Insights on VALUATION
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Chris Hamilton
CPA, CFE, CVA, DABFA
Arxis Financial, Inc

2468 Tapo Canyon Road
Simi Valley, CA 93063

Phone: 805.306.7875
Fax: 805.306.7891

chamilton@arxisgroup.com
www.arxisfinancial.com

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Standards of Value—Legal Definition

When we discuss "standards of value", we usually will do so in the context of the purpose of a valuation engagement. The purpose will nearly always dictate what standard of value is appropriate. But there are other times where we need to recognize that the standard of value may be defined directly by law, specific contracts, legal documents or indirectly as interpreted by case law.

The standard of value is an assumption, or set of assumptions, as to the specific characteristics of a buyer and seller (either hypothetical or actual) in a given set of circumstances surrounding a particular transaction (or assumed transaction).

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It is extremely important, in a legal setting, that a specific standard of value be determined as there is a potential for significant differences in an estimate of value based on different standards of value, or to put it another way, the different characteristics, or expectations, of different types of buyers and sellers.

Fair market value is the most often used standard of value in business valuation. It is used in valuation engagements for federal tax matters, including estate, gift, and charitable contributions. Although definitions of fair market value vary, the elements included in the definition typically include a hypothetical willing and able buyer and seller, neither acting under compulsion, and both having some reasonable knowledge of the relevant facts. For the valuation of a non-controlling, (i.e., minority) interest in a business entity under a fair market value standard, most, if not all, would agree that the standard would imply the use of certain discounts for lack of control and/or lack of marketability. But in certain legal documents, statutes, and case law, fair market value is defined as calculated without the application of any discounts, making it more in line with the fair value standard as used in dissenting shareholder cases.

One area of the law, which can be very confusing as to standard of value, is that found in marital dissolution. To date, there are only two states, Arkansas and Louisiana, which have specific reference to the use of a fair market value standard of value in divorce proceedings. Most other states infer a standard of value based on circumstances of a particular case or prior case law. In that case, the valuation analyst must work closely with the attorney in order to determine which standard or combination of standards will apply. Valuation analysts must also be careful in not simply applying a particular standard of value based on a shareholder agreement or operating agreement in a divorce case as the trial court may reject the use of the agreement as a basis for equitable distribution. And, although no state currently identifies fair value as the applicable standard of value in divorce proceedings, it appears that this may be the direction a number of states are heading, rejecting the application of discounts in the determination of value for equitable distribution.

Finally, a discussion of the legal implications regarding standards of value would not be complete without a mention of the fair value standard as it applies to shareholder dissent and oppression. But even though nearly every state has adopted the fair value standard in this type of litigation, there still are a number of differing interpretations of the definition of fair value. The Revised Model Business Corporation Act serves as the basis for the definition of fair value for many states and jurisdictions, some by incorporation of the definition word-for-word. The primary difference between fair market value and fair value in shareholder oppression litigation is that one of the parties in the litigation is not "willing." This facet of the definition has a significant impact on the determination of the estimate of value.

It is of extreme importance that we, as valuation analysts, learn and recognize the various legal definitions of standards of value in our engagements. The value of the subject interest and the value of our services to the client, depend on it.

"Double Dipping" in Divorce Matters

Double dipping arises when the cash flow of a closely held business is allocated between the in-spouse's salary and dividends while alimony is awarded to the out-spouse based on total cash flow, not just the salary portion. When this happens, the cash flow apportioned to dividends is counted twice—once when it is capitalized into the value of the business, and a second time when it is treated as a source of income for determining alimony. Generally, double dipping occurs when compensation is normalized to value the in-spouse's business, but his or her excess compensation over a fair market wage is not normalized to establish alimony.

However, as simple as the solution to this problem may seem, there are unintended ramifications that result from any particular course of action. For example, if alimony is awarded and the business is valued based on total salary, including the excess portion, then the out-spouse will receive in property settlement an amount less than his or her portion of the fair market value of the business. And though annual alimony will be larger, as it is based on total salary, it will take many years to make up for the diminished property settlement, if it ever does.

Another ramification occurs when avoidance of the double dip is sought by basing alimony only on fair market value salary. That amount of alimony, coupled with a comparably low return on the invested property settlement from the out-spouse's share of the business, produces an amount of

Breach of Contract

The calculation of damages from the breach of a contract involves the analysis of historical financial data, analysis of the current status of the parties involved, and projections of future economic activity. In most breach cases, there is a basic formula used to calculate damages. In simple terms, the difference between what would have happened without the breach of contract and what did happen as a result of the breach of contract is the economic damage. Quantifying that difference is based on a combination of actual verifiable data, assumptions, and projections.

There are three phases of most damage calculations. The first phase is the period from the commencement of the contract to the date of the "event" (breach). Generally, this is the period where data is most available, relevant, and reliable. The second phase is the period from the date of the breach to the date of trial. The information in this period is also reliable and relevant, but, depending on the circumstances surrounding the breach, may not be readily available. The third phase is the period of time from date of trial into the future. This is the period where economic activity is projected and is, by definition, the least reliable or available. It is also the phase where assumptions play a significant role in the calculations. It must be prepared and presented in a form, though, that is relevant and persuasive.

The role of the expert in a breach of contract matter is to assist the parties in quantifying the damages. This may involve assistance in discovery, developing reasonable assumptions, reading and interpreting contracts, compiling financial data, and presenting the data. Discovery will be based on the theory of damages being pursued, and an experienced forensic accountant can drive a more efficient process of collecting and using relevant data.

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income insufficient to meet living expenses. This forces the court to increase alimony that can only come from dividends or excess compensation that was previously capitalized into property value and divided between the spouses. We are back to the double dip the court tried to avoid.

Another ramification comes about when the court, rather than awarding say 50 percent of the stock in the closely held business, instead settles a cash equivalent amount on the out-spouse. This cash amount, when invested, produces a much lower return than would be forthcoming as a return on the closely held stock itself, even if the in-spouse continued to draw excessive compensation, as there would still be dividends paid. Therefore, to make up for this deficiency between a cash and stock property settlement, the court could award more alimony that would have to come out of excess compensation. Once more, we have returned to the double dip.

Further complicating the double dip issue is the idea of personal goodwill. Any portion of the total value of the closely held business that can be attributed to the personal effort, charisma, reputation, etc. of the in-spouse will be carved out of the total value and awarded to the in-spouse as his or her separate property. Consequently, this amount is neither divisible nor included in the marital estate. This depresses the amount awarded the out-spouse as property settlement; accordingly, his or her return on investment will be depressed, resulting in a greater amount of alimony needed to be awarded. You know where this is headed—the court will be forced to award that alimony based on total income of the in-spouse, not just the fair market value salary, backing us into the double dip again.

What started out as a simple issue has become rather complex. The problems described above occur every day in divorce court, highlighting the need for the assistance of a professional who understands all the inter-relationships and ramifications. To make matters worse, different states have different rules and guidelines derived from statutes and case law regarding the handling of the double dip and personal goodwill.

If a client or you find yourself facing these issues, you need a professional valuation analyst to navigate through these complexities. While not inexpensive, often the fees paid for that assistance result in benefits that exceed the costs.

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Presentation of the conclusions and the basis for the conclusions is often critical to the success of the engagement. There are a lot of experts who can do an adequate or even superior job in the analysis stage, but cannot present the data in a form that is understandable and reasonable for a trier of fact to adopt. Conversely, there are experts who tell a good story, but lack the analytical skills required. They either have others do the analysis and step in personally only to provide the testimony, or they do scant analytical work and rely on their testifying skills to carry the day. Finding both skills in one expert brings efficiency to the damages phase of the case. Regardless of the venue (jury trial, bench trial, or arbitration), the ability to present the conclusions in an easily understood presentation that is backed up with substantial data not only can win the case, it can also assist in settling the case before incurring the expense of a trial.

The following are some traps to avoid when retaining an expert to provide consultation and/or expert witness work in the damages phase of a breach of contract matter:

- Retaining the damages expert right before trial (at the last minute) is common but dangerous. Depending on the circumstances, clients are sensitive to litigation costs, and there is a working theory that the damage phase will be addressed if/when there is a decision that the damage actually took place. By doing so, any advantage of having a financial expert assisting with discovery and development of damages theories is lost. Additionally, experienced and busy financial experts will either be unavailable or have a policy of not taking on "last minute" cases.
- Telling the expert what you want the damages to be is ultimately self-defeating. Reputable experts will not allow themselves to be used in that manner. Often, it comes out in trial either directly or by implication and has a negative impact on results.
- Retaining an expert that is weak either analytically or in his or her presentation skills is an unnecessary compromise. The expert should be allowed to prepare the necessary analysis as well as design exhibits with the client and lawyers that are clear, expressive, and persuasive. This is often an interactive process that results in a smooth presentation.

Retaining an expert that is experienced in this type of work and has the communication skills to present the evidence and the conclusions in an understandable way is the key to success in this type of litigation. It not only provides an edge in trial, it can often facilitate the successful settlement of a case without incurring the cost of a trial.

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