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# Valuation & Litigation Briefing

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# What is the "value" of litigation?

Placing a value on litigation — that is, determining the probable outcome and its potential financial impact on a party — is important for several reasons. For instance, it not only can help you weigh the relative costs and benefits of various litigation strategies, but it's also relevant for business valuation and financial reporting purposes.

The value of litigation is particularly significant in light of the Financial Accounting Standards Board's (FASB's) proposed changes in the way loss contingencies are accounted for and disclosed in a company's financial statements. These changes raise some concerns regarding potential disclosure of litigation strategies and other confidential information.

## Accounting for contingencies

Accounting for litigation and other contingencies has always been a challenge. But FASB's proposed changes raise significant concerns for parties and their counsel, particularly from the defendant's perspective. (These changes may have been finalized by the time you're reading this; check with a financial expert for the latest information.)

Under current standards, contingent *assets*, such as a plaintiff's potential recovery, generally aren't recorded on a company's financial statements until they're recognized — in other words, until the litigation is completed and the contingency is resolved.

Contingent *losses*, on the other hand, such as a defendant's potential liability, may need to be recorded or disclosed in the financial statements. Loss contingencies are classified as "probable," "reasonably possible" or "remote." Companies must accrue contingent losses that are probable, provided the amount of the loss can reasonably be estimated.

If a loss isn't accrued, it must be disclosed if there's at least a reasonable possibility that a loss has been incurred. The disclosure should describe the nature of the loss contingency and, if reasonably estimable, the range of probable losses.

FASB's proposed changes would require companies to disclose more information about potential litigation losses. Among other things, the proposal would require disclosure of *remote* contingencies if their near-term financial impact would be "severe" if they came to fruition.

The proposal would also require disclosures to include both qualitative and quantitative information about contingent losses — including loss estimates — that critics fear could reveal litigation strategies, disclose privileged information or attorney work product, or affect settlement negotiations.

## Litigation as an investment

When making litigation-related decisions (such as to settle a case or bring it to trial),

it's helpful to view litigation as an investment. Valuation experts can use a variety of techniques — including decision trees, real options analysis and discounted cash flow analysis — to determine the potential "return on investment" of various litigation outcomes.

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For example, if trying a case would cost $500,000 and the probability of recovering more than that amount is slim, then pursuing this strategy would be an unwise investment.

### Impact on business valuation

From a business valuation perspective, pending litigation can have a big impact on what a hypothetical willing buyer would pay for a business; pending litigation increases a business's risk, which in turn has an adverse effect on its value. Valuators must work closely with counsel and management to assess the probability that pending or potential litigation will result in a gain or loss and to place a monetary value on that probability. Both the potential gain (or loss) and potential attorneys' fees must be considered.

In some contexts — such as valuations for gift or estate tax purposes — valuators must rely on their experience and professional judgment to estimate the impact of litigation contingencies on business value. In other cases, however, such as the sale of a business or marital dissolution, the parties may be able to avoid the uncertainties inherent in litigation by agreeing to adjust the terms of a transaction or settlement once the litigation has been resolved.

### Teamwork pays off

By working as a team, attorneys and their financial experts can assess the probability of various litigation outcomes and estimate the value of litigation for a variety of purposes. After FASB has finalized new standards for loss contingencies, consult your experts to discuss how the new standards will affect your clients' financial statements and litigation strategies. ◆

# Tax Court: Subsequent sale was best evidence of fair market value

In *Ringgold Telephone Company v. Commissioner*, the U.S. Tax Court discussed the impact of post–valuation-date sales on fair market value as well as the importance of choosing an experienced, qualified valuation expert.

The court found that the sale of a partnership interest, which was agreed to six months after the valuation date and completed nearly four months later, was "probative" of value, but not "conclusive."

### A New Year's resolution

On Jan. 1, 2000, Ringgold Telephone Company converted from a C corporation to an S corporation. At the time, Ringgold, BellSouth and two other companies each owned 25% partnership interests in Cellular Radio of Chattanooga (CRC). CRC's primary asset was a 29.54% limited partnership interest in the Chattanooga MSA Limited Partnership (CHAT). Thus, Ringgold indirectly owned a 7.385% interest in CHAT (25% × 29.54%).

BellSouth, in addition to owning a similar 7.385% interest in CHAT, also held a 40% general partnership interest and a 15.31% limited partnership interest through its wholly owned subsidiary, Chattanooga CGSA, for a total interest of 62.7%. As the sole general partner of CHAT, Chattanooga CGSA was the only partner with the authority to request capital contributions or make distributions.

In February 2000, Ringgold obtained a valuation report from a CPA firm that estimated the value of its partnership interest in CRC at $2.6 million. In July 2000, Ringgold agreed to sell its interest to BellSouth for $5,022,929 (subject to working capital adjustments on the closing date), and it completed the sale in November 2000 for $5,220,423.

### An unexpected tax bill

C corporations that convert to S corporations generally are subject to "built-in gains" tax on assets they own as a C corporation and then sell within 10 years after they convert. The taxable gain is equal to the excess of the assets' fair market value over their adjusted basis as of the first day of the company's first taxable year as an S corporation.

On its 2000 tax return, Ringgold reported built-in gain attributable to its interest in CRC based on a fair market value of $2.6 million (the value in the CPA firm's report) on the valuation date (Jan. 1, 2000). The IRS valued the partnership interest at $5,243,602 (based on the BellSouth sale price) and sent Ringgold a notice of deficiency seeking more than $1 million in taxes and penalties.

### Determining fair market value

The Tax Court noted that actual arm's-length sales of business interests within a reasonable time before *or after* the valuation date generally are the best evidence of fair market value — even more so than the value as determined by a qualified appraiser.

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Ringgold's valuation expert valued the interest in CRC at $2,980,000, using both a business enterprise value analysis and a distribution yield analysis (weighted equally). His business enterprise value analysis incorporated the capitalization of income, discounted future income, guideline company and guideline transaction methods. He did *not* consider the sale to BellSouth.

The IRS expert valued the interest in CRC using three enterprise valuation methods: the discounted cash flow method, the merger and acquisition method and the guideline company method. He concluded that the guideline company method potentially overstated CHAT's value and gave it no weight. Ultimately, he valued the interest

at $5,155,000 based on the discounted cash flow and merger and acquisition methods, weighted equally.

### Opposing arguments

The IRS argued that the sale to BellSouth provided the best evidence of value. Ringgold countered that the sale wasn't at arm's length and that BellSouth was willing to pay a premium over what an average hypothetical buyer would pay.

The Tax Court agreed with the IRS — in part. First, the court found that the sale took place within a reasonable time after the valuation date, noting that there was no evidence of intervening circumstances that would have affected the value. In addition, evidence showed that BellSouth was an unrelated buyer acting in its own self-interest, so the transaction was an arm's-length sale in the normal course of business.

The court agreed with Ringgold, however, that BellSouth's special circumstances required a valuation adjustment. Although there was no reason to believe that BellSouth would pay a *control* premium for the partnership interest (because it already controlled CHAT), it did have a history of submitting high bids for partnership interests to discourage other partners from exercising their right of first refusal.

The court concluded that the sale price "should be adjusted to reflect the likelihood that BellSouth viewed the CRC interest as a strategic acquisition and was willing to pay a premium…."

### A persuasive expert

Although Ringgold's expert didn't consider the BellSouth sale, the court found him to be more persuasive than the IRS expert. Unlike the IRS expert, Ringgold's expert was an accredited appraiser, had significant telecommunications industry experience, and considered CHAT's distribution history in his analysis.

The court determined its own value for the CRC interest by taking the values yielded by Ringgold's business enterprise analysis ($2,718,000), Ringgold's distribution yield analysis ($3,243,000) and the BellSouth sale price ($5,220,423). Weighing each equally, the court arrived at a fair market value of $3,727,142.

Unfortunately, the court didn't discuss the level of value represented by the various value conclusions. A phone call to Ringgold's expert confirmed that his business enterprise and distribution yield analyses produced a minority level of value. The BellSouth sale price, on the other hand, appears to represent something other than a minority level of value. Thus, combining the three values without adjustment may be comparing apples to oranges.

### Choose your experts carefully

The *Ringgold* case illustrates the significance of considering subsequent sales in valuing a business interest. Valuation experts who use subsequent sales carefully consider the level of value as well as intervening circumstances that might affect the value of the subject entity between the date of valuation and the subsequent sale.

The case also demonstrates how important it is to choose valuation experts who have appropriate business valuation credentials as well as experience within the relevant industry. ◆

Buy-sell agreements

# 4 valuation-related pitfalls to avoid

It's a fact: Businesses with multiple owners need to draft buy-sell agreements to protect the owners' interests in case of a partner/shareholder's death or retirement. But, all too often, owners make critical valuation-related mistakes when setting up such agreements.

A buy-sell agreement is, in a sense, the guiding light for a company when it goes through ownership changes, because it lays out the buyout terms. But some agreements just don't make the grade. Here are four valuation-related pitfalls you should be aware of:

**1. Buyout terms are ambiguous.** An agreement with undefined terms can lead to misinterpreted intentions. Comprehensive buy-sell agreements explicitly define the appropriate standard and basis of value to apply to owners' interests.

For example, an agreement might prescribe "fair market value" as defined in Revenue Ruling 59-60. For minority interests, fair market value implies a minority, nonmarketable basis of value, which means discounts will be applied. Conversely, an agreement might use the term "fair value" and define it to refer to each owner's pro rata share of the entire company's controlling, marketable value — that is, no discounts will be applied.

Other important valuation parameters include the appropriate "as of" date and payout mechanisms. Funds might be generated from life insurance proceeds, bank loans or seller financing. When exiting owners (or their estates) will be paid over time, it's important to specify duration, interest rates and variable-rate market indices.

**2. Oversimplified formulas are called for.** Some buy-sell agreements prescribe valuation formulas to avoid the time and expense of hiring valuation experts. Unfortunately, these formulas may be ambiguous, outdated and not indicative of fair market value.

Consider an agreement that stipulates the company is worth five times annual earnings. What does the term "earnings" really mean? One valuator might assume it refers to accounting net income and another might use pretax earnings, adjusted for nonrecurring items and quasibusiness expenses. Different interpretations can lead to substantial variance in opinions.

Consider, too, a situation where the company has been reserving cash to, say, purchase land adjacent to its plant for future expansion. The prescribed rule of thumb doesn't account for excess working capital and, therefore, is likely to *undervalue* the business. Conversely, if the company has significant contingent liabilities — for example, environmental cleanup or pending lawsuits — the formula might *overvalue* the business.

**3. Financial data is unclear.** Suppose an owner dies on Jan. 10, 2011. Would the valuator rely on 2009 audited financial statements, unaudited internal

records for the trailing 12 months, or the 2010 audit (which might not be available until April 2011)?

Thorough buy-sell agreements specify the appropriate valuation date and the requisite level of assurance (compilation, review or audit) necessary for the underlying financial information. If controlling owners engage in financial misstatement or deny minority shareholders' access to facilities or financial information, agreements also might call for the services of a forensic accountant.

**4. The appraisal timeline is undefined.** Remaining shareholders seldom are in a hurry to buy back shares, but exiting shareholders — or their surviving family members — have a financial incentive to cash out quickly.

Valuation often takes longer than owners anticipate, especially if the buy-sell agreement calls for multiple experts or valuation disputes arise. Predetermined timelines can establish reasonable expectations and pressure remaining shareholders to complete buyouts in a timely manner.

One last word about buy-sell agreements: For the agreement to remain credible, it must be reviewed and updated on a periodic basis. ◆

## THE ROLE OF FORENSIC SKEPTICISM IN LOST PROFITS CALCULATIONS

When financial experts analyze claims for lost profits or other business damages, they have a variety of tools at their disposal for calculating lost revenues and avoided costs. But it's also important to look behind the numbers for signs that they might have been manipulated or falsified. This "forensic skepticism" is part of what makes forensic accounting and damages analysis an art as well as a science.

Consider this hypothetical example: An explosion and fire shut down XYZ Chemical Company's plant for six months, causing the company to file a claim under its business interruption insurance policy for lost profits and other damages.

XYZ's insurance policy defined lost profits as "net profit before taxes, plus continuing normal operating expenses, including payroll." Business interruption policies typically compensate the insured for certain payroll and other continuing expenses to relieve the business owner from the burden and expense associated with replacing key employees once operations are restored.

In this case, XYZ submitted a claim for lost profits that included the continuing salaries of its eight regional sales managers. The company also provided copies of payroll tax returns to substantiate the expense. After interviewing the sales managers, the forensic accountant who reviewed the claim became suspicious.

Further investigation revealed that the payroll tax returns had never been filed and the taxes hadn't been paid. Inquiries with relevant government agencies also indicated that all eight employees had applied for and were collecting unemployment benefits. As a result of the expert's forensic skepticism, payroll costs were eliminated from XYZ's lost profits and damages claim.

This is just one example of the many ways that financial experts can dig beneath the surface to produce more accurate computations of lost profits.

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