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valuation & litigation briefing

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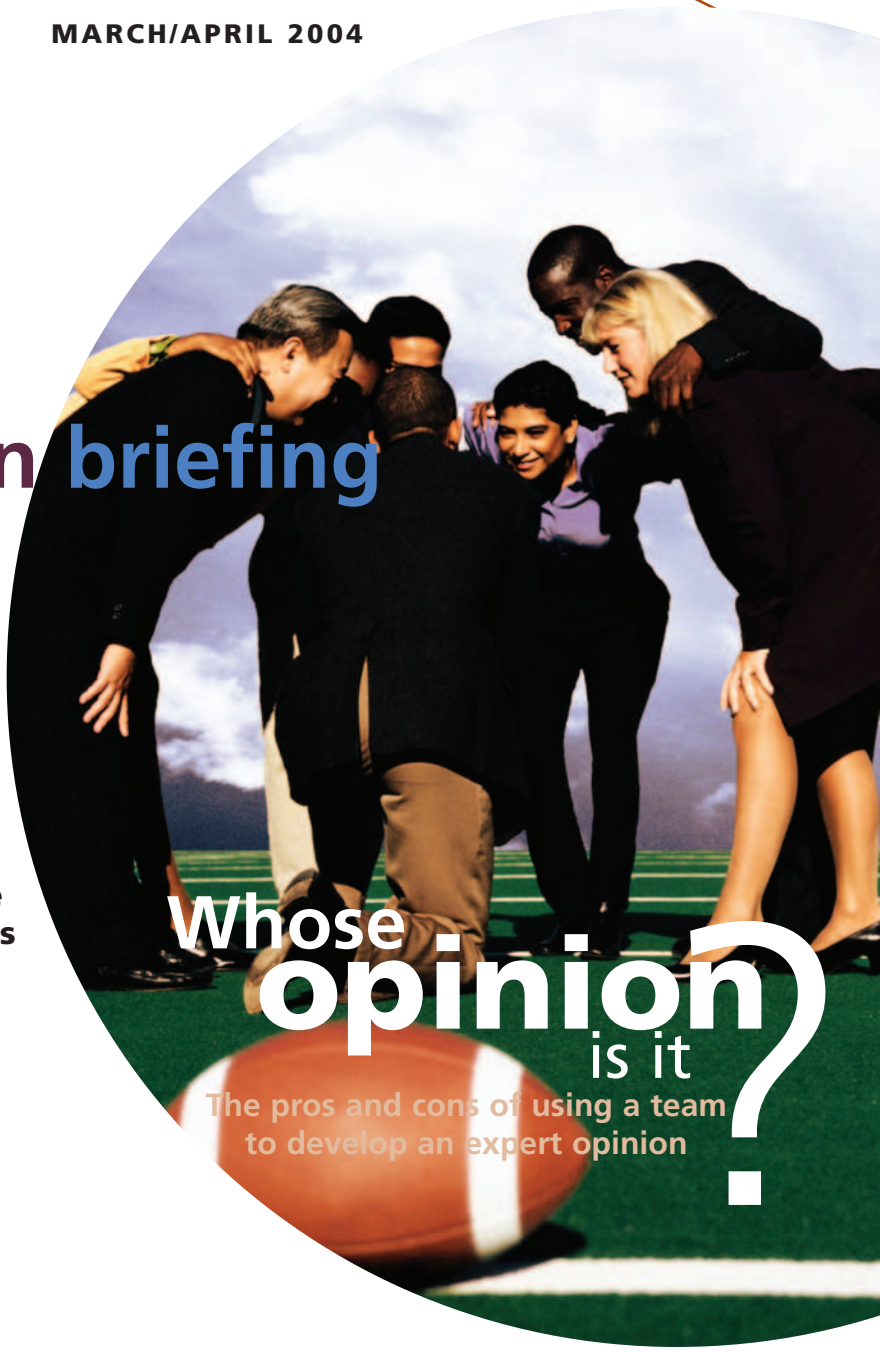

Whose opinion is it?

The pros and cons of using a team to develop an expert opinion

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Whose opinion is it?

The pros and cons of using a team to develop an expert opinion

Financial and valuation experts often rely on colleagues and staff to assist them in developing the analyses underlying their expert opinions. These professionals frequently find that the information they need to accumulate, analyze, digest and interpret is so voluminous that embarking on the engagement would be impractical without competent staff support. For instance, engagements involving investigations of large SEC corporations' books and records (not uncommon in the post Enron/WorldCom era) can easily require many thousands of hours of intensive labor. Although often necessary, basing expert testimony on such teamwork may cause questions to arise in court. Here is a brief look at some of the issues and their implications.

Sorting it out

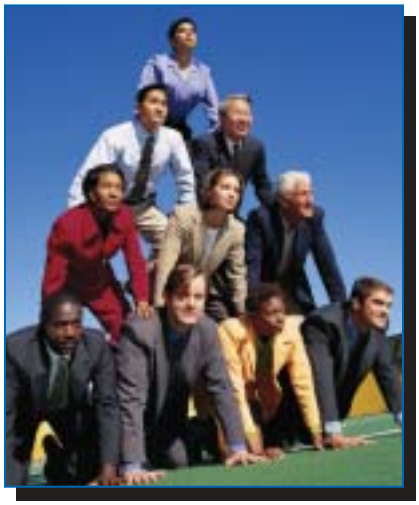
Using a team to develop a valuation report raises several questions, including:

- Should this report be considered "ghost written"?
- Whose opinions appear in the expert report?
- Are these really the testifying expert's professional opinions?
- Has the testifying expert done enough analytical work to render competent opinions in the matter?
- What are the discovery and evidentiary implications?

As case law over the last decade has better defined the standards to be applied to an expert's methodology, case law during the next decade may better define the standards to be applied to an expert's involvement in the work underlying his or her opinions. In the meantime, it is reasonable to expect more aggressive challenges of expert opinions based on team-developed work.

Go team go

To complete a job on time, the person in charge of the engagement needs to divide the work hours among a number (often a large number) of colleagues. The professional team usually consists of a principal professional and many other persons with varying skill sets and experience. Typically, a few experienced professionals supervise the work of the less experienced staff, under the direction of a seasoned principal expert. Ideally, the principal expert is the one who will be rendering opinions under oath at deposition and trial. But resource requirements may dictate that the person directing the work, though possessing a high degree of expertise and experience, is not the testifying expert but someone who works with him or her.



In these situations, the testifying expert is likely involved at the outset in defining the engagement's parameters. Also, he or she is typically kept up to date on the engagement's progress and given analytical summaries in final, or nearly final, form. A large project may involve thousands of hours of work, including inspecting and analyzing many thousands or perhaps millions of documents and gathering evidence in many different venues in different geographic areas.

By its very nature, such a project distances the testifying expert from the actual evidence underlying his or her professional opinion. As the staff's work concludes, they typically present the testifying expert with a final (or almost final) report, which will be presented to counsel, served upon opposing counsel and offered as evidence.

A meaningful role

In a recent Tax Court case (*Bank One Corp. v. Commissioner*), an expert's report was found to be inadmissible because whether the testifying expert actually wrote the report as well as whether he had generated its analysis and opinions was unclear. The court said, "Simply because an expert adopts the words of a report prepared by another as his or her direct testimony does not mean that the expert is familiar with all material matters in the report." In this case, the court couldn't consider the expert's report reliable because of the uncertainty as to whether the expert played a meaningful role in its preparation.

For expert witnesses, this case's implications are significant. Valuation experts who have traditionally relied heavily on input from their partners, colleagues and staff must revisit the concept of "meaningful role." The issue of meaningful role becomes even more complicated when an expert's opinion relies on the opinion of another expert. For example, business valuation experts often rely on outside real estate appraisals when valuing businesses that hold significant amounts of real property.

A swing of the pendulum

Valuation and other financial experts must recognize that the pendulum is clearly swinging in the direction of greater challenges of expert testimony. Perhaps the *Bank One* case is a precursor to a clearer definition of the meaningful role that a testifying expert must play in the testimony he or she presents. We are closely monitoring this situation as it develops. Please call with any questions you might have about valuation expertise to support your litigation. We would be glad to assist you. ❑

A limited partnership vs. an assignee interest: Which is worth more?

In spite of court and IRS challenges, family limited partnerships (FLPs) are still a popular vehicle to transfer family assets from one generation to the next. FLPs are useful because one generation, owning a general partnership interest, can control the cash flow from gifted assets.

FLPs can simplify estate planning, allowing for fractional interest gifting and helping consolidate family assets. Another FLP advantage is that they can protect family assets from failed marriages, "unworthy" heirs, creditors and family disputes. Let's take a closer look at some important aspects of valuing FLPs.

The million-dollar question

In valuing an FLP, an appraiser generally begins with an estimate of net asset value. He or she then considers applying the appropriate minority interest and marketability discounts based on each case's facts and circumstances. In an FLP valuation, the cumulative amount of discounting is important because, given a net asset value, it determines the fair market value at which interests are gifted — and thus the taxes that must be paid on the gift's value.

Because FLPs are relatively new to many attorneys and clients, they often ask valuators to answer questions about how to value them. Attorneys frequently ask: Because we are dealing with limited partnership interests, and what can be transferred in most instances is only an assignee interest, shouldn't a further discount be applicable to the assignee interest?

What ownership means

It is helpful to think of ownership in a limited partnership as consisting of two separate and distinct components:

1. The economic interest, and

2. The rights attached to the interest.

The economic interest is the pro rata ownership of, or claim to, distributions and assets. In almost all cases, an ownership interest of, say, 5% has a pro rata 5% claim on all distributions (whether interim or at dissolution). In addition, the ownership interest indirectly owns 5% of the assets underlying the partnership. Thus, in almost all cases, if a distribution of, say, $200,000 is declared, a 5% general partnership interest receives $10,000. This

is also true for a 5% limited partnership interest and a 5% assignee/transferee interest.

The rights attached are the second component of value, and the differences in rights attached can be significant. General partners might collectively own only 5% to 10% of total interests in a given partnership, but typically have exclusive authority to manage the partnership, including its investment policy, distribution policy and other management duties.

Limited partners and assignees/transferees typically have no real control over the partnership, despite the fact that they might own a majority interest of the outstanding partnership units. They achieve this relationship via the covenant that is the partnership agreement. This is akin to the difference between voting and nonvoting stock in a corporation, with some differences. Assignee interests are in essence limited partnership interests with economic participation equal to that of limited partnership interests, but typically without the same rights.

Different rights, different value

The difference in rights attached to limited partnership interests versus assignee or transferee interests can be significant. In most FLPs, limited partners' rights include the right to:

- Call partner meetings,
- Vote on matters such as dissolution of, and successors to, general partners,
- Inspect the partnership's books, and
- Transfer their interests to other partners or to third parties (sometimes subject to restrictions).

The difference in rights attached to limited p

versus assignee or transferee interests can be

Holders of assignee or transferee interests, on the other hand, typically do not have the right to vote, inspect the partnership's books or transfer interests.

The problem in attaching specific value to a limited partnership interest's rights versus an assignee/transferee interest's rights (or, conversely, discounting an assignee interest from the value of a limited partnership interest) is that a limited partner's rights usually are not transferable — only the economic benefit can be transferred. If a limited partner wants to assign, gift or sell his or her interest to another person, the interest the acquirer receives is generally an assignee interest, not a limited partnership interest. Typically, the partners vote to admit or refuse an assignee as a limited partner only after he or she receives or buys an economic interest in the partnership.

Proving the case

In *Kerr v. Commissioner,* a recent U.S. Tax Court case, the court saw no economic distinction between valuing a disputed gift as a limited partnership (LP) interest or an assignee interest (but ultimately valued it as an LP interest). Unfortunately, another Tax Court ruling, *Nowell v. Commissioner,* clouds the issue by agreeing that valuators should appraise certain LP interests as assignee interests for transfer tax purposes.

But in this case, the court then valued certain general partnership interests as general partner interests rather than as assignee interests, because an existing general partner received them. This was contrary to the typical valuation standard of "hypothetical" buyers and sellers.

artnership interests

significant.

This is because partnerships are contracts between persons designed for their mutual benefit. One protection that limited partners receive is that they cannot easily be forced to accept someone with whom they did not originally covenant as their partner. Thus, the assignee interest is a sort of in-between phase in which the acquirer of an economic interest in the partnership petitions to become a partner. In some cases, only the general partner must approve. In other cases, the process of becoming a full limited partner is more onerous.

Nonetheless, if the only transferable value is the economic benefit (and not the limited partner rights attached to it), then isn't every (or nearly every) valuation of a limited partnership interest actually the valuation of an assignee interest? Again, it is important to remember that a limited partnership interest's heir, acquirer or buyer actually receives an assignee interest, not a limited partnership interest.

The upshot

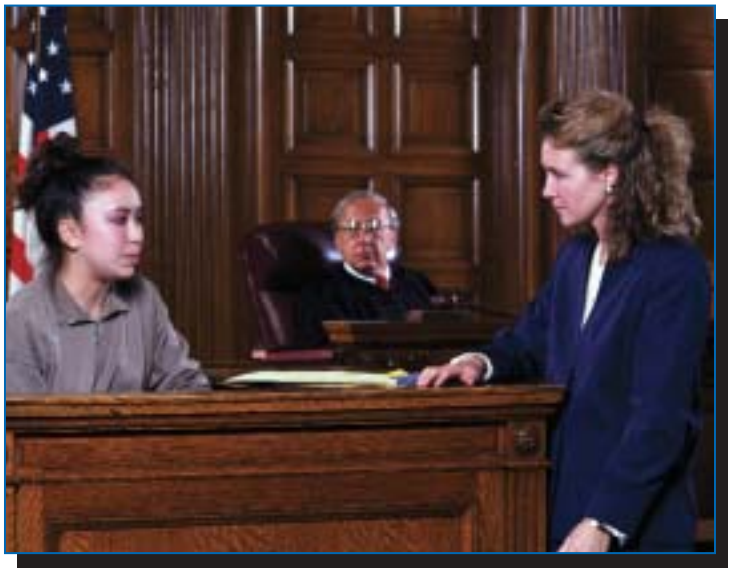
In light of market data related to voting rights versus nonvoting rights, the value of gifts of assignee interests appears to be only slightly lower than that of limited partnership interests. If, under appropriate circumstances, a valuator assigned value to limited partner rights above and beyond that of their economic interest, this adjustment's impact probably wouldn't be large.

Market evidence of the differential between voting and nonvoting common stock interests suggests a minor impact if translated to the relationship between assignee interests (nonvoting) and limited partnership interests (voting) — perhaps on the order of 5%. But in the context of a fair market value appraisal, a rational acquirer of an assignee interest would likely attribute little (if any) value to the vote, because such a vote is unlikely.

Please call us with any questions concerning limited partnership or assignee interests' value. We have experience in working with these interests and would be glad to advise you. ❑

The ins and outs of quantifying damages

In our litigious society, the need to quantify a potential or actual claim's economic value is common. Claims stemming from some causes of action, however, are more readily determinable than others. Although determining business, damaged property or real estate value losses may be relatively straightforward, determining other types of damages, such as "pain and suffering" in personal injury cases, can be much more ambiguous. Here's a look at the different types of damages as well as the factors valuators consider in determining damages amounts.



5 types of damages

The plaintiff bears the burden of proof for determining the types and amounts of damages suffered. In addition, winning the case often calls for outside financial expert witness testimony. Typically, damages fall under one of five categories:

1 ***Compensatory damages.*** This type is intended, as much as possible, to compensate plaintiffs and restore them to the position they were in before suffering from the defendant's wrongful conduct.

2 ***Economic damages.*** Also called "pecuniary damages," these consist of the actual "out-of-pocket" losses the injured party suffered.

3 ***Noneconomic damages.*** These "nonpecuniary damages" are expenses above and beyond out-of-pocket losses and may include "pain and suffering," "loss of enjoyment of life" or "loss of consortium."

4 ***Punitive damages.*** Also called "exemplary damages," these are intended to punish wrongful conduct. Determining applicability of these damage claims is complex and largely depends on state law.

5 ***Nominal damages.*** These consist of an award of a small sum of money (often $1) to a person who has proved an injury but hasn't been able to demonstrate any appreciable compensable losses.

"Collateral" damages

The "collateral source" rule holds that a defendant should not benefit from a plaintiff's fiscal prudence — for example, in buying insurance coverage against a loss. This can result in a plaintiff's collecting damages twice: once through an insurance settlement and again through legal proceedings against the defendant who caused the loss. In most jurisdictions, this rule has been modified or banned for some types of cases. Where the collateral source rule doesn't apply, the defendant gets a "set-off" against the judgment in the amount the plaintiff has received from the collateral source.

Courts won't compensate plaintiffs for damages they find speculative or unsupported by admissible evidence. But a plaintiff may be able to sufficiently show evidence of damages that are not yet fixed — such as future damages — based on reasonable projections. Expert opinions are key to ensuring that these projections are reasonable and reliable.

Lost earning ability

In an employment law case, a plaintiff may seek economic damages for "back pay" (wages lost between the time of wrongful termination and the verdict) and "front pay" (wages likely to be lost in the future, because of the job loss and possible career hindrance). Similarly, a person who suffers a physical injury may not be able to return to work and may be entitled to damages for lost wages. When determining the damages award, a valuation professional examines the plaintiff's earning capacity before the defendant's wrongful conduct as well as afterward. In determining earning capacity, the valuator also looks at factors that will affect future employability, including the defendant's:

- Age,
- Physical and mental health,
- Educational background,
- Job skills and aptitudes, and
- Labor market conditions in areas where the plaintiff may be eligible for work.

Expert testimony can help establish these factors on the plaintiff's behalf. More specifically, a valuation professional can produce an opinion projecting how the defendant's wrongful conduct affected the plaintiff's past and future earnings.

In some cases, medical, vocational or psychological testimony may be needed to establish the loss of physical or mental capacity to perform the type of employment the plaintiff previously held, or to explain or challenge any asserted limits relating to the plaintiff's ability to return to work. Often, both plaintiff and defendant present expert witnesses with competing damages projections.

Pain and suffering

When a person suffers a physical injury, that person frequently claims damages from "pain and suffering." There is no clear method for determining the value of pain, or the ability to lead a normal, pain-free life. This is an area where an attorney's advocacy can profoundly affect a damages award amount.

In light of equivalent facts and injuries, the manner in which an attorney demonstrates the effect of an injury or disability to a jury and the manner in which he or she requests damages can significantly raise or lower a damages award.

An art and a science

Many people believe that effective damages advocacy is more an art than a science. Of course, the extent to which this is true depends both on a case's facts and the injury's type and nature. This is an area where good legal counsel, and, as necessary, the testimony of a good financial or valuation expert, can potentially make an enormous difference in the case's outcome.

Please call with any questions you may have about determining damages for your clients. We would be glad to advise you. ❑

Medical practice transfer issues

Generally, the larger and more diverse a firm, the greater the transferability of practice goodwill. This is at least in part a result of client retention. But if a medical practice's success relies on professional or client referral because it provides specialized services, transferability is much more difficult. Why? Another provider cannot simply "take over" and expect the referrals to continue uninterrupted. This is why an "earnout or payout" is typical between buyer and seller.

An earnout is a way of structuring a sale allowing the buyer to pay in installments, with the balance contingent on the practice's financial earnings. Variables include the size of the down payment, the length of the earnout period, the ceiling and floor (regardless of client gains or losses), and the earnout base (including revenues, net earnings and total cases). The longer the earnout time period, the greater the impact the time-value of money and discounting the sales price will have.

The nature of the client base tends to differentiate the value of one professional practice from another. A more desirable practice is able to provide services to its clients on a recurring basis versus an as-needed basis. Practices may be worth more in areas of large competition. This is because purchasing an existing client base, when transferable, is easier than attempting to start from scratch.

Goodwill's value is likely based on expected future earnings, which may fluctuate depending on the type of practice, the fee basis and the general economic conditions. At issue is the predictability of future returns (risk). Goodwill may have value only if it increases future earnings. For instance, in the *Marriage of Brown,* the court said that goodwill was the tendency for customers to return to the same location or business because of its name or other attributes, regardless of its location. Typically, a valuator compares a new practice's revenues with those of an established practice — the difference is likely to be the goodwill value. In the *Marriage of Holbrook,* the court's position was that the firm's goodwill existed in its salaries. In *Hanson v. Hanson,* the court characterized "going-concern" value as the opportunity to walk into a successful situation, start work and earn money immediately without having to build a practice.

J.L. PIERSON & CO. LLC

BUSINESS VALUATION AND APPRAISAL

J.L. Pierson is an Accredited Senior Appraiser designated by the American Society of Appraisers (ASA) in the Business Valuation discipline. He specializes in business valuation for closely held businesses, family limited partnerships (FLPs), Limited Liability Companies (LLCs) and professional corporations. Valuations are performed for investment, estate planning, financial reporting, corporate insolvency, gift/estate tax and income tax purposes. This type of valuation work often involves discounts that must be based on reasoned and well-documented judgment — not a formula or software package — that is fully consistent with case law.

J.L. Pierson specializes in Business Valuation and appraisal only, including such projects as:

- ☛ Valuation of interests in FLPs and LLCs holding marketable securities, real estate or other investments including partnership interests.
- ☛ Valuation of professional practices, including accounting, medical and law, often for marital dissolution cases, earn-outs and other purposes.
- ☛ Succession planning, gift and estate planning, and asset protection for the closely held business in all industries.
- ☛ Determination of the appropriate corporate development strategy for enhanced business value including exit strategy.

We also provide valuation and litigation support services for a broad range of other purposes, including:

- ☛ Complex fractional real estate portfolio valuations.
- ☛ Lost profits/Business Interruption: Damage calculations and other litigation claims.
- ☛ Buy/Sell agreements.
- ☛ Dissenting & Oppressed shareholder suits.
- ☛ Employee Stock Ownership Plans (ESOPs): Feasibility studies and annual valuations.
- ☛ Financial reporting: Fair Value studies. Goodwill Impairment testing. SFAS 141/142/144.
- ☛ Mergers and acquisitions transaction support, fairness opinions, solvency opinions.
- ☛ Corporate development.
- ☛ Bankruptcy planning.
- ☛ Marital dissolution.
- ☛ High-tech, Internet, options, intellectual property [trademarks, copyrights, etc.] and other intangibles.

We welcome the opportunity to serve you. Please call us at (203) 325-2703 or e-mail: info@NYNJCT-BV.com and let us know how we can be of assistance.

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