

Patricia M. Adams, et al., Plaintiffs, vs. United States Of America, Defendant.

Civil Action No. 3:96-CV-3181-D

United States District Court for the Northern District of Texas, Dallas Division

2001 U.S. Dist. LEXIS 13092

August 24, 2001, Decided
August 24, 2001, Filed; August 27, 2001, Entered

For PATRICIA M ADAMS, RONALD MENDENHALL, NATIONSBANK OF TEXAS, NA, plaintiffs: Robert Don Collier, William R Cousins, III, Robert M Bolton, Attorneys at Law, Meadows Owens Collier Reed Cousins & Blau, Dallas, TX USA.

For USA, defendant: Michael D Powell, Attorney at Law, US Department of Justice, Dallas, TX USA.

SIDNEY A. FITZWATER, UNITED STATES DISTRICT JUDGE.

MEMORANDUM OPINION

Following the Fifth Circuit's remand of this estate tax refund suit, the court must determine the value of the interest of a 25% partner's assignee in a dissolved Texas partnership. When this case was last here, the court declined following a bench trial to discount the value except to reflect liquidation costs of the interest, a reduction that was insufficient to entitle the taxpayer-plaintiffs to any relief. The court rejected the taxpayers' claimed discounts for lack of marketability, lack of control, uncertain rights, and ownership of an undesirable mix of assets, concluding that the partner's assignees could receive the partner's share of the dissolved partnership's surplus, thus rendering such discounts irrelevant. The Fifth Circuit has reversed this legal determination and remanded the case with directions that this court consider evidence from both parties and determine the applicability of the various claimed discounts and the correct percentages of those that are found to apply. The parties have agreed that it is unnecessary for the court to hear additional evidence and that the case can be decided on written submissions. Having considered the parties' arguments, the court renders judgment in favor of the taxpayers for the reasons that follow.¹

I

The background facts of this case--which are largely undisputed--are set out in this court's opinion, see *Adams v. United States*, 1999 WL 172274, at *1 (N.D. Tex. Mar. 17, 1999) (Fitzwater, J.), rev'd, 218 F.3d 383 (5th Cir. 2000), and in the Fifth Circuit's opinion on appeal, *Adams v. United States*, 218 F.3d 383, 384-85 (5th Cir. 2000), and need not be repeated at length. The court recounts them only to the extent necessary to place the present decision in proper context.

Plaintiffs Patricia M. Adams ("Adams"), Donald Mendenhall, and NationsBank of Texas, N.A. are Independent Coexecutors of the Estate of Mildred M. Mendenhall ("Mendenhall"). The Estate consists of a 25% interest in Taylor Properties, a dissolved Texas general partnership. The remaining 75% interest in Taylor Properties is owned equally by three of Mendenhall's siblings: John M. Hawley

¹ As permitted by Fed. R. Civ. P. 52(a), the court sets out its findings of fact and conclusions of law in this memorandum opinion.

("Hawley"), Margaret H. Bourland, and Katherine H. Ford. The partnership assets included ranch land, securities, mineral royalties, and working interests. Hawley, who had exclusive authority over partnership affairs, managed Taylor Properties.

Following Mendenhall's death on June 23, 1992, the partnership dissolved pursuant to Texas Uniform Partnership Act § 31(4), Tex. Rev. Civ. Stat. Ann. art 6132b §§ 1-46 (Vernon Supp. 2001) ("TUPA").² The Estate Coexecutors filed a Federal Estate Tax Return that valued Mendenhall's 25% interest at \$7,480,975.43.³ The Internal Revenue Service audited the return, valued the interest at \$7,604,125.43, and assessed a deficiency. Plaintiffs paid the assessment and then filed the present refund action.

Defendant United States of America ("the government") filed a motion for partial summary judgment. The court held that the relevant interest to be valued is an assignee interest in a dissolved partnership.⁴ The parties then stipulated that (1) the gross value of Taylor Properties' assets at the time of Mendenhall's death was \$33.328 million and that the partnership had \$.247 million in debt, resulting in a net asset value ("NAV") of \$33.081 million, 25% of which is \$8.270 million, and (2) this figure is the starting point for valuing plaintiffs' assignee interest. They disputed, however, the applicability of various discounts to the interest, including reductions for lack of marketability, lack of control, uncertain rights, and ownership of an undesirable mix of assets.

After a bench trial, the court entered judgment for the government, concluding the discounts were inapplicable because, under Texas partnership law, an assignee of the partnership interest could receive his share of the partnership's surplus, thereby avoiding the effects of any undesirable aspects of the interest that would otherwise justify the discounts. Adams, 1999 WL 172274, at *3-*4. The Fifth Circuit reversed. It held that this court's refusal to apply some or all the discounts in question was based on the erroneous legal premise that under Texas partnership law, a partner's assignee has a "well-established statutory right" either (1) to force the partnership to liquidate and distribute to the assignee his pro rata share of the partnership's NAV, or (2) if the remaining partners chose to carry on the partnership business, to force the remaining partners to pay the assignee what he would have received had there been a liquidation.

Adams, 218 F.3d at 387. The panel concluded that such a right was not well-established. *Id.* at 383 ("The district court . . . reached the erroneous legal conclusion that the assignee of a 25 percent partner's interest has a 'well-established' right to receive a 25 percent pro rata share of the partnership's net asset value ("NAV") without being reduced by such discounts."); 384 ("Our 'Erie Guess' would likely be that--under the Texas partnership law, which is applicable to this case--an assignee's interest in a partnership would be subject to such discounts; but, more significant to today's inquiry, we are firmly convinced that it is anything but 'well-established' that a partner's assignee has the right to receive a 25 percent share of NAV."); 387 ("The district court held that such a legal certainty exists; we are less sanguine, falling somewhere between serious doubt and total disagreement."); 388 ("We agree with the Estate's expert that under Texas law there is either no clear answer to the question whether an assignee has liquidation rights or that the best *Erie* guess is that he does not."); 391 ("We need not and therefore do not attempt today to map the precise contours of the rights of an assignee of a partner under the TUPA. Nevertheless, because the hypothetical parties to the willing buyer-willing seller transaction are deemed to have 'reasonable knowledge of relevant facts,' we must assume that they would conclude, as we have, that the law is not well-settled--that it is at best unclear and uncertain." (footnote omitted)); *id.* ("The district

² The parties agree that this case is governed by TUPA, the state's version of the Uniform Partnership Act. Texas has recently adopted the Revised Uniform Partnership Act, but the new law does not control here because the parties did not so elect. See Tex. Rev. Civ. Stat. Ann. art. 6132b-11.03 (Vernon 2001).

³ As the Fifth Circuit noted; "the Estate's original return value of the interest was substantially greater than the value asserted in its suit for refund." Adams, 218 F.3d at 384 n.5.

⁴ See TUPA § 28-B(B) ("On the death of a partner, such partner's surviving spouse (if any) and such partner's heirs, legatees or personal representative, shall to the extent of their respective interest in the partnership, be regarded for purposes of this Act as assignees and purchasers of such interest from such partner.") On appeal, the Fifth Circuit held that the court had "correctly identified the relevant interest of the partnership in question[.]" Adams, 218 F.3d at 383.

court grounded its holding in the premise that the law establishes to a legal certainty that the assignee of a partner has precisely the same liquidation rights as the assigning partner. We reach the opposite conclusion, i.e., that this premise is *not* established to a legal certainty, and to hold that it constitutes error."). Therefore, the court held that on remand, the district court must consider evidence from both parties in light of our determination that the liquidation rights of an assignee are *not* clearly established but that, to the contrary, they are unsettled, and must determine the applicability of the various claimed discounts and the correct percentages of those that are found to apply. *Id.*

The discounts at issue are "lack-of-marketability discount, lack-of-control discount, and portfolio-mix discount that might be applicable in this case." *Id.* Additionally, the panel held that this court had not "considered that this very legal uncertainty might itself be an independent factor depressing the price a willing buyer would pay (or a willing seller might expect to be paid) for the assignee interest." *Id.* The circuit court explicitly did not go so far as to conclude that all of the discounts urged by the Estate are necessarily applicable in this case or to determine the correct percentage of those that might be; only that some or all might be applicable and that further fact-findings and legal determinations are necessary to determine which if any discounts should be applied and the quantum of each. *Id.*

II

"The Federal Estate Tax is an excise tax imposed on the fair market value of property transferred at death, less allowable deductions." *Id.* at 386 (footnote omitted). To determine this value, the court applies the "willing buyer-willing seller" test, which is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." *Id.* (footnote omitted). "The potential transaction is to be analyzed from the viewpoint of a hypothetical buyer whose only goal is to maximize his advantage. Courts may not permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer." *Id.* (footnote omitted) (quoting *Estate of Smith v. Comm'r*, 198 F.3d 515, 529 (5th Cir. 1999)). "In that same vein, the "'willing seller" is not the estate itself, but is a hypothetical seller.' Considerations that 'depend[] on the identity of the seller as the legatee and the executor, cannot control the value of the asset.' In every case all relevant facts must be considered." *Id.* at 386-87 (footnotes omitted). The burden of proof is on the taxpayer to demonstrate "both the excessiveness of the assessment and the correct amount of any refund to which he is entitled." *Portillo v. Comm'r*, 932 F.2d 1128, 1133 (5th Cir. 1991).

III

At trial, the government's expert, David Fuller ("Fuller"), valued the Estate at \$7.821 million. Assuming the existence of a liquidation right, he arrived at this figure by (1) reducing the partnership's total NAV of \$33.081 million by 5.4% to reflect the brokerage expenses associated with liquidation, and (2) multiplying that sum by 25% to compute the partner assignee's pro rata share of NAV, net of brokerage costs that would be incurred in liquidation. On remand, the government continues to argue that plaintiffs have the right as assignees to buyout the other partners, and it adheres to the \$7.821 million valuation of the property transferred--*i.e.*, the interest of the partner's assignee in the dissolved Texas partnership. Specifically, it contends the Fifth Circuit did not definitively answer whether a liquidation right exists and declined to direct this court explicitly to apply the discounts at issue. The government renews its argument that upon the death of one of the partners, Taylor Properties dissolved and the surviving partners had a choice either to wind up the partnership or to continue the business of the partnership. *See* D. Br. at 11-12 (citing TUPA §§ 41-42). If the business were continued, the new partnership would consist of the surviving partners. *Id.* Under § 42, the government argues, if the heirs chose not to be partners in the new partnership, the remaining partners could either (1) terminate the partnership and liquidate the assets or (2) continue the business and pay the heirs the value of their respective interests. On the other hand, if the heirs elected to become partners, they would then assume the right to terminate the partnership whenever they chose. *See id.* at 13.

The court rejects the government's reasoning. The Fifth Circuit considered the argument that the government now advances, and that this court adopted initially, that the assignees of a partner in a

dissolved partnership have an established right to liquidate or otherwise receive compensation in the amount of 25% of NAV--a full partner's interest. As the court has recounted above, *see supra* at § I, the court in several instances rejected this proposition. The Fifth Circuit "reached the opposite conclusion, i.e., that this premise is not established to a legal certainty[.]" Adams, 218 F.3d at 391. Indeed, it noted that its best guess was that an assignee's interest would be discounted. *Id.* at 384. The court therefore holds that it would err on remand to hold--despite the conclusions of the Fifth Circuit-- that the TUPA provides a liquidation right to assignees that obviates the need to discount their interest from a straight, ratable 25% share of net asset value.⁵

Moreover, the court rejects the government's contention that the relevant partnership agreement "permitted either the personal representative or the heirs to become partners and as partners they could effect the termination of the partnership." D. Br. at 23. The partnership agreement merely provides that the heirs of a deceased partner "shall have the right to continue this partnership by signifying in writing their acquiescence to the terms of this Partnership Agreement which shall continue under the same name and the same terms as herein set out." P. Ex. 1 at 4 (emphasis added). By continuing the partnership, plaintiffs would continue to be assignees of Mendenhall's interest in Taylor Properties. Furthermore, although the government cites to Adams' testimony in which she refers to the partnership as "we," there is no evidence that plaintiffs exercised a right to become partners even if such a right were available. Accordingly, the court holds that plaintiffs did not become partners and thereby assume the right to terminate Taylor Properties.

IV

Having concluded that the government's valuation of \$7.821 million is unsupported in light of the Fifth Circuit's opinion and the evidence in the record, the court now considers the applicability and amount of the discounts for lack of control, poor diversification of assets, lack of marketability, and uncertain legal rights.

A

At trial, plaintiffs' expert, Robert K. Conklin ("Conklin"), testified that the first three of these discounts would apply to the valuation of the assignee's interest.⁶ Using these discounts, he valued the interest at \$3.87 million. In addition to the discounts on which Conklin relies, the Fifth Circuit suggested that an additional discount might apply: that the legal uncertainty surrounding the rights of a buyer of the interest in question "might itself be an independent factor depressing the price a willing buyer would pay (or a willing seller might expect to be paid)[.]" Adams, 218 F.3d at 391. The government characterizes the discount that plaintiffs advance as "plainly absurd." D. Br. at 8, 24. But it has not presented any testimony to support what would be an appropriate discount if a liquidation right were not clearly

⁵ The court declines to reassess the applicability of *Bader v. Cox*, 701 S.W.2d 677, 681 (Tex. App. 1985, writ ref'd n.r.e.), and *Cauble v. Handler*, 503 S.W.2d 362, 365 (Tex. App. 1973, writ ref'd n.r.e.), in light of the Fifth Circuit's consideration of these cases and conclusion that they do not control the present case. See Adams, 218 F.3d at 390 n.27. Similarly, although the government contends they are not applicable, the court notes the Fifth Circuit's reliance on and approval of *Estate of Watts v. Commissioner*, 823 F.2d 483 (11th Cir. 1987), and *Shopf v. Marina Del Ray Partnership*, 549 So.2d 833 (La. 1989). The court will neither reexamine the Fifth Circuit's treatment of these cases nor consider other cases on this issue given that the Fifth Circuit has already answered the legal issue.

⁶ The government attacks the reliability of Conklin's conclusions, citing two cases in which it claims that Conklin's testimony was rejected by other courts. See D. Br. at 26-27 (citing *Knight v. Comm'r*, 115 T.C. 506 (2000), and *Morton v. Comm'r*, 73 T.C.M. (CCH) 2520 (1997)). The government has stipulated, however, that Conklin is sufficiently qualified to render an expert opinion, and it did not dispute his qualifications on cross-examination or by pre-trial *Daubert* motion. Therefore, although the court will review his testimony and expert report as they relate to applicability of amount of the various discounts, it declines to reject his testimony *in toto*.

established, and its expert conceded that if such a right did exist, lack of control and lack of marketability discounts would apply. Despite this dearth of evidence, the government suggests that "if this Court is inclined to consider that due to some uncertainty and potential litigation a discount is appropriate, we believe that such discount should not exceed 15%." *Id.* at 38.

B

Conklin applied a 20% minority interest, or lack of control, discount. This discount recognizes that as a minority interest, the Estate lacks control over the assets of Taylor Properties. In the present case, the lack of control is defined not only by the 25% interest, but by the fact that it is of an assignee rather than a partner and that a managing partner has exclusive authority over partnership decisions.

The government objects to such a discount, contending that Conklin based his assumptions on an erroneous conclusion that Taylor Properties was not dissolved. It argues that because the interest at issue is in a dissolved partnership, and the heirs of the deceased partner have either a liquidation or a buyout option, the lack of control is not so pronounced. Moreover, it maintains the partners would owe a fiduciary duty to plaintiffs, which would circumscribe the partner's management authority and limit the risk that plaintiffs faced. These arguments have already been rejected because the Fifth Circuit has held that there is no clearly-established liquidation or buyout right and has expressed doubt that such a right exists. *Adams*, 218 F.3d at 384 ("Our 'Erie Guess' would likely be that--under the Texas partnership law, which is applicable to this case--an assignee's interest in a partnership would be subject to such discounts; but, more significant to today's inquiry, we are firmly convinced that it is anything but 'well-established' that a partner's assignee has the right to receive a 25 percent share of NAV."). Furthermore, to the extent that Conklin mistakenly assumed the existence of an ongoing, rather than dissolved, partnership, his valuation is still valid because the legal rights surrounding the interest he valued and the interest the Fifth Circuit described in this case are virtually identical. Finally, the government incorrectly asserts that the remaining partners owe a fiduciary duty to plaintiffs. Partners do not owe such a duty to an assignee of a partner. See *Griffin v. Box*, 910 F.2d 255, 261 (5th Cir. 1990) (declining to impose fiduciary duty between partner and transferee).

Regarding the amount of the minority interest discount, Fuller conceded on cross-examination that a 10% to 15% minority discount would be appropriate, and stated that Conklin's 20% figure "may be a little bit on the high side." Tr. 134. Fuller did not offer his own specific figure, averring that he "hadn't done an analysis specifically." *Id.* at 132. Because plaintiffs' expert has provided the lone specific analysis of the issue, and his reasoning is consistent with numerous cases that plaintiffs cite, see P. Br. at 22 (citing cases), and is not substantially divergent from the government's own expert's figure, the court accepts plaintiffs' proffered minority interest discount of 20%.

C

The second discount Conklin applied was a 10% portfolio discount. A portfolio discount adjusts valuation for interests that feature poorly diversified assets.

In addition to the government's erroneous legal argument that plaintiff's enjoy a liquidation or buyout right, it questions the reasoning behind Conklin's portfolio discount. Its own expert, however, was less certain that a portfolio discount was inappropriate. Fuller testified that he did not "think there is a material portfolio discount associated with a purchase of these assets," Tr. 134, but admitted that in the absence of a liquidation he was "not sure in that context whether a portfolio issue would be faced or not," *id.* at 135. In the event of a portfolio discount, however, he conceded that it "could be up to 10 percent[.]" *Id.* Absent a specific alternative valuation from the government and the apparent reasonableness of Conklin's opinion, evidenced by Fuller's equivocal testimony on the issue, the court accepts plaintiffs' 10% portfolio discount.

D

The third discount that Conklin applied was a 35% lack of marketability discount. A marketability discount compensates for an interest's being harder to sell due to the absence of a ready market. *Estate of Andrews v. Comm'r*, 79 T.C. 938, 953, (1982).

Conklin based his determination of a 35% marketability discount on studies prepared by the Securities and Exchange Commission ("SEC") that compared the discounts attributed to restricted stocks with those of unrestricted stocks. Tr. 53-55. He concluded that the discount generally attributable to the restricted securities was 35%. Conklin Report at 22-23. In addition to these SEC surveys, Conklin also considered a study comparing the price of stocks from initial public offerings ("IPOs") with the price of such stocks in private transactions occurring within five months before the IPOs. *Id.* at 23. Based on these studies and an analysis of the characteristics of the assets of Taylor Properties affecting marketability, he arrived at a 35% discount.

The government disputes this figure, contending that Conklin based the discount on the assumption of an ongoing, not a dissolved, partnership, and that he did not establish the relevance of the studies on which he relied. Moreover, the government asserts that one of the factors that Conklin cites as reducing marketability--limitations in the partnership agreement on sale of partnership interests--does not apply to assignees. The court has already determined that the government's distinction between an ongoing and dissolved partnership is immaterial for the purposes of assessing Conklin's valuation. Furthermore, although Fuller criticized Conklin's studies for their lack of detail, he testified that analysis of private placement transactions is relevant to the valuation of the partnership. Even if Conklin did not take into account, as Fuller contends he should have, particular aspects of IPOs--apart from the fact that they are being offered to a public market--that make them more marketable, the court notes that he applied a discount on the conservative end of the median range. *See* Tr. 54, 56. Finally, Conklin's assumption about the transferability of an assignee interest--although based on a section of the partnership agreement explicitly applicable to partners--is supported by § 14.0(a) of the partnership agreement, which states that the terms of the agreement shall be binding on heirs and assignees of partners as well. In light of the reasonableness of Conklin's analysis and the absence of any specific findings on the valuation issue by Fuller, the court accepts Conklin's 35% discount for marketability.

E

In addition to the foregoing discounts, the Fifth Circuit directed this court to consider whether a discount should be taken based on the legal uncertainty surrounding the rights of the assignee. The court reasoned:

More to the point, the legal uncertainty that obscures the extent, if any, to which an assignee has the right to provoke liquidation or, alternatively, to force a straight pro rata redemption of his interest, suggests that any effort to exercise such putative rights would be met with strong resistance from the remaining partners. This legal uncertainty--which raises the specter of costly litigation in addition to an adverse result--is itself a factor that must be taken into account when appraising the fair market value of an assignee's interest for estate tax purposes. *Adams*, 218 F.3d at 384.

The district court grounded its holding in the premise that the law establishes to a legal certainty that the assignee of a partner has precisely the same liquidation rights as the assigning partner. We reach the opposite conclusion, i.e., that this premise is not established to a legal certainty, and to hold that it constitutes error. This error of law by the district court caused it to pretermitt inquiry into the quantum of any lack-of-marketability discount, lack-of-control discount, and portfolio-mix discount that might be applicable in this case. Neither did the district court consider that this very legal uncertainty might itself be an independent factor depressing the price a willing buyer would pay (or a willing seller might expect to be paid) for the assignee interest.

Id. at 391. Plaintiffs suggest that it might be appropriate to apply such an additional discount. *See* Ps. Br. at 36 (stating that "it is clear that the valuation discounts determined by Conklin *and/or* an additional discount for uncertain rights must be applied" (emphasis added)).

Although the court recognizes that, absent the discounts it has already applied, a deduction for legal

uncertainty might be warranted, such a reduction is not justified on the facts of this case. This is so because the court has already taken into account other discounts that are premised on the assumption that a partner's assignee has no right to receive a "straight, ratable 25 percent share of the partnership's NAV, thereby [obviating] these undesirable characteristics." Adams, 218 F.3d at 384. Stated another way, the court has removed any uncertainty surrounding the assignee's rights by assuming the assignee would not have them, and then discounting the value of the assignee's interest accordingly. In such circumstances, legal uncertainty is not an additional factor that "depresses the price a willing buyer would pay (or a willing seller might expect to be paid) for the assignee interest." Id. at 391.

Moreover, the circuit court appears to contemplate that a discount for legal uncertainty has relevance to the hypothetical buyer-seller calculus where the buyer would opt to enforce a right to liquidate the partnership or to force a straight, pro rata redemption. See id. at 384 ("More to the point, the legal uncertainty that obscures the extent, if any, to which an assignee has the right to provoke liquidation or, alternatively, to force a straight pro rata redemption of his interest, suggests that any effort to exercise such putative rights would be met with strong resistance from the remaining partners. This legal uncertainty--which raises the specter of costly litigation in addition to an adverse result--is itself a factor that must be taken into account when appraising the fair market value of an assignee's interest for estate tax purposes." (emphasis added)). But in these circumstances, the buyer would be seeking an interest that, if obtained, would not then be subject to devaluation based on lack of marketability, lack of control, or portfolio mix. Therefore, while it would make sense to reduce the value of an interest for legal uncertainty where it is assumed that the buyer would be required to engage in litigation to enforce an unsettled right, there is no logical reason to do so where it is assumed that the right does not exist and the value of the interest has for that reason already been discounted.

Accordingly, in light of the court's application of lack of control, portfolio, and marketability discounts, the court will not further discount the partnership interest for legal uncertainty.

F

Having accepted plaintiffs' position concerning most of the discounts to be made to the value of the interest of the partner's assignee, and having determined that an additional discount for uncertain rights is unwarranted on the facts, the court holds that for federal estate tax purposes, Mendenhall's interest in Taylor Properties as of June 23, 1992 was \$3.871 million and that plaintiffs are entitled to a refund.

V

The Fifth Circuit also directed the court to dispose of the issues of the reasonableness of the contingency fee agreement between plaintiffs and their counsel and the deductibility of accountant's and appraiser's fees. Pursuant to the court's September 9, 2000 scheduling order, the parties have resolved these issues.

* * *

For the reasons stated, the court finds and concludes that plaintiffs are entitled to judgment in their favor. Because the amount of the judgment may be affected by the parties' stipulations, the court directs that they confer regarding the form of the judgment and that plaintiffs promptly prepare a judgment for the court's consideration.⁷

August 24, 2001.

SIDNEY A. FITZWATER

UNITED STATES DISTRICT JUDGE

⁷ It will be helpful if plaintiffs will submit the proposed judgment on a diskette in WordPerfect format. This will assist the court in editing the proposed judgment before entry.