Valuation & Litigation Briefing

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Why an Arizona court accepted a "calculation" of value

Typically, when valuation experts value business interests for litigation purposes, they provide *conclusions* of value. But, in some cases, courts may accept *calculations* of value. A calculation of value is limited in scope and is generally considered to be less reliable than a conclusion of value. (See "How do calculations of value differ from conclusions of value" on page 3.)

Here's a summary of a recent Arizona divorce case where a calculation of value was used by the trial court to value a couple's law firm. The appellate court affirmed the trial court's acceptance of the limited-scope report.

Trial court ruling

In *Mikalacki v. Rubezic*, the wife petitioned for dissolution of marriage on June 7, 2019. She co-owned a law firm with her husband. At trial, the wife's expert valued the law firm at $269,000, based on a calculation of value. The expert used various valuation approaches and based his calculation on financial information provided by the wife and an independent analysis of comparable businesses.

The husband's lawyer "thoroughly questioned [the wife's expert's] methods and conclusions on cross-examination," but didn't offer any competing expert opinion. The husband argued that the firm was worth only $161,000 because the wife left the firm after she filed for divorce and took several clients with her.

The husband maintained that the expert's valuation should have been discounted because it wasn't an "opinion" of value.

The trial court found that the husband's testimony wasn't credible and accepted the calculation of value provided by the wife's expert. The court awarded the husband the law firm as his sole and separate property and ordered him to pay his wife for 50% of the firm's equity.

Appellate court decision

On appeal, the husband didn't dispute the expert's qualifications or argue that his report or testimony were inadmissible. But he maintained that the expert's valuation should have been discounted because it wasn't an "opinion" of value.

The Court of Appeals of Arizona disagreed. Citing its previous decision in *Larchick v. Pollock*, the appellate court said that a calculation of value

How do calculations of value differ from conclusions of value?

When experts value businesses, they typically provide *conclusions* of value. Specifically, a valuation analyst "is free to apply the valuation approaches and methods he or she deems appropriate in the circumstances," under the AICPA's Statement on Standards for Valuation Services.

In contrast, a *calculation* of value is more limited in scope. In such an engagement, the AICPA's standards explain, "the valuation analyst and the client agree on the valuation approaches and methods the valuation analyst will use and the extent of procedures the valuation analyst will perform in the process of calculating the value of a subject interest." Valuation standards also require calculation reports to disclose that these engagements don't include all procedures required for a conclusion of value, and that the result may have differed if a full-fledged valuation had been performed.

Because calculations of value are considered less reliable and persuasive than conclusions of value, calculations should generally be avoided once a matter proceeds to trial. But they may provide a cost-effective tool for transaction planning, case assessment and settlement discussions. A valuation analyst will consider the purpose and the nature of the engagement in deciding what's appropriate for your situation.

is "short of the gold standard," but that "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."

In this case, the husband could have provided his own valuation evidence, and his lawyer had an "unhindered opportunity" to question the wife's expert about his valuation analyses. Therefore, the appellate court concluded that the trial court didn't abuse its discretion in relying on the calculation of value.

The husband also argued that the expert's testimony was unreliable because he relied on financial information provided by the wife. However, this argument fell flat because the husband refused to make required disclosures of financial information. If he'd disclosed this information on a timely basis, the court noted, the wife's expert could have considered it.

In addition, the wife's expert valued the business as of the divorce filing date. The husband challenged this valuation date because it was *before* the wife left the firm. The appellate court rejected this challenge, noting that a trial court has wide discretion in choosing the appropriate valuation date. Plus, the evidence showed that the wife took only 16% of the firm's clients with her, and the firm's goodwill was closely tied to the husband's name.

Finally, the husband argued that the wife's expert failed to adequately explain certain adjustments in his valuation report. The appellate court rejected this argument, noting that the husband had ample opportunity to cross-examine the expert about these adjustments.

Handle with care

Although courts may accept calculations of value in certain limited circumstances, they can be perilous. For example, the outcome in *Mikalacki* might have been different if the husband had offered his own expert testimony and cross-examined the wife's expert more effectively. Contact a business valuation professional to determine what's right for your situation.

How valuation pros can help settle shareholder disputes

When sales are strong and market conditions are favorable, business operations tend to run smoothly. However, economic uncertainty can take a toll on a private business — and shareholder relations. Owners may be at odds about how to handle unexpected changes in market conditions. Or they may grapple with various business decisions. Should the company increase prices to cover mounting labor and input costs? Should bonuses and dividends be paid this year? Should they sell off an unprofitable business segment?

Ultimately, disagreements about the appropriate business strategy can lead to shareholder buyouts and costly litigation. A business valuation professional can help settle these matters — both in and out of court — allowing the remaining owners to refocus their attention on building and preserving value.

Case in point

Family-owned businesses aren't immune to shareholders disputes. Consider this fictional scenario: When Jan and Dan inherited their family business after their parents retired in 2000, the transition was seamless. Jan, who was disciplined and organized, handled finance, production and human resources chores. Creative and charismatic Dan focused on product development and sales. Everything ran smoothly until the COVID-19 pandemic caused the company to miss its revenue and profit goals in 2020 and 2021.

Dan believed Jan's frugality was hampering growth; he wanted to pivot into new markets and acquire operating assets from competitors that had closed during the pandemic. Jan accused Dan of excessive spending on research and development, as well as market research. Their constant bickering caused several key managers to resign. In early 2023, Jan decided to sell her interest in the company to Dan, but the siblings couldn't agree on buyout terms.

Their attorney recommended hiring a valuation professional to help sort out the details. The first step was a business valuation. The valuator analyzed future cash flows and provided several real-life comparable transactions to support her estimate. Then she provided recommendations regarding the timing and structure of a potential buyout to maximize cash flow, minimize taxes and comply with the shareholder agreement.

Jan and Dan were pleasantly surprised to discover that, in the current economy, the company's revenue had recovered — and the value of the business had increased significantly. But Jan was still burnt out and wanted to pursue other interests. So, they used the valuation to set a reasonable sales price for Jan's 50% interest. The valuator also helped them structure an installment sale arrangement that would give Dan time to buy his sister's share — and allow Jan to spread her taxable gain on the sale over several years.

Irreconcilable differences

Of course, not all shareholder disputes end on a positive note. Sometimes owners contemplate legal action. A valuator can help determine whether it's financially feasible to pursue a case. Hiring a valuator as soon as possible in the process improves the efficacy of discovery, increases the likelihood of out-of-court settlement and provides adequate time for the expert to perform a comprehensive analysis.

Valuators often serve as expert witnesses in shareholder litigation. A valuation expert might provide testimony concerning:

- The value of the business, including the fair value of each shareholder's interest,
- Economic damages, including temporary lost profits and diminution in business value,
- Formal rebuttal of an opposing expert's conclusions,
- Reasonable compensation for shareholder-employees, and
- Appropriate discounts for lack of control and marketability, depending on relevant legal precedent.

A valuator also may serve as consultant, helping the attorney critique the opposing expert's report and prepare questions for deposition and trial. But a valuator shouldn't serve as both expert witness and consultant on the same case. Keeping these roles separate helps prevent a valuator from being perceived as a "hired gun" by judges, juries and mediators.

Objective insight

From time to time, business owners may disagree, whether it's about past events or the company's future direction. When differences of opinion impair performance, business valuation experts can help the parties defuse emotions and focus on the financial facts. ■

Guideline transaction method: Are you comparing apples to apples?

There are three techniques used to value a business: the income, market and asset approaches. What's appropriate depends on the nature of the business being valued, the purpose of the valuation and other factors.

It's critical for business owners and attorneys to understand these approaches to ensure that their valuation experts' conclusions are supportable and to challenge the conclusions of opposing experts. Here's a close-up of one method that's often used under the market approach: the guideline transaction method.

Selecting guideline transactions

The guideline transaction method — also known as the guideline merger and acquisition method — is based on sales of controlling interests in companies engaged in the same, or similar, lines of business. Guideline transactions come from databases that may contain both public and private business interests.

Valuators consider various factors when evaluating guideline transactions. These include:

- Industry classification,
- Size,
- Growth,
- Financial performance,
- Capital structure,
- Geographical location, and
- Operational characteristics.

Timing is another important selection criteria. Transactions that occurred long ago or during economic conditions that differ from the conditions on the valuation date may not be relevant — or they might require adjustments to account for any changes.

Digging deeper

Transaction databases may include both stock and asset sales. In a stock sale, the buyer typically acquires the *entire* business, including all its assets and liabilities. However, most transactions involving small, private businesses are structured as asset sales, and the precise assets and liabilities acquired vary from transaction to transaction.

When evaluating asset sales, valuators must adjust their analyses to reflect the specific assets and liabilities transferred in the guideline transactions. If they don't, the resulting pricing multiples may be distorted, leading to inaccurate results.

For example, it's common in an asset sale for the buyer to acquire inventory, fixed assets and intangible assets. Meanwhile, most liabilities, as well as cash and accounts receivable, typically stay with the seller. When applying pricing multiples derived from such sales, a valuator would need to add the subject company's cash and accounts receivable and subtract its liabilities to arrive at the fair market value of the entire business.

Most transactions involving small, private businesses are structured as asset sales.

Valuators also may need to make adjustments for special terms of the guideline transactions. Examples include noncompete covenants, earnout provisions, and employment or consulting agreements with the seller.

Applying pricing multiples

After the valuator has compiled a group of relevant guideline transactions and made the requisite adjustments, it's time to develop pricing multiples. These multiples represent the ratio of the transaction price to a financial metric — for instance, price-to-earnings or price-to-revenue.

There's no universally optimal pricing multiple. Valuators often perform statistical analyses of guideline transactions to determine which financial variables have the strongest correlation. They also may decide to eliminate "outlier" transactions that might not meet the definition of fair market value and, therefore, skew the results. For example, a seller might have been under duress to sell quickly due to bankruptcy or the death of a key person. Related parties also may pay above- or below-market prices.

The valuator then applies the selected pricing multiple (or multiples) to the subject company's financial metrics. Valuators may use a range of pricing multiples, or they may select an average or weighted average of the multiples derived from the guideline transactions. A valuator also may assign greater weight to more recent guideline transactions or those involving the companies most similar to the subject company.

Detailed reports

Although the guideline transaction method seems objective and straightforward, adjusting guideline companies and selecting pricing multiples require informed professional judgment. Comprehensive valuation reports are key to understanding a valuator's analyses and conclusions. ■

Rosenthal v. Erber

Court rejects biased expert testimony

A recent New York case provides insight into what courts look for in valuation expert opinions. In *Rosenthal v. Erber*, the court rejected the respondent's valuation, finding that the expert appeared "to merely have been hired to proffer an opinion to defeat [the petitioner's] claims." It also criticized his reliance on financial data provided by the respondent without independently verifying it or requesting additional information.

Background

The case involved a boutique optical store. Each party owned 50% of the corporation's shares. The respondent ran the store, while the petitioner was a passive investor.

The passive investor filed a petition to dissolve the corporation in February 2021. The respondent subsequently made an election to buy the petitioner's shares for fair value.

Divergent opinions

In determining fair value, the court largely agreed with the valuation from the petitioner's expert that was based on the weighted average of several methods. However, it found that certain assumptions were "somewhat inflated."

Among other things, growth rates used for the discounted cash flow and capitalization of earnings methods were "far too optimistic," and comparables used in the guideline public company method were "not that comparable." The court made an across-the-board 20% reduction in value for these "aggressive assumptions." It also reduced the pricing multiple used in the guideline transactions method from 2.7 to 2.0. After these adjustments, the court valued the company at $283,816 ($141,908 for a 50% interest).

The respondent's expert valued the company at $0, but the court gave no credit to his opinion. A major factor in his valuation was the respondent's claim that the company owed nearly $385,000 in rent, based on a questionable letter from the landlord. In contrast, the petitioner's expert assumed that the outstanding rent was about $95,000, based on the landlord's invoices. The court said the conclusion that the company was worthless significantly undermined the expert's credibility, given the "significant value [respondent] continues to derive from it."

It also criticized the respondent's expert's reliance on the company's tax returns, which had been shown to be inaccurate, rather than its financial statements or QuickBooks® records. "It is troubling," the court observed, "that an expert would purport to render a serious opinion on the Company's value based only on its tax returns, knowing his client could easily have given him a more complete set of records."

Garbage in, garbage out

It's critical for valuation experts to use reasonable, market-based assumptions and empirical evidence and to maintain independence to avoid being perceived as "hired guns" by the courts. Business owners should also share all relevant financial information with their experts to help them perform comprehensive analyses. ■

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About Wouch, Maloney & Co., LLP

Wouch, Maloney & Co., LLP is a regional certified public accounting firm with offices in Horsham and Philadelphia, Pennsylvania and Bonita Springs, Florida. The firm has provided closely held business and individual clients with a wide array of accounting services for over 30 years. Wouch, Maloney & Co.'s domestic, multi-state and international clients reflect a broad range of industries from real estate and construction to manufacturing, wholesale and professional service. The firm offers a comprehensive group of services including tax, audit and accounting, business consulting, estate planning, business valuation, litigation support and forensic accounting.

Our Valuation and Forensic Services:

Our firm has partner and manager level staff who hold certifications as Certified Valuation Analysts (CVA's), Certified in Financial Forensics (CFF's) and Accredited in Business Appraisal Review (ABAR). They have extensive experience in providing valuation services and expert witness testimony in various courts on a wide range of litigation issues including:

- Shareholder/Partner and Business Disputes
- Lost Profits Analysis
- Damage Analyses
- Domestic Relations Matters
- Bankruptcy Services
- Fraudulent Actions
- Criminal Tax Matters
- Valuing Closely Held Businesses
- Purchase or Sale of Business
- Succession Planning
- Estate Planning for Gifts or Inheritances

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