J.L. PIERSON. ASA

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(203) 325-2703 Business Valuation (203) 434-4648

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Roundup on Divorce Cases: Discounts, Valuation Dates, & the Economic Downturn

Is the severe economic downturn sufficient reason for a divorce court to revalue business assets? Does the statutory fair value standard preclude marketability and minority discounts in divorce? And what happens when a trial court combines the income and market approach to valuing a business? The following four recent divorce cases answer these questions and more.

An unprecedented recession. In Mistretta v. Mistretta (Fla. App. 1 Dist)(Feb. 18, 2010), the trial court valued the parties' restaurant at $845,000, based on expert appraisals conducted in 2007. Not long after the divorce was final, the husband filed a motion to reconsider. The economic recession caused the restaurant to lose nearly $57,700 in 2008, the husband claimed, and this "newly discovered evidence" merited a new trial and valuation. The trial court granted the motion, finding the 2007-2008 recession was "totally unforeseen."

The wife appealed, arguing that the economic downturn was merely a change in circumstance, and the appellate court agreed. Business valuation is a forward-looking exercise, based on financial facts currently in existence as well as projected revenues and cash flows. "Economic recessions, like other vagaries in the business cycle, are contingencies appraisers must take into account in valuing a business," the court said. Although no valuation expert could have predicted the severe economic crisis, the trial court's order did not explain why, on rehearing, these same experts were more likely to accurately predict future economic conditions. "A cloudy crystal ball is no basis for a new trial," the court held, and it denied the motion.

Application of discounts and the statutory fair value standard. In Lemmen v. Lemmen (Mich. App.)(Feb. 9, 2010), the husband owned a minority (25%) interest in a profitable, privately held oil and gas business with his brothers. The husband's expert valued his interest at $5.5 million; the wife's expert said it was worth $17.5 million.

The trial court rejected the husband's valuation expert, finding that he incorrectly applied a discount rate to the company's dividend stream rather than net cash flows. This left testimony from the wife's expert, who declined to discount his $17.5 million value for lack of marketability or lack of control because the company enjoyed exceptionally strong cash flows, low debt, and a substantial cash base. Four years prior to the divorce, however, the same expert had valued the same company for one of the co-owners, applying a 25% minority discount and a 30% marketability discount. He did so only at the behest of the lawyers, the expert explained; it was not his general practice to discount the valuation of closely held stock. Nevertheless, the trial court applied the expert's prior discounts to his current valuation in divorce, and valued the husband's 25% interest at $11 million. Both parties appealed.

The appellate court deferred to the trial court's broad latitude to determine the value of stock in closely held corporations and accepted its valuations, including discounts. It also rejected the wife's arguments that the statutory fair value standard should apply to divorce cases. One judge on the panel dissented, which may set the case for an appeal to the state Supreme Court.

Emphasis on the correct date. In Goodwin v. Goodwin (Tenn. App.)(Feb 25, 2010), the parties owned and operated a steel detailing business together. The husband's expert valued it at $385,000, excluding goodwill. Importantly, he valued the company as of the date the wife stopped working for the company as a bookkeeper, in 2007, and the husband took over sole operations.

By contrast, the wife's expert concluded that the steel business was worth $1.65 million, valued as of December 31, 2008—just months before the parties' trial. After considering the evidence and applicable law, the trial court adopted the value as calculated by

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the wife's expert, and the husband appealed.

Resolving such a wide range of values is "one of the main roles of a trial court," the appellate court said. A trial court is free to value a marital business within the range of evidence presented, and "that is exactly what [this] court did." Further, state law requires valuing a marital business as close as "reasonably possible" to the date of trial. Since the wife's expert valuation was 19 months closer to this date than the husband's, the wife's evidence was more in line with the law, and the appellate court confirmed the lower court's $1.65 million valuation.

A mix of valuation methods. In Rozenman v. Rozenman (Ariz. App.)(March 11, 2010)(unpub.), the husband owned a separate cigar business, which appreciated during the marriage (2003-2008). As a start value, the trial court adopted a net asset valuation of the business at $177,000, not because an asset value is generally superior to an income or market approach, it said, but simply because it was the only evidence available.

The parties each presented experts to value the business at the end of the marriage. The husband's expert relied on a net asset approach ($274,000); he also applied a market approach ($518,000) but said it wasn't "financially feasible." By contrast, the wife's expert preferred the market approach because the comparables were good and the method adequately accounted for the business's strong, ongoing operations, its workforce, and goodwill.

The trial court adopted the market approach by the husband's expert ($518,000) and the husband appealed, claiming the court should have adopted a net asset value to measure the business both before and after the marriage. Under the circumstances, however, the rationale of the trial court was reasonable, the appellate court held, especially given the lack of market analysis for the start-up business at the beginning of the marriage.

Five Keys to Protecting Your Financial Expert's Credibility in Court

Attorneys are becoming increasingly sophisticated about business valuation, making it easier for the best of them to pick apart an expert witness's testimony. It's not enough that your expert is qualified by credentials and credibility. To "bullet proof" your expert witness in court against even the most aggressive cross-examination, take note of these five quick tips:

1. **Avoid "puffery."** One of the easiest ways to discredit financial experts is by identifying areas subject to "puffing"—i.e., where they have exaggerated or overstated their qualifications. For example, if an expert boasts he has 25 years of business valuation experience, a good lawyer will ask methodical, detailed questions about that experience. If, at the end of the questioning, it turns out that the expert has been working for 25 years but has only performed four appraisals of the type at issue in the litigation—that's puffing, and it can damage the expert's credibility.
2. **Avoid overconfidence.** Financial experts want a court to take their qualifications seriously, but in an effort to impress the trier of fact, they may take an overly confident or "blustery" approach. ("I've been doing business valuation forever and I know everything" is an exaggerated example.) Make sure your experts aren't caught trying to look as though they have more experience than they in fact do.
3. **Affirm the data.** There are two aspects to reliable expert evidence. First, an expert's valuation must be based on reliable underpinnings. The witness must be able to answer the questions, "Where did you get the data?" "Do you know how the data are collected and compiled?" It is up to the expert to substantiate the source of the inputs supporting his or her opinion, and to disclose (per the Federal Rules) all the documents and data that went into that opinion. Practice tip: Ask your testifying experts to come up with a working list or chart of what they need to form their ultimate opinions and discuss any materials that may not be available or forthcoming. Revisit the list later in the litigation to make sure the expert received the materials and reviewed them.
4. **Affirm the methods.** Second, an expert's methods must be reliable. For example, courts may be skeptical if an expert fails to perform a discounted cash flow analysis when conducting an enterprise valuation, or fails to explain why it wasn't appropriate in the particular case. If your expert does conduct a DCF, make sure the analysis conforms to valuation authorities' and generally accepted techniques.
5. **Reaffirm educator role.** Remember that the role of your financial expert is to assist the judge or the jury in understanding a complicated, specialized area of knowledge. The bar against unreliable, irrelevant testimony is high, so make

sure your experts rely on generally accepted valuation methodologies and omit anything novel or unproven. In addition, make sure your experts can describe their credentials and experience fairly and accurately, without overstatement. Finally—help them disclose and obtain all the materials they need to support their expert opinions, or risk surprise and loss of credibility at trial.

Experts Need to Show 'Analytical Fit' Between Data and Damages

In re Texans CUSO Insurance Group (Bankr. N.D. Tex.)(March 2, 2010)

In 2007 the owner of several insurance businesses sold them to a Texas insurance company for $19 million plus an earnout payment of up to $21 million over three years. The owner also agreed to stay on as president, to manage his former operations and accrue the additional earnout. But fewer than four months into the transition he was fired. After a bitter and extended arbitration, the company was ordered to reinstate him with all back pay and benefits.

The company failed to comply, however, and the former owner sued for breach of the arbitration award and the parties' repurchase and employment agreements. Just two months before trial, the company filed for Chapter 11 bankruptcy, and the owner filed a proof of claim amounting to $22.3 million.

Company never intended to permit earnout. The facts clearly demonstrated the company fired the owner without cause, never intending to reinstate him, the federal bankruptcy court held. The parties' employment agreement stipulated the amount of back pay and benefits, which an expert for the owner (now plaintiff) determined to be $348,000.

The plaintiff's expert also presented a detailed description of consequential damages based on how the company would have performed had it kept the plaintiff in charge. Interestingly, the expert did not prepare a formal report on damages but relied on trial testimony and demonstrative exhibits. The company objected to the expert's proposed testimony under Rule 702 of the Federal Rules of Evidence and the Daubert standard. But since the court did not have a written report, it postponed its Daubert findings to permit the expert to present his calculations.

The parties' original sale agreement provided a complicated formula to determine the earnout amount based on annual revenues and earnings over the three-year contractual period (2007-2009). Accordingly, the expert applied the formula to the company's forecasted earnings, fixed and variable costs, and projected EBITDA to conclude that the total earnout payments would have amounted to just over $20 million. During his deposition (which took place three days before the Daubert hearing), the expert conceded he was not entirely familiar with the content and methodology of an industry study that he used to develop his damages model. By the day of trial, however, the expert was able to testify in detail about the survey's method. More importantly, he was able to explain the analytical link between the data and his conclusions.

Based on this testimony, the court concluded the expert appropriately relied on industry data and had "cured any deficiency" in his analytical understanding. Further, the expert had accounted for broad economic and industry factors in reaching his damages determinations. Finally, even though he had no prior experience in the insurance industry, the expert's qualifications as a CPA and CFE (certified fraud examiner), with experience in calculating and reviewing financial damages models in litigation, were sufficient to establish his expertise in this case, and the court denied the Daubert motion.

Court Adjusts Discount Rate to Reflect Current Economic Risks

Miller Bros. Coal v. Consol of Kentucky, Inc., (Bkrtcy. E.D. Ky.)(Dec. 11, 2009)

Cases on the appropriate discount rate are relatively rare, so even this brief discussion by a federal bankruptcy court indicates how current economic conditions may impact this critical cost of capital calculation.

Downturn is not an 'act of God.' In the first half of the opinion, the defendant tried to excuse its breach of a coal mining agreement by claiming that the severe economic downturn in 2009 amounted to a force majeure—an exterior event, completely outside its control. However, declining consumer demand, rising inventories, and stalled operations are "normal" market risks, the court ruled, and not the

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result of "superior force." In agreeing to the fixed-price contract, the defendant assumed "the normal risk … that the market will change," the court said, and it could not escape responsibility despite a precipitous drop in coal prices and contract opportunities.

The plaintiff claimed it was entitled to lost profits damages in excess of $10.2 million. In particular, the expert applied a discount rate of 10%, based on the plaintiff's actual cost of capital (which had been under 8% prior to its parent's bankruptcy) plus a slight risk premium. She also believed the 10% discount rate was consistent with the effective annuity nature of the income stream under the coal mining agreement, especially given its fixed-price aspect and its costs.

Overall, the expert's analysis was "convincing" and supported the plaintiff's claims for damages calculations in this case, the court held. However, the court believed the 10% discount rate was too low, and found a 15% rate "more reasonable in light of the normal attendant risks of mining coal." The court also adjusted the expert's analysis for $2 million in projected losses for surface mining operations and approximately $4 million in other fees and costs, ultimately awarding net damages of just under $4 million.

J.L. Pierson, ASA is a designated business appraiser based in Darien, CT who specializes in valuation for estate/gift tax, litigation such as shareholder and divorce disputes, succession planning, corporate development and transactions.

He can be reached at:
(203) 325-2703
jlp@NYNJCT-BV.com

J.L. PIERSON, ASA
P.O. Box 2392
Darien, CT 06820-0392
http://www.NYNJCT-BV.COM
(203) 325-2703

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