on investment (18.8 percent) by the result of step (1); and then
3. Multiply the result ($3.32 million) by 2.13, or the ratio of the compensation of Lowe's CEO to that of Home Depot's CEO.

The appellate court considered the Tax Court's formula an arbitrary and dizzying adjustment. It disregarded differences in the full compensation packages of the three executives being compared (the Home Depot CEO made more than $124 million from 1998-2004) , differences in whatever challenges faced the companies in 1998, and differences in [their] responsibilities and performances (Menard was by far the most active, hard-working).

Not a concealed dividend. The Tax Court ignored the substantial level of risk in Menard's compensation structure, given its direct tie to company earnings.

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Not to mention the fact that the 5 percent bonus program had been in place for 25 years before the IRS "pounced," the court said. It did not look like a dividend, because corporate dividends are generally tied to specific dollar amounts and do not serve the same incentive purpose to the passive shareholder.

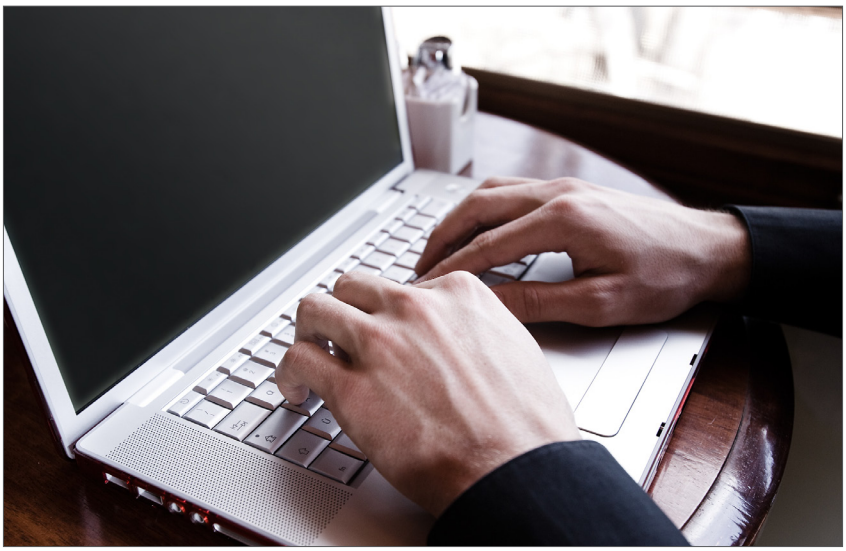
The Seventh Circuit reversed the Tax Court's decision.

In Dueling Daubert Motions, Both Experts' Evidence Accepted

Uniloc USA, Inc. v. Microsoft Corp., 2009 WL 691204 (D. R.I.)(March 16, 2009)

If after six years of litigation a jury finds that Microsoft had infringed Uniloc's—a little known software developer—patent on anti-piracy software, the court will be "called upon to determine what a reasonable royalty would be." Before the jury could undertake such an exercise, the court considered the parties' dueling Daubert motions.

Plaintiff's expert challenged as arbitrary and junk science. Microsoft claimed that testimony by Uniloc's damages expert was unreliable, because the valuation: 1) assigned an "arbitrary," unsupported base value of $10 to price the one-time activation of the patented software; and 2) relied on a "25 percent rule of thumb" to estimate usage, which is a "junk science method" for calculating royalty rates.



On Microsoft's claims, the court found that the expert's derivation of the $10 activation fee was not conjecture or rough approximation, the court found, but based on a figure in an internal Microsoft memo, while the 25 percent rule has been accepted as a proper baseline from which to start a reasonable royalty analysis in other cases. In both instances, the court said, "Microsoft may rely on cross examination and other tools of the adversary process to address the weaknesses in this testimony."

The defendant's expert uses lump-sum calculation. Uniloc challenged Microsoft's financial expert for asserting that a "paid up," one-time lump-sum royalty ranging from $3 million to $7 million would be appropriate. The court found that the expert's opinion "clearly" fell within the bounds of Rule 702 (of the Federal Rules of Evidence) and Daubert. In addition, federal law does not prescribe a single "correct" formula for computing damages in a patent case. "The lack of any 'running' aspect to [the expert's calculation] is important," the court observed, "but it goes to the weight of his testimony and may be grist for cross-examination. It does not make it unreliable."

Editor's note: A jury awarded Uniloc $388 million in patent infringement damages against Microsoft on April 8, 2009. Microsoft intends to appeal the verdict, the second largest in the U.S. this year and the fifth-largest patent jury award in U.S. history.

Divorce Experts Agree on Nothing but the Definition of Fair Market Value

Brickner v. Brickner, 2009 WL 683706 (Ohio App. 12 Dist.)(March 16, 2009)

When competing valuation opinions leave little room for consensus, frustrated courts are forced to cobble an outcome from what little agreement the experts were able to admit, and the appellate court is likely to uphold it.

'Never seen such different valuations.' During their twenty-year marriage, the Brickners co-owned a company that provided home-based support for the disabled. At their divorce trial, the husband's expert used the cost and market approaches to value the company at $314,131 and $640,292, respectively. The wife's expert used the cost and income approaches to find respective values of $250,000 and $380,000.

"I can honestly say I have never in the life of trying cases found valuations more different," the trial judge said. The judge went on to find that the market analysis was unreliable and disregarded it, choosing instead the higher of the two cost analysis outcomes.

The appellate court found that in light of the widely divergent opinions and the trial judge's careful

consideration of them, the decision was neither unreasonable nor unconscionable, and the valuation was affirmed.

Bankruptcy Court Cannot Just 'Split the Difference' in Divergent Discount Rates

United Air Lines, Inc. v. Regional Airports Improvement Corp., 2009 WL 1181852 (C. A. 7 (Ill)) (May 5, 2009)

In United Airlines' Chapter 11 reorganization, the bankruptcy court considered how much the airline owed lenders that financed the improvements to its gates at Los Angeles International Airport (LAX). The original 2004 loan amount was $60 million. According to its reorganization plan, United would have to pay the full, present value of the assets that served as security; i.e., the improved, leased space at the airport. Any excess would be unsecured debt, which the airline could write down.

Absent a liquid market for improved space at an airport, the fair market value of the property turned on the amounts that would be agreed upon by a hypothetical willing buyer and willing seller.

The appropriate rental rate. The airline expert used $17 per square foot, the historic market rate that LAX charged to airlines, for United's leased space. The lenders disagreed, arguing that this was the rate that the airport offered prior to the 1984 Olympics for unimproved space. The trustee's expert looked at rental rates charged by a consortium of airlines that operated out of the airport's second terminal (LAX2). In 2004, the year of the loan, the consortium leased gates to other carriers at $63 per square foot. The bankruptcy court determined that an estimation of market rental rates was too speculative, and adopted the airline's $17 figure. On review, the district court agreed.

The Seventh Circuit found fault with both lower courts. The Seventh Circuit disagreed, finding that the price was more likely somewhere between the $17 and $63, noting that, "Any potential rental price higher than $30 would make the collateral worth at least [the] $60 million [loan amount]," the court ruled, even with the discount rate that the bankruptcy court selected. That is where the court turned its attention next.

A judge must choose the right discount rate. In its DCF analysis, the lender's expert chose an 8 percent discount rate, citing the rate that LAX currently paid on unsecured general revenue bonds. By contrast, United's expert selected 12 percent as the rate that investors would demand, given the industry's volatility. "The bankruptcy judge added the two estimates and divided by two," the Seventh Circuit explained. "An arbitrator might choose such a method, and perhaps a jury would do so behind closed doors, but a judge should choose the right discount rate rather than split the difference between the parties," it said, with emphasis.

Instead of looking at the general industry risk, it would have been more credible to look at the risks of this airport, the court added. If the airport could raise money at 8 percent without giving security, then secured debt investors would not demand more, and that "is all we need to know" to conclude that the discount rate could not exceed 8 percent.

Using the $17 per square foot rental rate, bankruptcy court projected industry-rate increases over the term of the loan (2021) to reach $146 million. Discounted by 8 percent, the court arrived at a present value of $46 million. Increasing the rent to $23 would make the lenders fully secured, the court held, in reversing the lower courts' judgments. "Because improved space in [LAX2] fetches almost three times the price needed to make these loans…secured, the lenders are entitled to a full recovery."

The Most Credible Experts Admit the Weaknesses in Their Reports Up Front

As judges boost their knowledge and more IRS engineers and appraisers become BV-credentialed, they are better able to spot the weaknesses in valuation reports. Should you admit them up front? "Absolutely," says U.S. Tax Court judge, the Honorable David Laro. "If you don't address them, the other side will, or the court will have questions." If an appraiser discusses and analyzes, for example, omitted methods, and explains why they were not

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applicable to a particular case, they automatically raise the sophistication level of their report.

What other elements must a report have? Ethics, independence, intellectual honesty, and transparency, Laro said. “When you offer a report that is free of bias and advocacy, independently arrived at and transparent, then this is the best we can have.” Howard Lewis, former national program manager of the IRS and current IBA executive director, seconded these requirements, as applied to the Service. “It is not the job of the IRS to be advocates,” he said. IRS appraisers and examiners are “charged with the responsibility to be fair, honest and unbiased.” At the same time, they regularly see only the worst-case appraisals, and this system-bias led even Lewis to develop a bias early in his career, which he focused on correcting in later years, in both himself and his fellow engineers. The point: “Understand the perspective of the IRS,” he said.

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