



Top Valuation Questions That Lawyers Love to Ask

The list of potential “aces” that can throw experts (or their attorneys) off their courtroom game is endless. To help witnesses stay on their toes during even the most intense cross-examinations, here are a few favorite zingers—and how to lob them back with grace and style:

Q: Would *you* buy this company for what you’ve valued it?

A: The witness should pause for a moment, and then explain that the values stated in his/her report arise from the company’s unique circumstances, taking into account the actual market conditions of what others are paying for similar companies. Moreover, analysts are not in the business of recommending what a buyer ought to pay; that decision must reflect the buyer’s personal view of the market, tolerance for risk, etc.

Q: You’ve never actually sold a business—so you don’t have a clue what real buyers and sellers consider, do you?

A: The answer depends on a business appraiser’s actual background and experience in purchase and sales, of course. The more common-sense understanding of buy/sell transactions the witness has, the less vulnerable he/she will be to this line of attack; make sure to rehearse responses to this question, adapted to the valuator’s particular strengths.

Q: The specific value in your report represents a *range*, doesn’t it? If so, what is an “acceptable” range, plus or minus, and where does *your* value fall?

A: This is one of the most common “trick” questions, designed to get the witness to admit that the value is subject to adjustment within the “range.” Any valuation has a subjective element; the witness can retain credibility by admitting this, and explaining what observations, analysis and other data went into the valuation, thus creating an advantage: a second opportunity to repeat direct testimony.

Q: There’s a math error in your report, and that makes it *unreliable*, correct?

A: Of course, it’s best to submit an error-free report.

But slips happen (keep this in mind when reviewing your opponent’s report). The best way to keep credibility with the judge or jury is to admit any mistake, and explain how to account for it or remedy it.

Q: Do you consider “So and So” to be an authority in business valuation?

A: Any industry, including business valuation, has its better-known, leading authorities. The trick in this question is when the attorney whips out an excerpt from this acknowledged authority which contradicts the witness’s assumptions, calculations, or conclusions. But the passage will most likely be selective, out of context or out of date; and/or offer only one opinion on a subject about which reasonable experts could disagree. The latter is important, because what may have been a best practice standard years ago may no longer be relevant today, and it’s appropriate to demonstrate where even a so-called “leading authority” has made a mistake or become obsolete.

Watch for Discovery Minefields During the Valuation Engagement

By nature, business valuers tend to be careful and deliberate—real plusses in their profession, but it can create potential minefields during the discovery process. For instance, say that a client’s tax return shows significant tax liability, which is factored into the overall business valuation. But then the client calls and points out that the inventory was in fact much lower. The standard BV practice is to adjust the valuation and note the file—but unfortunately, that note is now discoverable, and may make the valuator more vulnerable on cross examination.

In preparing their case, savvy attorneys and their appraisers should discuss these and other documents that could possibly turn against them:

- *Standard language.* Many analysts use the first person plural in their reports, as the client hired the firm rather than the individual. Continue to use this reference in court, however, and cross-examiners

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will ask to whom is the “we” referring. If the expert answers by saying “my partners”—he or she will likely endure a paragraph-by-paragraph dissection of the report to eliminate what those partners may have written.

- *Web page claims.* Watch out for claims on a valuator’s web pages that say anything close to “we help attorneys win cases,” as they can undermine the analyst’s credibility.
- *Checklists:* Checklists might be good for audits but litigators will question why you varied from standard procedure.
- *Cliff notes’ for juries.* In general, preparing summary documents of valuation opinions for juries is not a good idea. No one can teach capitalization rates in minutes; valuation witnesses will win their cases by being honest, and by convincing the judge and jury they did their work well.
- *Powerpoint vs. poster board.* Presentations disappear the moment the computer shuts down; consider using charts that will stay in front of the courtroom for the rest of the day.
- *Calendars.* An aggressive attorney could use the various meetings between lawyers and their experts and other professionals to dilute or discredit the experts’ opinions and qualifications. In difficult trials, consider using the web site www.gotomeeting.com, which schedules those meetings without making records on a computer’s hard disk.

When Determining Market Value, Rely on More than Revenue Forecasts

Susan Fixel, Inc. v. Rosenthal & Rosenthal, Inc., 2006 Fla. App. LEXIS 1101 (February 1, 2006). Judge Rothenberg.

Accuracy and reliability are the cornerstones of any business valuation—but sometimes the hard data are simply not there. And sometimes errors can mar even the most careful assessments.

The *Fixel* case concerned claims for breach of fiduciary duty and negligent misrepresentation, resulting in the total loss of a business. To determine damages based on the market value of its business at the time of its alleged destruction, the plaintiff offered expert testimony calculating damages from future revenue and cash flow projections, which one of the plaintiff’s principals had prepared. The projections assumed that the plaintiff company would receive

\$3 million from investors—though this funding never came through. The company was also a start-up, which never turned a profit and incurred constantly increasing costs. Lastly, no comparable company data was available. As a result, the court found the expert’s valuation “too speculative,” and didn’t even permit him to testify at trial.

Speculative data fail to support lost profits and market value calculations

The company tried to argue that while a lost profits calculation may require more evidence than projected earnings, a market valuation of the business could rely on forecasts—but the court disagreed. “It is as inappropriate to use purely speculative forecasts of future revenue to determine the market value of a business as it is to use such speculative forecasts in determining lost future profits.”

A critical error in the report didn’t help matters: the court found that the expert had relied on the wrong date when determining the company’s market value. Pursuant to applicable law, the correct time for valuing a destroyed business is on the date of the loss—which in this case would have been the time when the company ceased operations. For reasons the Court does not mention, the expert relied on a date almost a year earlier—a mistake that unfortunately rendered his report unpersuasive.

Another Reason to Hire BV Analysts to Provide Fairness Opinions

Ha-Lo Industries, Inc. v. Credit Suisse Boston, 2005 U.S. Dist. LEXIS 23505 (October 12, 2005). Judge Gettleman.

Fairness opinions are rife with potential conflicts of interest, none so obvious as when an investment firm’s fee is tied directly to the completion of a deal, which in turn depends upon that same firm issuing an opinion that the deal is financially “fair.”

That’s what happened here, when plaintiff Halo-Industries, a promotional products company, wanted to acquire a technology platform for internet expansion, and hired defendant investment banking firm as financial advisor. Defendant’s fee was specifically tied to the purchase price; if the deal fell through, defendant would end up with no more than its retainer and a modest “break-up” fee.

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As defendant had no specific expertise in technology systems, it advised plaintiff to hire Ernst and Young to assess this aspect of the deal. E&Y's report came back negative, indicating that the target's systems were incomplete, requiring significant investments. Plaintiff's CEO allegedly presented a positive picture to the Board, however, and the company proceeded with the acquisition; defendant, who disputed receiving E&Y's report, issued its fairness opinion and earned its \$2.5 million fee.

Despite investing millions post-merger, plaintiff later filed Chapter 11 bankruptcy—and filed suit against defendant bank for “gross negligence” in rendering its fairness opinion.

Among its claims: 1) the investment bank had valued the target using a methodology that would overstate its value; 2) it had disregarded relevant information about value and public information about the target's management practices; and 3) it had permitted self-interest in a lucrative fee and future business to override reasonable judgment.

‘Simple mistakes’ in valuation lead to Fifth Amendment plea

Before the facts went to a jury, defendant filed a motion for summary judgment, arguing that the claims lacked legal merit. In denying the motion, the U.S. District Court (N. Dist. Illinois) touched on several undisputed facts, primary among them defendant's admission that any errors in its valuation of the target resulted from “simple mistakes.”

Given that the investment analyst who'd gathered the data had asserted his Fifth Amendment right to avoid self-incrimination rather than testify how the “simple mistakes” occurred, the court could not, as a matter of law, absolve the defendant from bad faith.

For now, the case is moving forward—while fairness opinions are headed for further scrutiny. If more “independent” opinions are called for, then business appraisers may be among the more experienced professionals to answer the call.

Goodwill Hunting: Does a Motion Picture Director Create Professional Goodwill?

In re Marriage of McTiernan, 2005 Cal. App. LEXIS 1692 (October 28, 2005). Judge Flier.

You may have seen this director's movies—including the blockbusters *Die Hard* and *Hunt for Red October*.

But would you have guessed, even in California, that his career supported a finding of professional goodwill valued at \$1.5 million?

Credit the testimony of Professor Arthur de Vany, Ph.D. (UC Irvine) for persuading the trial court that the husband “[had] developed an earning capacity and reputation in his profession...which greatly exceeds that of most [of his peers].” Moreover, the husband's success was dependent on:

...his personal skill, experience and knowledge...and in that respect, the profession which he practices is similar to that of an attorney, physician, dentist, accountant, editor, architect, or any other professional who has established a successful professional practice, with quantifiable expectation of future patronage, based upon his or her personal skill, experience, and knowledge.

The trial court adopted the academic's excess earnings approach, and found that—rather than merely possessing personal skill and experience, the movie director husband owned a business asset that could be characterized as goodwill, subject to division.

There's no business like show business

The goodwill of a *business* is property and is transferable—and that became the issue on appeal, whether the definition of business could include a movie director as a “person doing business” in his field, sufficient to generate a saleable asset of goodwill.

The appeals court went on a hunt of its own, looking to the historical definition of goodwill and the “plain” language of the business and professional codes. Its findings: “No California case has held that a natural person, apart and distinct from a ‘business,’ can create or generate goodwill.” In the case of professionals, it is the practice which generates goodwill, not the principals. Expanding the definition of a business to include natural persons would implicate “much of the working population,” the court said, and there would be no distinction between a popular movie director and musicians, artists, and actors.

“Something that cannot be...sold has no value on the market. Dividing such a non-transferable quantity” would create an obligation without ensuring a source of funds. Endowing persons with the capacity to generate goodwill would create an asset predicted on “nothing other than predictions about earning capacity,” the court concluded—which in Hollywood would be a risky business, indeed.

Productivity Adjustment Key For Private Practice Valuations

Schiro v. Schiro, 2005 Mich. App. LEXIS 2085 (August 25, 2005). *Per Curiam*.

The *Schiro* case illustrates the real-life productivity adjustments that the valuation of a dental/medical practice often requires. The parties agreed that the husband's 50% share of the tangible assets in an oral surgery practice amounted to \$120,000, per the only valuation analysis in the case, submitted by husband's expert. Not surprisingly, the disagreement was over the expert's calculation of the intangibles—specifically, the estimated annual hours variable, which reflected the number of procedures the husband performed rather than the time he spent in the office.

To value the intangibles, the expert took the husband's projected work hours (based on procedures) and multiplied them by an estimated rate of collections, giving her a total projected annual collection. Subtracting payroll taxes and other expenses, she arrived at a value of \$585,000 for the intangibles, for a total practice value of \$705,000.

On cross-examination, the expert admitted that the practitioner had worked an estimated 2,750 annual hours in 2001. In 2002, he reduced his hours to 2,100 per year, to take care of his son. Pursuant to the surgeon's new work schedule, and in projecting his 2003 hours, his expert used a base of 1,320 per year, even though the industry standard was 1,600. The expert also admitted that her prior practice valuations had ranged as high as \$1.5 million, based on the husband's 2002 income of approximately \$950,000.

The trial court discredited the husband's claim that he would only work 1,320 hours per year. The industry average wasn't entirely persuasive either, as this going-concern business could reasonably expect 1,800 annual hours from its chief practitioner. Plus, the husband had just hired a new partner and bought a new house for \$775,000; it was clear to the court that historically, he was a harder-than-average worker "who likely would continue to work hard." His practice was worth \$1 million, according to the lower court—and the appeals court agreed, stating that the value fell within the range of the evidence *and* realistic experience.

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