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Litigation & Valuation

REPORT

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What's a business worth? It depends

Business value isn't an abstract concept. Valuation experts can't place a value on a business or business interest until they answer certain key questions, such as "value to whom?" "value when?" and "value for what purpose?"

In a litigation context, the same business interest may have different values depending on the nature of the case, applicable law and other variables. Here are some factors to consider.

Subject of the valuation

The valuation process can't begin until you identify the subject ownership interest. Is it a complete, "fee



simple" interest or is it something less, such as a term or life interest? What are the interest owner's rights in the business? If the interest takes the form of stock, are there any preferences or restrictions related to voting rights, dividends or liquidation? If it's a partnership interest, what rights or limitations are in the partnership agreement?

An ownership interest is defined by the legal rights it confers on the owner, and each of those rights impacts the value conclusion.

Standard of value

The most widely recognized valuation standard is fair market value (FMV). It's often used as the standard of value for businesses or business interests for sale or for a variety of federal and state tax purposes. FMV typically is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of relevant facts.

FMV assumes a *hypothetical* willing buyer and seller. But at times it's necessary to calculate "investment value," which is based on a *specific* buyer's or owner's investment requirements and expectations. This measure may be appropriate, for example, in calculating damages for destruction of a business. If a defendant's wrongful conduct drives a plaintiff out of business, it may be appropriate to value the business from the plaintiff's perspective.

In certain types of litigation, the standard is prescribed by law. In shareholder litigation, a dissenting shareholder's stock is usually priced at "fair value" — a statutorily defined value that's intended to be fair to all parties. The theory is that a minority investor should receive at least his or her pro rata share of the company's expected cash flows upon liquidating that interest. In many states, fair value is equal to FMV that's been calculated without

consideration of marketability or control discounts. It may also exclude any appreciation or depreciation in value in anticipation of the transaction that gave rise to the lawsuit.

In divorce cases, it's important to review statutory or case law that governs valuation standards. Typically, business valuation in a divorce is based on FMV, but state law can modify traditional FMV concepts, often in significant ways. The law varies from state to state, for instance, on whether personal or enterprise goodwill is a marital asset subject to division.

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Premise of value

The premise of value refers to the assumed circumstances surrounding the valuation. For example, should the expert assume that the business will continue as a going concern? Or should he or she assume that the business will be liquidated and its assets sold? If the latter, will the assets be sold in an orderly disposition or as part of a forced liquidation?

Typically, experts assume a premise of value based on the business's "highest and best" use unless special circumstances or the business's actual plans dictate otherwise.

Get on the same page

These are just some of the factors to consider in valuing a business interest for litigation purposes. Others include the level of value (see "Leveling the playing field" at right), the valuation date, state laws that affect owners' rights and contractual provisions — such as buy-sell agreements, voting agreements or rights of first refusal — that have an impact on value.

LEVELING THE PLAYING FIELD

The level of value on which a value is expressed frequently confuses users of valuation reports. It refers to the level of control an owner has over the business as well as the level of marketability of the interest. The more control an interest confers, the lower the risk; the more readily it can be liquidated, the more it's worth. But confusion can arise because different valuation methods reflect different levels of value. For example, when valuing a minority interest in a closely held business it may be appropriate to apply discounts for lack of control and marketability.

But discounts aren't automatic. Publicly traded stock is highly marketable, so a marketability discount is usually appropriate when valuing a closely held business. But when it comes to lack of control, the answer is less obvious.

Suppose a valuator uses the guideline public company method, which values a business interest by applying market multiples (such as price-to-earnings) from comparable public companies. Some argue that publicly traded stock prices already reflect lack of control, so an additional control discount isn't appropriate. On the other hand, because public companies tend to be professionally managed, some say lack of control has little or no impact on the value of a minority interest.

Many experts believe that the most important factor is the earnings or other economic benefits to which market multiples are applied. So, for example, if a valuator applies public company multiples to the estimated benefits a controlling owner would enjoy, a discount for lack of control would be appropriate.

The key is to understand the appropriate level of value for the subject business interest as well as the level of value inherent in any benchmark data, and to apply discounts (or premiums) only when these levels don't match.

It's critical for attorneys and valuation experts to discuss these factors and ensure that all assumptions on which a valuation is based are explained in the expert's report. ♦

In the battle of experts, one weapon simply isn't enough

Business appraisers generally consider several valuation methods in reaching a value conclusion. Indeed, most professional appraisal standards contemplate the use of multiple methods. In a recent case — *In Re Hanover Direct, Inc. Shareholders Litigation* — the Delaware Chancery Court found the petitioner's valuation expert to be “totally, completely unreliable,” in large part because she'd relied exclusively on one valuation technique.

3 broad approaches

Business valuation methods generally fall within one of three approaches:

1. The *income* approach, in which the valuator converts expected economic benefits (such as earnings or cash flows) into a present value,
2. The *market* approach, in which the valuator analyzes and applies valuation multiples derived from transactions or stock prices of comparable companies, and
3. The *cost or “asset”* approach, in which the valuator calculates the replacement cost or market value of a company's assets.

Because valuation is an inexact science, valuers typically use several techniques, each of which serves as a cross-check on the others. Determining which methods to use and the relative weight to assign each method depends on the nature and financial condition of the company being valued as well as the quality of data available.

An underwater company

In *Hanover Direct*, the issue was the fairness of a going-private merger to the company's public shareholders, who were cashed out at \$0.25 per share. The company had been heading toward



insolvency for some time, and its combined debt and contractual obligations to preferred shareholders exceeded the value of its common stock.

After consulting with an independent financial advisor that valued the company, the board of directors approved the merger proposal. The board concluded that the \$0.25-per-share price exceeded the stock's fair value. The court arrived at a similar conclusion: The company was “underwater,” so the per-share value of its common stock was less than \$0.00. Accordingly, any merger price above zero was fair.

Several shareholders filed suit against the company, claiming that \$0.25-per-share was entirely or grossly unfair. They asserted that the stock's intrinsic value at the time of the merger was \$4.75 per share.

An unconvincing expert

Resolving the valuation issue came down to a battle of experts. The company's expert used three valuation techniques — a discounted cash flow

(DCF) analysis, a comparable company analysis and a comparable transaction analysis — arriving at a per-share value of less than \$0.00. The shareholders' expert relied solely on a comparable public company analysis.

The company expert's valuation used multiple valuation methods and data that raised no reliability issues, thus leading the court to accept the company's valuation.

The court questioned the reliability of the data used by the shareholders' expert, noting that she included “data points that seemed to be at worst outliers and at best failure by the expert to adjust appropriately even for the possibility that these data points were outliers.” But the most significant problem was that

her valuation “was based entirely on one valuation technique ... rather than on a blend of techniques.”

Because of these and other weaknesses in the shareholders' valuation, the court concluded that it couldn't place any confidence in the \$4.75-per-share price calculation. The company expert's valuation, on the other hand, used multiple valuation methods and data that raised no reliability issues, thus leading the court to accept the company's valuation.

The court acknowledged that there may be circumstances in which a single valuation methodology is the “best and only method by which to value a particular company.” But those circumstances didn't exist in this case.

Choose your weapons

Hanover Direct illustrates the importance of using multiple valuation methods whenever possible to support value conclusions. And in cases where a single methodology is appropriate, your valuation expert should be prepared to explain why such an approach is valid and reliable. ♦

When it's time to calculate damages

How to ensure a reasonable discount rate

Consider this scenario: In 2010, a company fires an employee for stealing trade secrets. It goes to court to recover the lost profits it likely would have earned in the future had the employee not divulged the secrets to a competitor. But what's the best way to determine those lost profits?

It's not an easy answer. But a skillful financial expert can discount future damages to present value, providing the ammunition businesses need to receive a just award.

Recognize the impact

Many plaintiffs don't recognize the impact that discounting can have on damages awards. The difference between discounted and *undiscounted*

damages awards, however, can be substantial. A defendant who fails to object to an undiscounted award may end up overpaying. Suppose that a plaintiff recovers damages for lost profits of \$500,000 per year for five years. Without discounting, damages would total \$2.5 million. But discounting those damages to present value (using a 10% discount rate) would reduce the award by more than \$250,000.





If an award is discounted, parties on both sides must ensure the discount rate is reasonable. Even small rate variations can affect the damages amount.

Understand what affects the discount rate

The discount rate is the rate of return a hypothetical investor would demand, given the level of risk or uncertainty associated with the plaintiff's "but for" profits and, specifically, with the probability those profits would materialize.

If the plaintiff's company has a track record of consistent earnings and its risk of falling short of projected future earnings is low, a modest rate of return may be appropriate. But if the plaintiff's company is in a high-risk industry or has volatile

earnings, an investor would require a higher return to compensate for the risk.

Financial experts choose from several methods of calculating a discount rate; each involves a risk factor analysis. The "build-up" method, for example, begins with a "risk-free" rate of return — typically the yield on long-term government bonds. The expert methodically increases that rate to reflect the risks associated with the projected lost cash flows.

If an award is discounted, parties on both sides must ensure the discount rate is reasonable. Even small rate variations can affect the damages amount.

Know how to approach damages

Once they have a discount rate, financial experts can use two approaches to calculate lost profits damages. They can determine the plaintiff's expected future income stream and then discount it to present value using a risk-adjusted discount rate. Or, they can also incorporate risk considerations into the future income projection and then reduce projected income to present value using a lower-risk discount rate.

The first approach may offer greater simplicity. But in reality, the second approach may be easier for a judge or jury to grasp — critical in any case. Triers of fact may have trouble understanding how risk factors are used to modify the discount rate but readily comprehend the impact of risk on a plaintiff's future earnings potential.

No easy task

Many plaintiffs simply don't recognize the impact that discounting can have on damages awards. As a result, it's critical that they retain a financial expert who understands the ins and outs of discounting future losses to present value. ♦

Poking holes in your damages case

Critiquing expert can help avoid disaster

In commercial litigation, the quality of your financial expert can make the difference between winning and losing a case. But no matter how thoroughly you prepare, it can be difficult to recognize weaknesses or errors in your expert's report. Even if you have a firm grasp of the concepts on which the expert will testify, both you and the expert may be too close to the case to evaluate it objectively.

When large sums are at stake, consider engaging an independent "critiquing" expert to ensure your expert's report will withstand adversarial scrutiny.

Choosing a critiquing expert

A critiquing expert can help you uncover mathematical or typographical errors, missing or incorrect assumptions, inconsistencies, questionable methodologies, and invalid or unsupported conclusions — any of which might cast doubt on your expert's reliability in the eyes of a judge or jury. This expert may also identify alternative approaches that your testifying expert didn't consider.

The critiquing expert should have similar qualifications and industry experience as your testifying expert. In addition, the critiquing expert should be fully independent and objective so he or she can evaluate your expert's report from the opposition's perspective.

It may be possible to use another expert from the testifying expert's firm to perform the critique. If you choose this route, protect his or her work product from disclosure to your opponents.

Building a "Chinese wall"

Most notes, correspondence, workpapers, reports and other materials prepared by or relied on by a testifying expert are discoverable by opposing parties. To protect a critiquing expert's work product against disclosure, you must ensure that he or she is considered a *consulting* rather than a *testifying* expert. The best way to do that is to use a critiquing

expert who has no ties to the expert whose report he or she will review.

Ideally, the critiquing expert will work for a separate firm and you — not your client — will hire and pay him or her. If you use a critiquing expert from the testifying expert's firm, you must build a "Chinese wall" between them. Also, include language in your engagement letter clarifying that the critiquing expert is a consultant and that all communications between you and the expert must be confidential. Moreover, prohibit the critiquing expert from communicating with your client except at your direction.



Be prepared

When the outcome of a case turns on expert testimony, an independent critiquing expert can help you spot errors or weaknesses in your testifying expert's report and, if necessary, request a revised or supplemental report that addresses any issues. If the critiquing expert is involved early enough in the process, his or her comments can be worked into the expert's original report. Even if your expert's report is sound, the review process can help you anticipate the opposition's attacks and be better prepared to counter them. ♦