



Shannon Pratt Valuations

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# Defensible Business Valuations™

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*This newsletter is provided as a courtesy of Shannon Pratt Valuations, LLC, a premier national business valuation firm focusing on all types of business appraisals, valuation report reviews, and solvency and fairness opinions. This issue, authored in part by our CEO, Dr. Shannon Pratt, one of the country's leading business appraisers and experts, focuses on what you need to know about getting the most from your business appraiser, how to avoid valuation traps in court, creating defensible valuation reports, and fairness opinions. We hope you find the newsletter informative. For more information, or to contact us about a possible valuation engagement, please call us at 503-459-4700 between 9 am and 5 pm Pacific Time for a free consultation.*

## **Getting the most benefit from your business appraiser**

**By Shannon Pratt, DBA, CFA, FASA, MCBA, CM&AA, MCBC**

Most attorneys don't get as much benefit as they should from their business appraisal expert when they are dealing with a matter involving the value of a business or practice.

This is the first in a series of columns giving tips from my own experience about the services that the business appraiser can provide, and the client benefits that can ensue. It also includes a few examples of how clients have been disserved by the attorney not using a business appraisal expert when it would have been beneficial to do so.

### **Getting the appraiser in early**

All too often, lawyers try to save the client a little money by resolving a valuation issue without retaining a valuation expert. At best, the client is usually not well served. At worst, failure to retain a qualified expert may result in a legal malpractice suit.<sup>1</sup>

One important service that a valuation expert can provide early on is to provide a ballpark range for negotiation, even though at first it may be a wide range.

Sometimes the best few thousand dollars that can be spent are for preventing the client from expending huge resources pursuing an unattainable goal.

On the other hand, you want to prevent your client from accepting any offer that in retrospect will be shown to have been unreasonable at the time.

### **To litigate or not**

If there is litigation involved, the appraiser can give the attorney guidance that will help the attorney in advising the client regarding settlement versus proceeding to trial. Such guidance may involve not only a range of potential values, but also the risks as to the potential outcome.

### **Reviewing others' appraisal work**

If either your side or the other side of a prospective transaction or litigation has prepared a valuation work product, one of the most valuable services that an expert can render is to review the valuation work already available.

In one case, an attorney retained my firm to do an appraisal without providing my firm with appraisals that had already been done on both sides. We came in close to the other side's appraisal. Had we first reviewed the two appraisals already done, the client could have settled quickly and saved about 90 percent of our fee. When we corrected the errors in the first appraisal for our side, it came out about the same as the other side's numbers.

In other cases, the initial review work may lead to commissioning a full appraisal. In other cases, the review work may lead to continuing valuation consulting, which may be in support of work already done, rebuttal to work by an opposing expert, or both.

### **Allow adequate time for valuation**

The most obvious role of a valuation expert is to actually do a valuation. For even a small business or practice, a thorough valuation usually begs a few weeks lead time. Too many lawyers defer the start of appraisal work in hopes of settlement, and then put pressure on an appraiser to come through with

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an appraisal at the last minute. This almost always results in the client not being served as well as he should be.

The valuation requires discovery. This means obtaining and reviewing company documents, a site visit (which we very highly recommend), and one or more interviews. If the client is not involved in the company or practice operations, the time required for discovery is usually longer.

The valuation also requires research. This may involve many facets to use in reaching a fully defensible valuation conclusion, such as:

- industry average financial data for comparison with the subject,
- industry and relevant economic outlook data,
- reasonable compensation data,
- prices at which transactions in similar companies have taken place, and
- much other important data.

### **Insist on thorough discovery**

It is almost never in the client's interest to try to save time and/or money by cutting corners on discovery. Don't succumb to "we don't need a site visit or interviews . . . we can just do the appraisal from the records." Experts virtually always gain a better understanding of the company or practice with a site visit and interviews. Courts recognize this, and give more credibility to the expert who has done the thorough investigation.<sup>2</sup>

And don't let the operating party stonewall your expert if you are representing the non-operating party. If properly requested by the expert, courts will almost always order discovery adequate to satisfy the needs expressed.

### **Allow enough budget**

A good valuation requires a substantial number of applied hours by an appraiser with a high level of valuation expertise. Attaining the expertise involves a significant level of education and training. Keeping it up requires many hours of continuing reading and education. Applying it requires access to large volumes of library and data sources. As a result, hourly rates for good valuation experts are comparable to those for good attorneys.

Most lawyers tend to underestimate the number of hours that are required for a good valuation. Those who have referenced my books have some

understanding of the extent of the work process involved.<sup>3</sup>

<sup>1</sup> See for example, *Callahan v. Clark*, 901 S.W.2d 842 (Ark., 1995); *Corey v. Norman, Hanson & DeTroy*, *infra*, p.12.

<sup>2</sup> See for example, *Zeefe v. Zeefe*, 125 Ohio App.3d 600, 709 N.E.2d 208 (1998).

<sup>3</sup> See, Pratt, Reilly & Schweih, *Valuing a Business*, 4th ed., New York: McGraw-Hill, 2000; and Pratt, Reilly & Schweih, *Valuing Small Businesses and Professional Practices*, 3rd ed., New York: McGraw-Hill, 1998.

## **Avoiding Valuation Traps in Court**

The two most critical caveats of any valuation case are: Know thy law—and know thy law. Those are the lessons that emerged from a recent Florida case, which focused on the valuation of an early-stage entity. The start-up company, an apparel manufacturer, had sued a supplier for allegedly “coercing” it to enter into an agreement with a textile manufacturer, which led to the loss of plaintiff's business. In its suit for damages based on the supplier's negligent misrepresentation and breach of fiduciary duty, plaintiff needed to prove the value of its lost business. The relevant timeline: The plaintiff began operations in February 1997; signed the third party agreement on or about October 12, 1998; and closed its doors in December 1999.

### **First issue: valuation date**

In cases such as these, the attorney determines the valuation date as well as the standard of value pursuant to local law. However, the valuator should also be aware of these laws in preparing reports. In this particular matter, plaintiff's counsel chose and the expert utilized a valuation date of October 11, 1998, the day before the company signed the agreement with the third party manufacturer. Logically, this date allowed a determination of the plaintiff's value “but for” the coerced agreement, as well as the company's resulting loss of value. Opposing counsel never challenged the valuation date, and there did not appear to be any valid, presented reason to choose another.

However, the trial court found otherwise, holding that the plaintiff's losses occurred on the date that it ceased operations in late 1999. (On review, the Court of Appeals agreed, citing local case law, prevalent in many jurisdictions, that “if a business is completely destroyed, the proper measure of damages is the

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market value of the business on the date of the loss.”) When the trial judge issued his finding, opposing counsel quickly moved for a directed verdict and won, as there was no evidence for lost value based on the December 1999 date.

*First lesson:* Although it’s hard to anticipate every curve ball that a court might toss—if there’s any legal possibility for more than one valuation date, analysts, in consultation with their attorneys, should consider preparing alternative valuations to avoid having the court reject their work.

### **Second issue: Speculative forecasts**

In rejecting the expert’s report, the court also found that his reliance on forecasted future cash flows was “too speculative.” But valuation often (if not always) involves some measure of a forward-looking perspective. If historical operations don’t accurately indicate the future, analysts will commonly use the discounted cash flow (DCF) method. One challenge to any DCF is its reliance on the target’s forecasted future cash flows. A careful, well-constructed and well-supported forecast is necessary for the DCF to render a meaningful valuation; for a start-up entity, the analyst must take extra care to avoid allegations that the forecasts are “speculative.”

*Second lesson:* Attorneys need to know, and their appraisers need to ask, whether the “new business rule” would prevent a start-up company—one that has yet to turn a profit—from proving damages for loss of its entire value. For example, in this particular case, local Florida law held that a business can recover lost prospective profits, regardless of whether it has an established earnings record. But no case in that jurisdiction specifically addresses the recovery of lost *value*, and argument would rest on analogy

from the lost profits case or appropriate law in other jurisdictions.

In addition, a valuator should review the AICPA’s *Audit and Accounting Guide: Guide for Prospective Financial Information*; although courts and appraisers are not required to follow accounting guidelines, they do provide useful support to strengthen your DCF analysis.

## **Bullet-proofing Your Business Valuation Reports**

It’s no longer enough for expert valuers to defend the data or discount rates in their reports by citing their training, knowledge, and experience. They’ve got to have sufficient empirical and other support, especially in these three critical areas:

- *Normalization adjustments.* This is the most misunderstood area of a business valuation report, by many clients and courts. Experts must be able to explain each adjustment—what they are and why they apply—first to the client’s attorney and then to the trier-of-fact, and then provide back-up. For example, a physician who takes home half a million dollars a year is not necessarily receiving unreasonable compensation; any adjustment to earnings must come with sufficient empirical evidence and supporting analysis.
- *Capitalization rates.* An expert’s “art” (experience and judgment) can add to the numerical “science” in determining the applicable cap rates. But these rates cannot be arbitrary, and the analysis cannot be entirely subjective. Supporting data is key, and analysts should be prepared to provide the specific year and date of their sources, and explain the precise factors they considered in the build up of the rate and how they qualified them.
- *Discounts for marketability and minority support.* Likewise, the danger here is that subjectivity allows too much play—forcing unwary experts to fall back on their “experience and training” for support, making them vulnerable to attack. On the other hand, analysts who have relied on published studies from the SEC, The FMV Restricted Stock Study™, Valuation Advisors’ Lack of Marketability Discount Study™ and others that target specific industries and companies, comparable to the subject company, will be able to fortify their reports, so long as they back up the data with solid details and explanation.





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## Your Source for Defensible Valuations™

At Shannon Pratt Valuations (**SPV**), we not only provide the highest quality, objective and defensible valuations, but we also offer a comprehensive suite of services to match all your needs. Turn to **SPV** for expert testimony, fairness opinions, arbitrations, as well as valuation analyses and report reviews.

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- Marital dissolution

### Authoritative Valuation Experts

Our staff, including Dr. Shannon Pratt, one of the business valuation profession's leading and most respected authorities and one of its most successful expert witnesses, have authored or co-authored some of the leading texts in this area, and have been – and continue to be – guest lecturers at numerous national and local business valuation, estate planning, accounting, and related conferences and seminars. Dr. Pratt's works have been cited by federal and state courts at all levels, and Dr. Pratt's expert testimony has resulted in ground-breaking legal precedent.



**Shannon P. Pratt**, CFA, FASA, MCBA, CM&AA, has a legendary and unparalleled reputation in the field of business valuation. He is the owner and CEO of Shannon Pratt Valuations, LLC, and is the Publisher Emeritus of *Business Valuation Update*™. Over a distinguished career of more than three decades, he has performed valuation engagements and reviews for M&As, ESOPs, and numerous other purposes. He has testified in a wide variety of federal and state courts across the country and frequently participates in arbitration and mediation proceedings. He has written more than ten industry standard books, including *Valuing a Business*; *Valuing Small Businesses and Professional Practices*; *The Lawyer's Business Valuation Handbook*; *Cost of Capital: Estimation and Applications*; and *Business Valuation Body of Knowledge*.



**Alina V. Niculita**, CFA, is President and COO of Shannon Pratt Valuations, LLC. She earned her Bachelor of Economics in banking and finance from the Academy of Economic Studies in Bucharest, Romania, and her Master's in Business Administration in finance from the Joseph M. Katz Graduate School of Business at the University of Pittsburgh. Ms. Niculita is a Chartered Financial Analyst, a member of the CFA Institute, and a candidate of the American Society of Appraisers in Business Valuation. Ms. Niculita is a regular contributor to valuation books, articles, and conferences.

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