An Allinial Global publication with contribution from:

Mueller Prost
CPAs + Business Advisors

Advising with Vision®

Valuation Report

Business Valuation Trends and Strategies

Spring 2018

Litigation Outlook

Court Cases Highlight Valuation Issues

The valuation community is always following court cases that shed light on interesting valuation issues. Here are two recent cases of note.

Goodwill in Divorce Slutsky v. Slutsky

One of the valuation issues in this New Jersey divorce case hinges on the question of goodwill. The husband, an attorney, was an equity partner in his law firm. As a specialist in complex tax matters, he didn't bring in his own clients, but he was nonetheless quite successful due to his work ethic and billable hours.

As a partner in the firm, he was bound by a shareholder agreement that included a buyout formula if a partner left the firm.

At the initial trial, both the husband and wife presented valuation testimony. The wife's side presented a calculation of value that included a goodwill interest of nearly $1.2 million. After some challenges by the husband's team, the wife's expert recalculated his opinion of value to a slightly lower amount, admitting that his original numbers were flawed.

In the husband's expert's presentation, the expert contended that the husband had no separate goodwill interest. Further, he contended that the husband's income was reasonable and not excessive. Therefore, his expert said, no excess compensation existed, and the wife was due no more than half of his interest in the firm as calculated in the buyout formula.

Interestingly, the trial court judge adopted the wife's expert's original—higher—calculation of value and goodwill, saying the husband's contention that the firm had no goodwill was "incredible." With no further fact finding, support, or commentary, the court awarded the wife half of the total value of the husband's interest and the goodwill interest she claimed existed.

The husband appealed, claiming that the trial court's conclusion demonstrated a "misunderstanding of the facts, misapplication of the law, and abdication of responsibility to reach a result that was the product of a careful and reasoned application of the law to actual facts." He also pointed out that even if a law firm has goodwill, the firm's individual lawyers may not have separate goodwill.

The appellate court agreed with the husband's position, saying, "We believe the trial judge misunderstood [the husband's expert's] conclusion" about the firm's goodwill. The appellate court noted that the husband "was actually paid what a similarly skilled attorney would be paid" and that his "compensation matched his earning capacity, nothing more." Thus, said the court, "there was no additional component of goodwill."

For these and other reasons, the appellate court remanded the matter for additional review and, citing "certain credibility determinations," suggested a "newly assigned" judge hear the case.

Continued on page 3

2 Valuation Expert Witnesses
3 Interesting Valuation Cases
4 Valuation Balance Sheets

Word to the Wise

How to Work Best with Valuation Expert Witnesses

In litigation, expert testimony can make or break your case. As set forth in the 1993 U.S. Supreme Court case *Daubert vs. Merrell Dow Pharmaceuticals*, the expert witness's reliability and relevance are essential for credibility. But in addition to those two baseline qualities, there are ways of working with an expert that can make a positive difference in a case.

Here are a few best practices to consider when working with a valuation professional.

Hire right. The right valuation expert for your case has the experience and credentials your case demands, as well as a personality and work style that fit with your team. If you are expecting your valuation expert to testify in court, you must also consider his or her ability to present information in a clear, concise, and compelling way. This includes the ability to simplify complex facts and circumstances so the court and jury can easily understand the expert.

While most valuation experts can handle the technicalities of most cases, if your circumstances require knowledge of a highly specialized field, you may want to seek specific expertise in that area.

One way attorneys often find effective experts is by paying attention to the opposing side's expert in other court cases. If that expert is a particularly good witness, you may want to consider retaining him or her in the future.

Start early. Bringing in a valuation professional early in your case can be extremely helpful. He or she can point out strengths or weaknesses in your case, assist with damage theory, hone your line of questioning in depositions, and help you prepare your discovery outline and document requests. Bringing in the expert early can also save you money. No one has an unlimited budget, and an expert can help narrow the discovery process to information that will truly impact the case.

The expert can also identify areas where additional expertise might be necessary or helpful. Remember the two Rs of the Daubert case: reliability and relevance. Asking your expert to opine about something outside his or her scope of expertise can cause problems in both of those areas.

Share openly. Your expert needs to know the big picture *and* the relevant details of the case. Armed with this knowledge, he or she can produce a report and opinion that is most appropriate in terms of nature of the dispute and other circumstances.

Hiding from your expert what might be perceived as bad news—weak or questionable parts of the case—is not a good idea. It's best to lay out everything before you get to the courtroom so that your valuation expert isn't caught off guard in front of a judge or jury. Moreover, the expert may be able to add perspective to what might be a weak spot in the case and assist in strategy to accommodate deficiencies.

Expect neutrality. While attorneys are tenacious advocates for their clients, valuation expert witnesses are required to be neutral and to render objective, unbiased opinions. In other words, they must be advocates for their opinion, not the client. This neutrality is key to credibility, both in the matter at hand and in future litigation.

Your expert's opinion will be damaged by any appearance of bias, so be sure your team is aware that while the expert was hired by your side, he or she must be independent and impartial.

If you are preparing for litigation that involves valuation, don't hesitate to reach out to a valuation professional with questions—the sooner, the better!

Our valuation team is experienced in litigation support and is ready to assist you.

Interesting Valuation Cases

Continued from page 1

Lessons learned: Goodwill can be difficult to calculate, but in this case, the appellate court agreed with the husband that there was no separate goodwill to discuss.

But even beyond that conclusion about the facts of the case, the appellate court showed very little regard for the ruling made by the original judge, suggesting that the judge was somewhat clueless about valuation. Indeed, the appellate court felt so strongly about the judge's lack of understanding of the issues, it recommended that the original trial judge on the case be replaced with a new judge. Ouch!

ESOP Valuation Gone Wrong Brundle v. Wilmington Trust

This case involves the employee stock ownership plan (ESOP) of a privately held security firm. The firm had two main clients, government entities that represented 70 percent of the firm's revenues.

In mid-2013, the owners of the firm formed an ESOP, selling 90 percent of their shares to the ESOP and holding 10 percent in warrants. Known for its ESOP expertise, the firm hired Wilmington Trust as the ESOP trustee, and Wilmington Trust hired Stout Risius Ross (SRR) as the ESOP's financial advisor.

The litigation referred to two valuations. McLean Group did the first in January 2013, before the ESOP was formed. The McLean appraiser used management forecasts for the remaining months of the year. He performed a discounted cash flow (DCF) analysis and used the guideline company method (GCM) but ultimately ignored the GCM result because the guideline companies were so different from the target company.

In his DCF analysis, the McLean analyst included a "specific company and industry risk factor" due to the company's small client base. He also applied a discount for lack of marketability and, for the nonvoting stock, a discount for lack of control.

Later that year, SRR did another valuation to determine price per share, relying on both DCF and GCM methods. SRR added a 10 percent control premium for the GCM analysis and adopted five-year management projections.

With the end of the year approaching, the parties hurriedly agreed to a $4,235 per share price. Notably, the trustee committee asked very few questions about the SRR valuation and none about the McLean valuation.

In early 2014, due to financial concerns, management negotiated a quick sale of the company, and the ESOP ended after just seven months.

The ESOP's unusually short life and the hurried nature of the sale prompted a U.S. Department of Labor investigation of the trustee's conduct. Did the trustee ensure that the price the ESOP paid for the stock was no more than fair market value (FMV)?

After hearing testimony from two financial experts, as well as the McLean analyst, whom it considered to be "highly credible," the court found that the ESOP indeed paid more than FMV for the stock because the trustee didn't adequately review the SRR valuation.

Specifically, the court pointed out that, among other deficiencies, the trustee never examined the McLean valuation report. Also, the trustee knew of the company's very concentrated client base but didn't seem to accommodate for that risk.

The court concluded that the ESOP overpaid by $28 million due to the trustee's failure and requested that Wilmington Trust pay up.

Lessons learned: An ESOP trustee is responsible to the ESOP and is obligated to perform due diligence, including careful examination and understanding of a valuation. It seems obvious that the trustee didn't do its job here, having overlooked several key factors in the valuation that should have raised red flags about the stock price. In this case, regardless of intent, it appeared that the trustee bought into a scenario painted by SRR that significantly benefitted the sellers.

Interested in learning more about these or other valuation-related cases? We'd be happy to discuss them with you.

Mueller Prost
CPAs + Business Advisors

www.muellerprost.com

MISSOURI
St. Louis (main office)
7733 Forsyth Blvd., Suite 1200
St. Louis, MO 63105
tel: 314.862.2070
fax: 314.862.1549

MISSOURI
St. Charles
2460 Executive Drive
St. Charles, MO 63303
tel: 636.441.5800
fax: 636.922.3139

CALIFORNIA
Irvine
3 Park Plaza, Suite 400
Irvine, CA 92614
tel: 800.649.4838
fax: 562.624.9818

Balance Sheet ≠ Value

It's natural that business owners keep tabs on the value of their companies. In most cases, the company is the owner's most valuable asset—one he or she hopes to sell for a healthy price at some point in the future.

Where do owners look for clues about value? They often start with financial statements. For example, it would seem reasonable to look at the assets on one side of the balance sheet and subtract the liabilities on the other, with the result being something akin to the value of the equity in the business—a bit like a house with a mortgage. Unfortunately, that's typically not how it works.

That's because the balance sheet only reflects the historical amount invested in the business. It's a rough proxy for the fair market value in an orderly liquidation—the value of a business if it sold its tangible assets, paid off its debts, and shut down.

What the balance sheet doesn't show is the return on that investment. The return is reflected in goodwill and intangible assets such as brands, customer lists, and proprietary technology.

Accounting rules say these assets generally can't be recorded, which is unfortunate because they represent the vast majority of many companies' value. In fact, according to Ocean Tomo, well over 80 percent of the components of S&P 500 companies' market values is represented by these types of intangibles, which means it is not reflected on the books. This is a lot of value that's invisible on companies' balance sheets.

With this in mind when contemplating value, it's helpful to incorporate all the assets—including the intangibles—and consider a "valuation balance sheet," which would look forward to the business's expected future returns. This type of exercise would more accurately point toward the company's value as a going concern.

This publication is distributed with the understanding that the author, publisher, and distributor are not rendering legal, accounting, tax, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. The information in this publication is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of (i) avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed in this publication. © 2018