# Valuation & Litigation Briefing

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# Court rejects valuation based on unsustainable past earnings

In a recent divorce case, *In re Riddle*, the Court of Appeals of Arizona, Division 1, vacated the trial court's ruling regarding the value of a business interest owned by the wife. Why? In a nutshell, the husband's expert valued the business based on past earnings, but "there was no evidence that similar earnings would continue" in the future.

## Case facts

The parties separated in 2008 and began divorce proceedings in 2017. Their marital estate included an ownership interest in a company that the wife, along with her business partner, continued to operate after the separation date. The company coordinated medical care for clients referred by personal injury attorneys, collecting its fees when the litigation ended — up to two years after it began providing services.

At trial, the parties disputed the size of the wife's ownership interest in the business. The company's operating agreement stated that the wife owned 25% and her partner owned 75%. However, the husband argued that the wife owned the *entire* business, based on the company's tax returns. According to the wife, she listed herself as the sole owner on the tax returns to distinguish that the business was her property, and the husband owed no taxes for the company. The trial court sided with the wife, ruling that she owned a 25% interest.

In October 2015 — before divorce proceedings began — the wife sold her interest in the business to her partner for $60,000. At the same time, the partner started a new company under a different name that performed the same types of services as the original business. The wife didn't have an ownership interest in the new venture.

## Dueling experts

The husband hired a business valuation expert who assumed the company was a viable going concern that would continue to earn new revenue through new referrals. He valued the interest at $905,000, using two valuation methods:

1. The capitalization of earnings method, using projected cash flow based on prior years ending in 2016, and

2. The guideline transaction method, applying a pricing multiple from sales of comparable businesses to projected earnings based on prior years ending in 2016.

## Court accepts calculation of value in divorce case

In another Arizona divorce case — *Mikalacki v. Rubezic* — the parties were equal partners in a law firm. The trial court adopted a value of $269,000 for the firm, based on a calculation of value prepared by the wife's expert. The court awarded the husband sole ownership of the firm and ordered him to compensate the wife for her 50% interest. The expert valued the business using financial information provided by the wife and an independent analysis of comparable businesses.

On appeal, the husband challenged the valuation, because it was a *calculation* of value rather than a full *opinion* of value. However, the husband never presented opposing valuation evidence to the trial court. He also failed to meaningfully contest the expert's testimony that the business goodwill associated with the husband's name had considerable value.

The Court of Appeals of Arizona, Division 1, acknowledged that although a calculation of value falls short of the "gold standard . . . a fact-finder need not discount an expert's opinion solely because the expert did not consider every single process and procedure that would be included had he conducted a fuller valuation." (Internal quotations omitted.)

The wife hired her own expert, who estimated a range of value between $42,000 and $112,000 for the entire company. This valuation was prepared under the assumption that the business wouldn't continue after the wife sold her interest, except to collect any outstanding fees under existing contracts.

The trial court accepted the valuation by the husband's expert, based on the significant profit the original company was generating. It ordered the wife to pay the husband $113,125 (half of 25% of $905,000).

### Appellate court findings

On appeal, the court deferred to the lower court's decision regarding the size of the interest. The appellate court further noted that the sale of the wife's 25% interest to her partner for $60,000 implied a value of $240,000 for the entire business ($60,000 divided by 25%).

After the husband's expert conducted his initial valuation, the expert learned that the wife's partner had been conducting business under a new name. The husband's expert wasn't asked to update his valuation based on that information. However, the valuation prepared by the wife's expert recognized that the original company generated no new revenue after October 2015.

***The expert assumed the business was a viable going concern that would continue to earn new revenue through new referrals.***

According to the appellate court, the undisputed evidence showed that, after October 2015, while the business continued to collect substantial fees from existing clients, it added no new clients to produce any future earnings. Because one of the "basic foundations" of the trial court's valuation was incorrect, the case was remanded to the trial court to determine the value of the wife's interest.

### Back to the future

As *Riddle* demonstrates, valuing a business based on only its earnings *history* is insufficient. There also must be evidence that those earnings are *sustainable* in the future. ■

# Valuing collateral in bankruptcy

In *In re Sears Holdings Corporation*, the U.S. Court of Appeals for the Second Circuit provides a primer on valuing collateral for bankruptcy purposes. The case involved claims by three "second-lien" secured creditors that the value of their collateral (largely consisting of the debtors' inventory) had diminished after the petition date. If their claims were successful, they'd be entitled to administrative "super-priority" — that is, the right to be paid ahead of all other creditors up to the collateral value they lost.

## Court-approved asset sale

The bankruptcy court approved the purchase of substantially all the debtors' assets by one of the second-lien holders. The other second-lien holders weren't parties to the transaction. But they were obligated to participate in a $433.5 million "credit bid," under which the second-lien holders essentially forgave debt in exchange for a dollar-for-dollar reduction in the purchase price.

The second-lien holders claimed that the credit bid fell short of their collateral's value on the petition date, effectively entitling them to super-priority treatment to the extent of the shortfall. To establish whether the collateral's value had decreased, it was necessary to determine its value as of the petition date and then subtract the amounts owed to the first-lien holders as of the petition date. The second-lien holders would have a viable super-priority claim if this amount exceeded the $433.5 million credit bid.

## Collateral value

To value the debtors' inventory, the bankruptcy court considered several approaches:

- Full retail price,
- A depressed liquidation price, or
- Net orderly liquidation value (NOLV).


NOLV refers to an orderly companywide going-out-of-business sale that would yield more than liquidation value but less than full retail value. The bankruptcy court adopted the NOLV approach for most of the inventory, finding that a complete liquidation of the debtors' assets was a genuine possibility.

The court also assigned zero value to certain non-borrowing-base (NBB) inventory and deducted the face value of certain letters of credit from the collateral value. This was done under the assumption that the letters of credit would be drawn, and those creditors would have priority over the second-lien holders. The court valued the collateral on the petition date at $2.147 billion. Subtracting $1.96 billion of first-lien holders' claims, the second-lien holders were left with $187 million. Because this amount was less than they had already realized from the $433.5 million credit bid, the second-lien holders weren't entitled to any super-priority claims.

## Failed appeal

On appeal, the second-lien holders argued that the debtors "retained and used" the inventory, so it should be valued at replacement or retail value. The Second Circuit disagreed: The expectation was that the inventory would be disposed of. How it would be disposed of wasn't certain on the petition date, but the bankruptcy court "reasonably recognized that there were two 'realistic scenarios' — a going-concern sale or a forced liquidation."

The bankruptcy court valued the collateral somewhere between a forced liquidation and full retail price — an approach the appellate court found sensible. The second-lien holders argued that retail value was appropriate because the debtors didn't liquidate. Instead, they operated many stores for months and then sold the remaining business as a going concern. The Second Circuit rejected this argument, explaining that the relevant inquiry was the collateral's value on the petition date, not how the collateral was ultimately used.

The Second Circuit upheld the bankruptcy court's decision to assign zero value to the NBB inventory because "the second-lien holders failed to offer a reasonable valuation method" for those assets. It also ruled that the bankruptcy court reasonably deducted face value of the letters of credit from the collateral value. Although it may have been possible to discount their value based on the probability they would be drawn, "the second-lien holders never offered any such analysis."

### Be prepared

As *Sears Holdings* illustrates, bankruptcy courts have a great deal of leeway in valuing collateral. For this reason, among others, parties should be prepared to offer reasonable, well-supported valuation analyses and methods.

## M&A due diligence

# Buyers should exercise caution when relying on financial statements

Comprehensive due diligence is an essential part of acquiring a business. But it can be a daunting task — especially for inexperienced buyers. Fortunately, financial professionals can help evaluate historical and prospective financial statements, identify potential hidden liabilities and misrepresentations, and prepare independent forecasts and projections. This information is critical when determining the optimal offer price and deal terms.

### Looking back … and ahead

When figuring out how much to offer, buyers need to review copies of historical and prospective financial statements. In terms of the acquisition target's historical performance, it's important to evaluate a *full* business cycle, including cyclical peaks and troughs. If a seller provides statements during only peak years, there's a risk that the buyer could overpay. It's generally advisable for a potential buyer to examine at least five years of financial statements to help determine possible future business trends.

On the other hand, prospective financial statements are based on management's expectations for the future. Likewise, a buyer's offer is based on how much return the business interest is expected to generate. Fair market value is a good starting point, but buyers may be willing to pay more (or less) depending on the situation.

### Playing devil's advocate

When reviewing the prospective financial statements, it's important to evaluate the underlying assumptions. For instance, suppose management expects to grow at 20% annually. The buyer needs to recognize that fixed assets and human capital have limited capacity, so fixed costs probably can't sustain such high growth over the long run. At some point, the business will need to buy more equipment, open additional facilities and hire more managers to achieve forecasted revenue. So, carefully review the terminal (or residual) value that's included in any discounted cash flow analysis.

Also, ask who prepared the prospective financials. If they're prepared by an outside accountant, do the reports follow the standards provided by the American Institute of Certified Public Accountants (AICPA)? Buyers may have more confidence in projections and forecasts prepared by outsiders — especially if they conform to AICPA standards — but these reports are typically based on management's assumptions. Because current management (the seller) may have a financial incentive to paint a rosy picture of financial performance, it's a good idea to hire your own expert to perform an independent analysis.

## Digging deeper

Historical balance sheets tell buyers about a company's tangible assets, acquired intangibles and debts. But some liabilities may not appear on the financial statements. Examples of unrecorded liabilities include pending lawsuits, warranties, insurance claims, bad debts and underfunded pensions. Some issues, like broken equipment or obsolete inventory, can be unearthed only during a site visit.

Hidden liabilities can be a major issue in stock sales. Unlike asset sales, in which the buyer cherry-picks assets and liabilities to acquire, stock sales transfer all outstanding shares of stock to the buyer, and the business continues to operate uninterrupted. From a legal perspective, that means the buyer may be vulnerable to future lawsuits, such as employee discrimination or intellectual property claims that relate to conditions that existed before the deal closed.

Buyers also need to be skeptical of representations the seller makes to seal a deal. Misrepresentations that are found after closing can lead to expensive legal battles. An earnout provision or escrow account can be used to reduce the buyer's risk that the deal won't pan out as the seller claimed it would.

## Avoid costly mistakes

Many private business owners are inexperienced when it comes to these complex deals. Overpaying in M&A can cause problems down the road — and even lead to impairment losses in future periods. So, it's prudent, over the long run, to hire an outside valuation professional to help vet the deal.

# Market approach: Don't compare apples to oranges

Under the market approach, the value of a business is derived from comparisons between the subject company and transactions involving similar businesses. It hinges on the selection of reliable "comparables" — that is, businesses with similar characteristics to the company being valued. External comparables may be either: 1) prices of publicly traded stocks under the guideline public company method, or 2) sales of private businesses from proprietary databases under the guideline transaction (M&A) method.

## Selection criteria

No two companies are identical, so selecting comparable businesses can be subjective. U.S. Tax Court cases have identified several factors to consider, including:

- Industry,
- Product and service offerings,
- Nature of competition and marketing position of the subject company,
- Geographic location,
- Financial performance, including earnings and dividend-paying capacity,
- Capital structure,
- Business maturity, and
- Management depth and experience.

Under the guideline transaction method, it's also appropriate to consider the timing of the transaction. In determining selection criteria, the goal is to ensure that the underlying economics that drive a comparable business closely match to those that drive the subject company.

## Real world application

When a valuation is prepared for litigation purposes, the parties should be prepared to defend their selections of comparable companies — or risk exclusion from evidence. There are no bright line rules regarding the number of comparables that an expert must use to derive value. But a small sample of closely related comparables will generally provide a more meaningful comparison than a large sample of loosely related ones.

For example, in *Heck v. Commissioner*, the Tax Court rejected use of the market approach to value a champagne producer based on a comparison to just two wine producers. The court acknowledged that, in prior cases, it had accepted valuations based on as few as two comparable businesses. However, those cases involved companies in the *same* line of business. The court explained, "As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies."

> *No two companies are identical, so selecting comparable businesses can be subjective.*

In *Heck*, the two comparable businesses weren't sufficiently similar to the subject company. Although the comparables were involved in a similar line of business — the sale of wine — there were significant differences in size, product lines, profitability, growth and other factors.

## Relevant comparisons

Failure to apply relevant selection criteria when identifying a sample of comparables can result in an apples-to-oranges comparison, casting doubt on the reliability of the valuator's conclusion. So, it's important to get it right.

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- Fraudulent Actions
- Criminal Tax Matters
- Valuing Closely Held Businesses
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