Valuation & Litigation Briefing

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The terms "fair value" and "fair market value" are sometimes used interchangeably. To a business valuation professional, however, they have very different meanings. Adding to the confusion, "fair value" may be statutorily defined for shareholder litigation and divorce purposes — and that definition may vary depending on the case's venue. Moreover, fair value means something entirely different when it's used for financial reporting purposes. (See "Fair value under GAAP" on page 3.) Ultimately, an expert's conclusion can differ significantly, depending on which standard of value is appropriate.

Fair market value

Fair market value is probably the most widely recognized valuation standard. It's commonly used to value businesses or business interests for sale and tax purposes. The IRS defines fair market value in Revenue Ruling 59-60 as "[T]he 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."

Fair market value is determined based on the expected price in an open and unrestricted market. This standard isn't the same as "strategic" or "investment" value, which refers to a business's perceived value to a *specific* investor.

Under Rev. Rul. 59-60, a valuation expert considers eight factors when estimating fair market value:

1. Nature and history of the business,
2. Economic outlook for the general economy and industry,
3. The company's book value and financial condition,
4. The company's earnings capacity,
5. The company's dividend-paying capacity,
6. Goodwill and other intangible value,
7. Previous sales and the size of the block of stock, and
8. Market prices of comparable stocks.

Depending on the size of the business interest and restrictive agreements, fair market value also may incorporate discounts to reflect a business interest's lack of control or lack of marketability.

Fair value

Fair value is a term — defined by state law and/or legal precedent — that may be used when valuing business interests in shareholder disputes or marital dissolution cases. Typically, a valuator uses fair market value as the starting point for fair value, but certain adjustments are made in the interest of fairness to the parties.

Fair value under GAAP

U.S. Generally Accepted Accounting Principles (GAAP) define fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This definition — found in Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements and Disclosures* — is similar to the definition of fair market value, with some subtle differences.

For example, rather than an open and unrestricted market, fair value for GAAP purposes only considers participants in the principal, or most advantageous, market. In addition, ASC 820 establishes a three-tier hierarchy for valuation inputs: It gives the highest weight to quoted prices in active markets for *identical* assets or liabilities, a lower weight to comparable assets and liabilities and the lowest weight to an entity's cash-flow models or other internal data.

For example, dissenting shareholder litigation often involves minority shareholders who are "squeezed out" by a merger or other transaction. Unlike the hypothetical, willing participants contemplated by fair market value, dissenting shareholders are neither hypothetical nor willing. The fair value standard helps prevent controlling shareholders from taking advantage of minority shareholders by forcing them to accept a discounted price.

In many states, fair value is defined as a shareholder's proportionate share of the fair market value of the company as a whole, without regard to any discounts for lack of control or marketability. To avoid providing a windfall to dissenting shareholders, fair value generally doesn't include any strategic or synergistic premiums that might otherwise increase the company's fair market value. In addition, it's common to exclude from fair value any appreciation or depreciation in value in anticipation of the transaction that gave rise to the litigation.

Divorce cases

In a divorce context, it's important to review all applicable statutory and case law that governs valuation. The rules vary substantially from state to state. In many states, valuation in divorce cases is based on fair market value, but some states apply fair value standards similar to those in dissenting shareholder cases. A few state statutes simply use the term "value," or don't address valuation at all, so it's critical to examine the courts' interpretation of the term.

Even in states that purport to use fair market value, adjustments may be required. For example, more than half of states exclude the value of a spouse's personal goodwill from the marital estate. Some states exclude both personal goodwill *and* enterprise goodwill — that is, goodwill associated with the business itself — while others include all goodwill in the marital estate.

Get it right

Whenever it's necessary to determine the "value" of a business or business interest, it's critical to learn about valuation standards and work with experts who understand the subtle nuances. The definition of fair value varies dramatically from state to state (or even from court to court), and fair market value may depart from its traditional definition in some contexts. ■

Avoiding pitfalls when estimating lost profits

When calculating lost profits in commercial litigation, it's critical to understand how *costs* are treated in the relevant jurisdiction. In general, avoided variable costs should be deducted from lost revenue to arrive at lost profits. But the treatment of fixed costs may be less certain.

Defining lost profits

In a financial reporting context, the term "profits" refers to the difference between gross revenue and the costs incurred to produce the revenue. This includes variable costs — which increase or decrease in proportion to production or sales volume — and fixed costs, such as rent or insurance, which are incurred regardless of volume.

Allowing a plaintiff to recover its lost revenue without deducting avoided costs would give the plaintiff a windfall.

In a litigation context, defining "lost profits" is more complicated. That's because, when a defendant's misconduct damages a plaintiff's business, it not only deprives the business of revenue, but it also allows the business to avoid certain variable costs that it otherwise would have incurred to produce the revenue, such as materials, direct labor and shipping expenses.

Allowing a plaintiff to recover its lost revenue without deducting avoided costs would give the plaintiff a windfall. For this reason, most courts require plaintiffs to deduct variable costs associated with the revenue lost as a result of the defendant's actions.

Generally, fixed costs aren't deducted in lost profits calculations. By definition, they're *not* affected by

changes in volume and, therefore, *not* avoided as a result of the defendant's actions. (However, certain fixed costs may become variable or step-variable over the long run.) Arguably, if costs that the plaintiff will continue to incur are deducted from lost profits, the plaintiff will be undercompensated. Nevertheless, some courts do require deductions for fixed costs when calculating lost profits.

Revisiting relevant case law

Fixed costs were the subject of debate in a significant 2008 breach of contract case in Florida (*RKR Motors v. Associated Uniform Rental & Linen Supply*). Here, Associated Uniform alleged that RKR had breached three contracts to rent and launder its employees' uniforms. Associated Uniform's expert calculated lost profits of approximately $82,000, but RKR's expert concluded that lost profits were just over $10,000. The experts agreed on lost revenue, but they disagreed about which costs to deduct.

Both experts deducted the variable expenses that were directly avoided by not having to fulfill the contracts. RKR's expert also deducted a portion of Associated Uniform's administrative and other fixed expenses, reasoning that these expenses were "involved with rendering services to RKR Motors."

The appellate court accepted the lost profits calculation prepared by RKR's expert, holding that deducting a portion of fixed costs "allows for a true measurement of the amount the non-breaching party would have earned on the contract had there been no breach." The court explained that Associated Uniform's average net profit margin was 8% and failing to deduct fixed costs from lost profits would result in a net profit margin of 64% on the breached contracts, providing Associated Uniform with a windfall.

Arguably, the court's logic ignores the fact that the lost revenue caused by RKR reduced Associated Uniform's net profit margins on its remaining contracts, negating the windfall argument. Nevertheless, it remains the law in Florida.

Doing your homework

It's critical for attorneys and experts to understand the methodology a particular court uses to compute lost profits. The treatment of fixed costs can have a significant impact on the amount of lost profits that are recoverable. ■

Forecasts vs. projections: What's the difference?

Valuations are often based on management's estimates of expected cash flow. Even when a valuation expert or the company's CPA prepares the estimate, the basis is typically management's representations about the company's future plans to handle market opportunities and potential threats. So, it's important to evaluate whether expected cash flow seems reasonable and appropriate given the purpose of the valuation.

An important distinction

There's a noteworthy distinction between the terms "forecast" and "projection," according to AICPA Attestation Standards Section 301, *Financial Forecasts and Projections*:

Forecast: "Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's *expected* financial position, results of operations, and cash flows. A financial forecast is based on the responsible party's assumptions reflecting the conditions it expects to exist and the course of action it expects to take." [emphasis added]

Projection: "Prospective financial statements that present, to the best of the responsible party's knowledge and belief, *given one or more hypothetical assumptions*, an entity's expected financial position, results of operations, and cash flows. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as, 'What would happen if … ?'" [emphasis added]

Valuation professionals generally use forecasts — that is, expected results based on the expected course of action — when appraising private business investments. But projections may sometimes be more appropriate, depending on the nature of the assignment. For example, the date of and reason for preparing the estimate can affect whether forecasts or projections are more relevant, as well as whether certain adjustments to the future earnings are required.

Starting point

Historical financial statements are a logical starting point for both forecasts and projections. But management can't necessarily assume that current revenue and expenses will grow at a constant rate commensurate with inflation. That's unrealistic for many companies today.

Savvy business managers factor emerging threats and market opportunities into their forecasts and projections. They also consider how competitors are performing under the same market conditions. In an evolving or uncertain market, the performance of competitors — especially market leaders — is often more meaningful than historical results.

Effect on value

It's perfectly acceptable for valuators to rely on an estimate of expected cash flow that's prepared by the company's management. But it's important to understand the type of estimate that was created and gauge whether it appears to be reasonable in today's marketplace. Small differences in expected cash flow can have a big impact on the value of a business.

For example, suppose management has prepared two estimates of net cash flow over the last year:

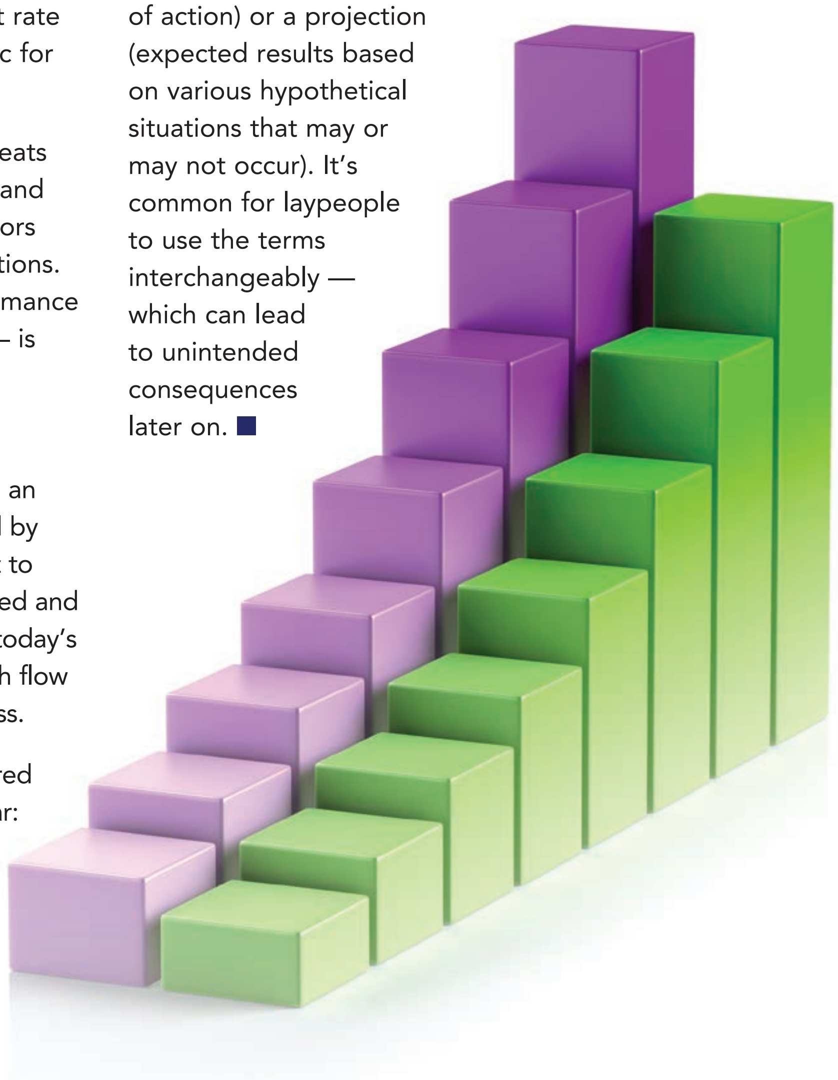
1. Equity net cash flow of $10 million based on a *projection* the company's owner prepared to apply for financing the construction of a new plant, or

2. Equity net cash flow of $8 million based on a *forecast* prepared by the company's CPA in accordance with the AICPA attestation standards.

If a valuator applies a 20% equity capitalization rate to both estimates, the resulting values would be $50 million ($10 million divided by 20%) and $40 million ($8 million divided by 20%). In other words, if the valuator uses the projection rather than the forecast, every $1 of additional net cash flow results in an extra $5 of value at a 20% cap rate.

Know where you stand

A valuation is only as reliable as the assumptions it's based on. Before using prospective financial statements prepared in-house or by an external CPA, check whether the results represent a forecast (expected results based on the expected course of action) or a projection (expected results based on various hypothetical situations that may or may not occur). It's common for laypeople to use the terms interchangeably — which can lead to unintended consequences later on. ■



Experts can help reduce headaches in reduction-in-force cases

When an employer significantly reduces its workforce, there's a risk that terminated employees will allege unlawful employment discrimination. Finance and accounting professionals with statistical expertise can help employers structure layoffs in a manner that minimizes the risk of discrimination allegations. And, in the event that a reduction in force (RIF) leads to litigation, experts can help demonstrate that the employer's actions served a legitimate business purpose — even if they also have a disparate effect on women, minorities, older employees or some other protected class.

Minimize litigation risks

A pre-RIF statistical audit is one of the most effective tools for anticipating discrimination claims and ensuring the employer has a solid defense. That's because the expert analyzes the same data and makes the same computations as a plaintiff's expert when he or she evaluates a discrimination claim.

An audit can, for example, lead to recommendations that reduce the likelihood an employer's RIF plan will be challenged. For example, the expert may conclude that the plan relies too heavily on subjective criteria — such as "quality of work" or informal performance reviews — making it difficult to mount a defense in the event there's a discriminatory effect. The plan may be more defensible if objective, quantitative criteria — such as years of service or performance ratings — are incorporated.

Correlate terminations with nondiscriminatory variables

A pre-RIF audit can also predict whether implementation of a RIF will disproportionately affect a protected class. If so, the audit can determine whether the results are better explained by a legitimate, nondiscriminatory business purpose.

There are a variety of statistical tools at the expert's disposal, but one of the most effective is multiple regression analysis. This tool analyzes a set of variables to model relationships between a "response (or dependent) variable" (the result one is attempting to explain) and one or more "explanatory (or independent) variables" — that is, variables that cause or are positively correlated with changes in the response variable.

For example, the plaintiff(s) in a RIF age discrimination case might demonstrate a positive correlation between age (an explanatory variable) and termination rates (the response variable). However, the employer's expert might use multiple regression analysis to show that there's a stronger relationship between termination rates and a nondiscriminatory explanatory variable, such as a lack of computer skills. Arguably, such an analysis would support the employer's position that terminations weren't age-driven, even though they had a disparate effect on older workers.

Plan ahead

Ideally, a financial expert should be consulted long before a contemplated RIF. That gives the expert time to study the employer's RIF plan, assess its effect on protected classes of employees and recommend adjustments that minimize the risk of discrimination claims. ■