Valuation & Litigation Briefing

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Daubert challenges

Communication with experts is key to avoiding exclusion

Litigants in federal cases often challenge the admissibility of expert testimony, arguing that it fails to meet minimum standards of relevance and reliability. Those standards were established by the U.S. Supreme Court in *Daubert v. Merrell Dow Pharmaceuticals*. The landmark case anointed federal trial judges as the "gatekeepers" of expert evidence.

Before *Daubert*, most courts applied the less stringent *Frye* standard, under which admissibility required only that an expert's methods were generally accepted as reliable in the relevant scientific community. In 1999, the Court clarified in *Kumho Tire* that the *Daubert* standard applies to nonscientific testimony, opening the door for challenges against financial experts.

Overview of admissibility rules

Daubert applies a two-pronged test for expert admissibility. First, the expert's methods and reasoning must be *reliable*. Second, the expert's conclusions must be *relevant*. In other words, they must be properly applied to the facts at issue.

The Court listed four nonexclusive factors judges should consider in evaluating reliability of an expert's theory or technique:

1. Can it be and has it been tested?
2. Has it been subject to peer review or publication?
3. What's the known or potential error rate?
4. Is it generally accepted in the relevant scientific or technical community?

Best practices

To avoid exclusion of expert witnesses, communication is key, beginning in the early stages of litigation. Before deposition or trial, address these questions with your expert:

What's the applicable standard? *Daubert* applies in federal court and most state courts. However, some states continue to apply the *Frye* standard or other less restrictive standards. It's critical to determine which standard applies and ensure your experts understand how it affects their work and their testimony.

Recent developments in Florida illustrate the potential uncertainty, in some states, regarding the appropriate evidentiary standard. In October 2018, the Florida Supreme Court in *Delisle v. Crane* ruled that the *Frye* standard applied, despite the state legislature's codification of *Daubert* in the state's evidence code five years earlier. The court decided that the evidence code amendments unconstitutionally encroached on the court's authority to establish procedural rules. But just seven months later, the court reversed course in *In re Amendments to Florida Evidence Code*, ruling that *Daubert* was the applicable standard.

Reliability vs. credibility

In determining whether an expert's testimony should survive a *Daubert* challenge, courts often make a distinction between reliability and credibility. Reliability is the province of the judge. But credibility — or accuracy — is the province of the jury.

For example, in *Dominion Liquid Technology v. GT Beverage*, a federal district court admitted a damages expert's testimony about a production line's "going concern potential value." The plaintiff argued that the expert's testimony was unreliable because, instead of a "dollars and cents" valuation, he merely provided an opinion based on his own unsupported conclusions.

The court disagreed, noting that the expert's opinion was based on 30 years of relevant industry experience, as well as an inspection of the production line, a review of the equipment manufacturer's proposals and a meeting with the company's president. The pertinent inquiry, the court explained, wasn't whether the expert offered precise damages calculations but whether his opinions would assist the court in understanding the evidence or determining a factual issue.

The court rejected the plaintiff's arguments because they "fundamentally confuse the credibility and accuracy of [the expert's] opinion with its reliability." The right way to challenge his testimony wasn't to exclude it, but to vigorously cross-examine it, present contrary evidence and provide careful instruction on the burden of proof.

Are the methods reliable? To avoid *Daubert* issues, your experts' reports and testimony must meet the four reliability factors. Ask experts to gather evidence that their methods are generally accepted, including authoritative treatises, peer-reviewed articles by reputable authors and compliance with applicable professional standards. If you're concerned that your experts' methods may not pass the *Daubert* test, ask them to prepare calculations using alternative methods as a backup.

Also, check whether your experts' academic credentials, certifications and experience are relevant given the issues in the case. Experts should be ready to explain the standards that govern their work — and they should avoid opining on matters beyond their expertise.

Are the assumptions reasonable? Review your experts' assumptions with a healthy dose of skepticism. They should be realistic and consider all relevant data — even information that doesn't support the desired conclusions. If an expert relies on data or work furnished by the client or other third parties, it must be reliable.

Experts' work also must pass the "real-world" test. In other words, their methods and assumptions should adhere to the same professional standards, and apply the same level of intellectual rigor, as nonlitigation engagements involving the same issue.

Avoid exclusion

There are two main reasons financial experts can be excluded under the *Daubert* standard. First, an expert who uses insufficient data or methods that aren't generally accepted may be deemed to lack *reliability*. Second, an expert whose testimony exceeds the scope of his or her role or isn't tied to the specific facts may be deemed to lack *relevance*. Discussing the relative strengths and weaknesses of experts' testimony can help you develop strategies for increasing the chances of admissibility. ■

Valuing “synergies” in M&A

When does 1 + 1 = 3? In mergers and acquisitions (M&As), it’s often said that the combined entity is more valuable than the sum of its parts. The reason is related to a concept known as “synergies,” which are benefits to a specific strategic buyer.

Saving costs vs. generating revenue

Synergies typically break down into two broad categories:

1. Cost-saving. These are simple to visualize and predict. Common examples of postmerger cost savings include staff reductions (such as downsizing offices and consolidating positions), strategic reassessments (such as spinning off product lines or closing poorly performing divisions) and consolidated overhead expenses (such as eliminating redundant marketing and administrative expenses). The combined entity also can achieve better economies of scale by buying more supplies in bulk or reducing IT expenses by consolidating networks.

Sellers may expect buyers to share synergistic value with them during price negotiations.

2. Revenue-generating. These synergies are harder to quantify and are affected by many other factors, such as interest rates and market conditions. For example, a buyer might be able to cross-market its acquisition’s products to its own current customers and vice versa. Lower costs might also enable the company to offer more competitive pricing, which can increase market share. However, coming up with an accurate estimate of such future revenue can be difficult.

Sharing the wealth

Synergies can be quite lucrative — so, sellers may expect buyers to share synergistic value with them during price negotiations. Doing so can ease the postmerger integration process by providing sellers with incentives to assist in the transition process.

Sharing synergies may require the use of creative deal terms. For example, a seller might ask for a percentage of any potential synergy-related profits over an agreed-upon period on top of the sale price. In exchange, the seller might be willing to concede to a lower sale price. Buyers find this latter proposal appealing because it reduces the price *and* lowers their risk. If the merged organization fails to save on synergies, the buyer has no further obligation to the seller.

Sharing synergistic value with sellers can be particularly advantageous for public companies. A sharing strategy can boost the stock price of the newly merged company, because it shows investors that both parties have a stake in ensuring a smooth transition and quickly realizing cost savings.

A different approach

Valuing synergies requires a thorough analysis of the combined entity’s future annual growth potential and accurate estimates of savings that could be achieved from consolidation. The discounted cash flow (DCF) method is routinely used in M&As to value synergies. But how it's applied is often far from routine. Special risk-based adjustments may be made when valuing synergies. In some situations, synergies are valued separately from "normal" business operations due to the inherent risk that they won't be achieved.

For example, valuation experts may assign different types of synergies into separate "buckets" and assess them separately according to risk. Others use a higher discount rate, such as the cost of equity, for synergies. Still others give synergies a "haircut" — that is, they reduce synergy-related cash flow projections to reflect the risk they won't be realized.

The approach depends in part on the nature and risk of the synergies. For example, easily achieved cost synergies — such as those derived from eliminating redundant management — might not require a separate valuation. But revenue synergies, such as those derived from cross selling to a new customer base or sharing distribution channels, might need to be treated separately, given the higher risk involved.

We can help

Valuing synergies can be challenging, especially when buyers and sellers have unrealistic expectations about the combined entity's expected future performance. A valuation professional can help the parties stay grounded and improve the chances of a successful deal. ■

Beware the pitfalls of using EBITDA multiples

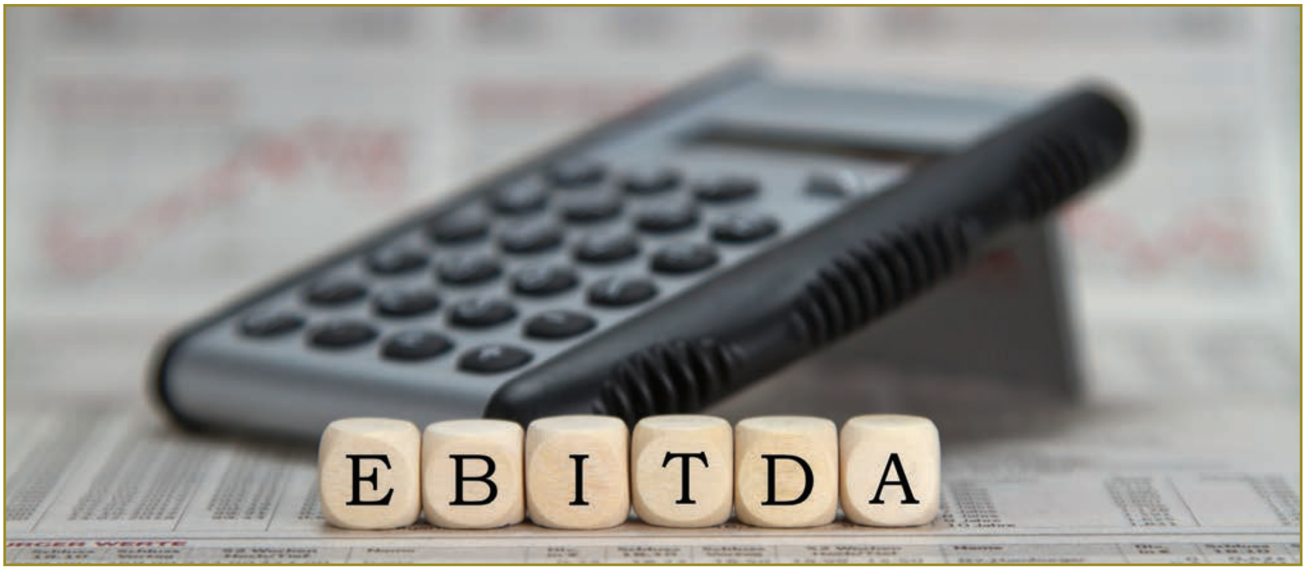
At the end of 2019, the median multiple of selling price to earnings before interest, taxes, depreciation and amortization (EBITDA) across all industry sectors was 4.4 times. Business owners and their legal advisors may be tempted to rely on average or median EBITDA multiples to estimate the value of a business. But this shortcut can be costly when it's used for federal transfer tax, litigation or M&A purposes.

Key differences

Historical EBITDA is sometimes used as a rough estimate of future operating cash flow. But there are several reasons why it may differ from the metric that's used in a discounted cash flow analysis — expected net free cash flow to equity investors and lenders. And these differences can lead to erroneous conclusions of value.

The most obvious difference between these amounts is that *historical* earnings may not reflect *future* earnings. Market conditions or changes within the company can cause a company's earnings to grow or contract over time. This can make historical EBITDA a poor proxy for future operating cash flow. EBITDA multiples also don't consider future working capital needs or trends that may affect future cash flow.

In addition, depreciation expense may not reflect the amount that the company needs to spend on annual capital expenditures. This is particularly true if the company's assets are older and fully depreciated — or if the company uses accelerated depreciation methods. In the first situation, EBITDA might be artificially high, because depreciation expense would probably be lower than the annual



cost of acquiring new fixed assets. The reverse might be true with the use of accelerated depreciation methods.

Earnings manipulation

When an EBITDA multiple is used to value a business, the conclusion may be susceptible to earnings manipulation by the controlling shareholder. Owners planning to sell their business can take steps to *increase* EBITDA and, therefore, *maximize* their selling price. Likewise, owners valuing the business for estate planning or divorce purposes can take steps to *decrease* EBITDA and, therefore, *minimize* the value derived using an EBITDA multiple.

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For example, the fictional High Growth, Inc. has been spending significant amounts of money on hiring new salespeople, marketing its products and researching new production methods. These expenses lower EBITDA over the short run, but they'll likely increase value over the long run, which would benefit a potential buyer.

On the flip side, Cash Cow Co. has a stable level of earnings. Its owner is planning to retire soon. So she's cut back on discretionary spending items — such as marketing, repairs and maintenance, employee benefits and staff training — to boost EBITDA over the short run and look more profitable to prospective buyers. These cutbacks may impair earnings over the long run, however.

Both hypothetical companies report $1 million of EBITDA. Which company would you rather invest in? Relying exclusively on historical EBITDA multiples, the companies would have the same value, even though Cash Cow Co. has made short-term spending cuts that would likely compromise its ability to generate operating cash flow in the future.

Leave it to the pros

EBITDA multiples have their place in the science of valuing a business. In fact, credentialed valuation experts may use EBITDA multiples when valuing businesses under the market approach or when performing sanity checks on value estimates derived under other methods. But when laypeople rely exclusively on such simplified multiples without making adjustments for how EBITDA differs from operating cash flow or what's expected to happen in the future, it can lead to erroneous business decisions. A credentialed business valuation professional can help you get it right. ■

Stephanos v. Stephanos

Personal vs. enterprise goodwill in divorce

The treatment of business goodwill in divorce cases varies from state to state. Courts in more than half of the states make an important distinction between personal and enterprise goodwill. Here's some insight from a recent Florida circuit court decision on this issue.

Florida applies majority rule

Goodwill is an intangible asset that results from a business's name, reputation, customer loyalty, location, products and similar factors. Like many other states, Florida law treats *enterprise* goodwill as a marital asset subject to division. But it specifically excludes *personal* goodwill from the marital estate when alimony is awarded based on a spouse's earnings from the business.

Enterprise (or business) goodwill is associated with the business as a standalone entity. It may be attributed to the business's location, brands and employees. Personal (or professional) goodwill is associated with a specific owner's or employee's reputation, skills, experience and education.

Husband had limited role

In *Stephanos v. Stephanos*, the husband was sole owner of a hormone replacement therapy clinic. The Florida Circuit Court for the Fifteenth Judicial Circuit ruled that the wife had met her burden of proving that the clinic's goodwill was a marital asset.

The wife had hired a business valuation expert who used the residual method to estimate the value of goodwill. He determined that the company's fair market value was $5.3 million. Next, he allocated $3.1 million to the company's net assets. The remaining $2.2 million (the residual) was attributed to goodwill. The wife presented ample evidence to demonstrate that all the goodwill value was enterprise goodwill and, therefore, subject to equitable distribution.

She also offered substantial evidence that her husband's role was so limited that he contributed nothing to the business. Among other things, the husband had a previous felony conviction in connection with illegal steroid sales. In addition, several employees testified that he had little or no involvement with managing the company or dealing with customers or business affiliates.

Absent any credible evidence that the husband played a key role in the business, the court found that all the goodwill was enterprise goodwill. The court also rejected the husband's argument that the goodwill was personal to him because a buyer of the company would demand that he sign a noncompete agreement.

Consult a valuation expert

Stephanos is an unusual case. It's rare that a service business owned by one individual would have no personal goodwill, but it sometimes happens. Distinguishing between enterprise and personal goodwill is a challenge, so it's important to involve a business valuation expert. ■

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- Damage Analyses
- Domestic Relations Matters
- Bankruptcy Services
- Fraudulent Actions
- Criminal Tax Matters
- Valuing Closely Held Businesses
- Purchase or Sale of Business
- Succession Planning
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