WHAT YOU NEED TO KNOW ABOUT BUSINESS VALUATION FOR LITIGATION

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As any business owner knows, growth brings complexity. It also brings an increased risk of having to address litigation matters, during which business value is likely to be disputed or impacted.

Business valuation is the process of determining the economic value or worth of a business. This specialized skill is often required at trial. The valuation process spans the entire length of a case, helping to guide discovery, settlement discussions, trial strategy, testimony, and cross-examination.

The best business valuations use objective data, and evidence-based valuations are especially important at trial. Every data point needs to stand up to scrutiny, often in an adversarial setting where the other side will review with the goal of finding ways to argue and impeach credibility. Inconsistencies, discrepancies, and a lack of support can force significant value adjustments. Frequently, one or both sides will employ an independent valuation firm.

This article provides an understanding of the fundamental aspects of business valuation for litigation scenarios, including valuation standards, valuation methods, and common complicating factors so that you can ask informed questions of your valuation partner and be prepared for even the most contentious scenarios.

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LITIGATION SCENARIOS THAT REQUIRE BUSINESS VALUATIONS

The first consideration is whether business valuation services will be important to your litigation scenario. There are a wide variety of cases in which business value is a (or the) primary point of contention, including:

- Contract losses
- Divorce
- Embezzlement
- Eminent domain
- Executive compensation
- Partnership dissolution
- SEC investigations
- Shareholder disputes

In a divorce, for example, difficulties often arise when valuing a business and separating business value from personal goodwill value. Say the market compensation for a business owner is $300,000 per year, but he or she is foregoing that salary. In the divorce, the market compensation should still be deducted as an annual expense from the business because it is what a buyer would do if they were to buy the business and employ someone with similar skills as the business owner.

A comprehensive analysis of business value is often necessary to reach a resolution. That analysis needs to be grounded in proven standards, methods, and data. A clear, provable analysis of business worth, backed by data, can move tricky conversations forward, improve understanding, and lead to better outcomes for all parties.

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STANDARDS OF VALUATION

The two primary standards of valuation are "fair market value" and "fair value."

Fair market value is the price that something would get on the open market.
The most commonly cited definition comes from IRS Revenue Ruling 59-60, which states "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

At a minimum, fair market value considers eight factors to determine value, including the nature and history of the business, economic and industry outlook, book value of the stock and the company's financial condition, earning capacity, dividend-paying capacity, the existence of goodwill or intangible value, sales of the stock and the size of the subject block of stock, and market prices for similar stocks.

Fair value in the litigation context is a rational and unbiased estimate of the potential market price of a good, service, or asset.*
Generally, fair value is defined by state law and varies from state to state. Fair value is frequently the value of a 100% interest in a business without consideration of any discounts for a minority holding. This 100% value may be adjusted for contractual matters including discounts for lack of marketability or competition from key people. It may also consider real-world market issues like lack of access to capital markets. Adjustments are important

because contracts frequently mandate a discount for marketability, control and other matters.

Exceptions always exist, but fair market value often includes adjustments or discounts for lack of control and lack of marketability for a non-controlling interest, while fair value represents a pro rata portion of the value of 100% of the business.

One additional clarification to keep in mind in litigation scenarios is the reference to "book value" and "formula value." While these references may be legally binding, they will not necessarily result in an accurate determination of the true economic business value. Book value is the total of the company's balance sheet assets minus its total liabilities. Book value always includes tangible assets like property but may or may not include appreciation for tangible assets, intangible assets like business goodwill, software, brand names, trademarks, and patents.

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METHODS OF VALUATION

The methods of business valuation for litigation scenarios will depend on the type of case, the industry, and the jurisdiction. An appraiser will use one of three methods to determine the value of a business:

1. **Market approach**
   In methods based on a market approach, the value of a company is determined by looking at the stock prices or transaction prices of similar companies. Specific methods that fall into this category include the guideline company method and the transaction method. This approach is appropriate for businesses with industry comparable companies that are publicly traded or have recently sold.

2. **Income approach**
   In methods based on an income approach, the value of a company is determined by looking at the income that the business is expected to generate. This can be done by looking at historical earnings and projections of future cash flows. Specific methods that fall into this category include the capitalization of excess income method and the discounted cash flow method. This approach is almost always considered when the business generates income or is expected to generate income.

3. **Asset or cost approach**
   In methods based on an asset approach, the value of a company is determined by looking at the value of the assets of a business, like real estate holdings and intellectual property. This approach is typically limited to asset-dependent companies like real estate holding companies or businesses facing liquidation.

Intangible assets like professional licenses and personal goodwill fall into the latter category.

COMPLICATING FACTORS IN LITIGATION BUSINESS VALUATIONS

Be prepared to address a host of nuanced challenges related to presenting a business valuation in a litigation scenario. Here are a few of the most important factors to consider when having a business valuation prepared for trial.

Intangible Assets
Some aspects of business valuations in litigation scenarios are straightforward and rarely result in controversy or prolonged discussion. For example, the total revenue of a company for the previous three years is readily available in tax documents. Other aspects of a business valuation, however, require significant corroboration and data to ensure that the conclusions drawn can stand up to scrutiny.

Intangible assets like professional licenses and personal goodwill fall into the latter category. In cases of divorce and in certain states, for example, personal goodwill is not considered a marital asset. In those cases, the value of personal goodwill is deducted from the total business value and is not subject to division. Determining the value of intangible assets in litigation scenarios needs to be backed by robust research and data to ensure that it will stand up to the scrutiny of the court and to cross-examination from an opposing party.

Premiums and Discounts
To accurately determine the value of an ownership stake in a business, valuation experts often need to apply premiums and discounts. The purpose of these adjustments is to make fair comparisons.

For example, take a subdivision of identical homes where some homes include a golf membership and others don't. The homes with the membership sell for $50,000 more

than homes without a golf club membership. It would be appropriate to adjust any valuation analysis for golf club memberships. The same is true for business appraisals.

The most common premium is the control premium, which reflects the fact that a controlling interest in a company is more valuable than a non-controlling interest. The ability to determine compensation, declare dividends, set business policy, and other benefits give increased value to majority shareholders, and these benefits must be taken into account when determining the value of a majority interest.

Conversely, a discount for lack of control is applied when the ownership stake does not have control. This discount adjusts the value to reflect the fact that a non-controlling stakeholder has little or no control over the business. Depending on the legal structure of the company, a majority economic interest in a business may not have control.

For example, partnerships often have general partners who may only represent 1% of the economic ownership but retain all of the control and voting rights. The remaining 99% economic ownership is limited, with no elements of control.

Another common discount is applied for a lack of marketability. This discount is applied because private businesses are not able to sell for cash in three days, like shares of publicly traded companies. In this case, even a 100% interest in a private business can be subject to lack of marketability. Non-controlling ownership interests in a private business are even more difficult to sell than majority ones because they are significantly less attractive to investors. Limitations on transfer also frequently impair marketability, because many agreements require general partner or majority approval prior to admitting a new partner or shareholder.

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Following Procedural and Evidentiary Rules

Generally, valuation professionals will need to abide by the rules of discovery, coordinate site visits with counsel, and abide by strict confidentiality requirements. They often will need to prepare a statement of expert opinion, the evidence to support that opinion, qualifications, compensation, and other cases where the expert has testified. As with any materials prepared for court, each conclusion will be supported by evidence. An experienced independent valuation firm will anticipate questions that other parties will have, then document and provide education to address those areas of concern.

Adversarial Setting
In litigation scenarios, your independent business valuation firm must be prepared to do more than create a sound business valuation and robust documentation. They must be prepared to testify in court as an expert witness capable of presenting and explaining details clearly, have a thorough understanding of the case, and articulate the data and methods. They also must be able to remain calm under pressure. Not all valuation experts possess these skills. It is important to choose a partner who is experienced in litigation contexts and confident in the environment.

Discovery
When the company involved in a litigation scenario is closely held, independent valuation firms often face challenges obtaining the documentation required to provide an accurate assessment of the business's value. Non-controlling shareholders in closely-held companies may have very limited access to financial statements (potentially only on an annual basis). Extra steps, facilitated by the court, may be necessary to gain access to quarterly or monthly financial information.

In a recent case, more than $1 million in legal fees have been spent arguing over document access. A more thoughtful shareholder agreement could have mitigated or eliminated this information access dispute. (We will discuss additional ways to prevent or deter business valuation dispute litigation scenarios in a future post.)

This report is important because it is the method to share not just the answer but more importantly the process and rationale to get to the answer.

ALTERNATIVES TO LITIGATION

Not all situations that are adversarial need to be resolved in court. There are two common alternatives: mediation and arbitration, both of which can offer several advantages over litigation.

Mediation is a process designed to resolve disputes between two or more parties without the need for a court of law.

- It is typically less expensive and less time-intensive than litigation

- It is more flexible, with relaxed rules for procedures and evidence
- It allows parties to revise the conflict scope, solutions, and settlements as circumstances change

In arbitration, both sides present evidence to a neutral third party, called an arbitrator. The arbitrator hears both sides and makes a decision on the dispute in question. The process can be either binding or non-binding. If arbitration is non-binding, the arbitrator's ruling is advisory only, and must be accepted by both parties to be considered final. If the arbitration is binding, the decision is considered final, and it can be enforced in court.

- Arbitration is generally faster and less expensive than trial
- Parties often do not need to follow federal or state laws of evidence
- A neutral arbitrator has the authority to make a decision about the dispute

CHOOSING THE RIGHT LITIGATION VALUATION PARTNER

Choosing the right third-party valuation partner can have a substantial impact on the outcome of a trial. The right expert can result in a quick settlement.

Recently, Adams Capital was able to resolve a matter that had been litigated for years. It had been stalled by a lack of a clear and obvious path to a judicial resolution. Our team brought a unique perspective and ability to discuss sensitive topics with both sides that allowed us to identify a clear path to resolution.

Choose a business valuation firm that has experience in litigation, and whose credentials fit the case. Ensure your potential partner has experience with:

- Similarly-sized companies to your own
- The type of litigation you're facing (e.g., divorce, SEC investigations, shareholder disputes)
- Personal goodwill

Adams Capital is an experienced firm with a track record of exceptional results in a variety of business valuation circumstances. We offer a no-cost initial telephone consultation to provide a sounding board to business owners who require or are considering a business valuation.

Please email us at tara@adamscapital.com or call us directly at 770-432-0308 to schedule a consultation or to learn more.