FEBRUARY 2010
VOL. 82 | NO. 2

NEW YORK STATE BAR ASSOCIATION Journal

NYSBA

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Reprinted with permission from the New York State Bar Association *Journal*, February 2010, Vol. 82, No. 2, published by the New York State Bar Association, One Elk Street, Albany, New York 12207.

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Business Valuation Reports – The Importance of Proactive Lawyering

By Peter E. Bronstein and David A. Typermass

Lawyers see business valuation reports in many contexts and situations. Frequently prepared in divorce cases, these reports can be used in estate, tax and corporate cases as well. In a divorce, for example, such an appraisal can be the linchpin for substantial capital awards between spouses. Yet, attorneys and judges often don't pay enough attention to the appraisal process and how small changes in the assumptions and procedures can have a major impact on the bottom line.

Appraisers make judgments based upon parameters that they have chosen, often subjectively. As a result, an appraiser can come up with substantially different valuation results depending on the assumptions he or she uses. Understanding the key methodologies, concepts, and terms that underlie the typical business valuation report will help the practitioner understand the dangers implicit in failing to carefully assess and challenge, if necessary, the assumptions underlying each report.

The Neutral Appraiser

Many judges will accept as presumptively correct the findings made by a "neutral" appraiser who has been appointed by the court to produce an unbiased valuation report. Therefore it is crucial for the attorney to understand the process and to proactively find ways to advocate for the proper methodology before the appraisal is finalized. If the process is allowed to take its natural course, an appraiser will be appointed and after an investigation that might take place directly with the principal, and without any input from counsel or counsel's expert, a report will be issued. If a preliminary report is submitted and counsel does not understand that there are issues with the draft report that cut against the client's position, and counsel does not pose the right questions or offer the correct counter-arguments to the court's expert, the final report will box both the client and the appraiser into fixed positions.

The first step, then, is for the attorney to get to know the business at issue and to make sure the client completely understands the valuation process so that, together, the attorney and client can provide the appraiser with all the information necessary to produce a report that accurately reflects the positions most favorable to the client.

The Importance of a Preliminary or Draft Report

Unfortunately, all too often, once the final report issues the appraiser feels compelled to "defend" the decision to use a certain process and convincing a court to ignore the neutral's conclusion is very difficult. When possible, it is advisable to have the court and the neutral appraiser agree to

provide both sides with a preliminary or "draft" appraisal and to solicit comments from each side about the findings contained in that draft report. From the neutral's point of view such a debate over preliminary findings can save the expert from embarrassment later when he or she could be confronted with a fact or an authority that had been ignored or overlooked.

The draft report provides insight into the proposed analytical process. For example, let's say the preliminary report reveals that the appraiser has used a discount rate that assumes a low risk of disruption to a future income stream. Having the opportunity to convince the appraiser that the discount rate should be substantially higher – to take into account risks that he or she might not have understood or considered in the preliminary analysis – could greatly influence the bottom line.

The point is, every appraisal has a methodology or approach that leads to a final valuation conclusion. Even a small alteration can lead to a major change in the conclusion and a combination of such changes can radically alter the result. The attorney must proactively seek to understand that approach and its underlying concepts and, where possible, make sure that the expert has the advantage of the facts, circumstances, and analysis he or she needs. The preliminary or draft report affords the advocate the opportunity to suggest alternative databases, facts or methodologies and perhaps the chance to open the eyes of an appraiser to flaws or weaknesses in his or her analysis. When confronted with persuasive arguments rebutting some of the assumptions and conclusions of a draft, appraisers are more apt to accept suggestions than after issuing a final report that they might feel compelled to defend. If the advocate can convince the expert of the existence of an indefensible position in the draft, the expert still has the time to change the final report and can thereby avoid a rough cross-examination on the witness stand and possible damage to the expert's valuable reputation.

While judges may be wary of an "independent" business appraiser falling prey to the undue influence of an aggressive advocate and as a result may be tempted to forbid or limit any communications between attorneys and a neutral appraiser, such restrictions will only weaken the expert opinion, in that it will not address all the alternative approaches that counsel might want addressed. Failing to address issues early on in the process will inevitably lead to a longer and more complex cross-examination at trial and ultimately to the possibility of greater confusion for a court not schooled in financial analysis. A better course might be for appraisers to submit preliminary reports to counsel well in advance of trial so that any errors in fact or judgment can be corrected and all issues can be openly debated before a final report is made.

Avoid the "Neutral Trap"

Judges are understandably persuaded by court-appointed neutrals, for two reasons. First, the neutral is doing the judge a favor by accepting the assignment – and the court is grateful. Perhaps the court has imposed time deadlines, which require the neutral to set aside other work; or perhaps the neutral has been called in because the judge believes that the parties – or their lawyers – are difficult or abusive. Being appreciative of the expert's willingness to accept the assignment, the judge might not particularly want to see the expert battered in cross-examination. Second, unlike the partisan experts appointed by the parties, the court's expert is supposedly unbiased; therefore the court might be inclined to give more weight to the expert's opinion than to that of a "hired gun."

Yet the appraisal process is not an exact science, and independent or court-appointed appraisers can misunderstand the relevant facts. Helping the expert correct the mistakes in a draft report will ultimately save time and money, perhaps by shortening the trial or leading to a settlement in advance of a trial. The need for partisan experts might also be obviated where the independent appraiser has a chance to address all the relevant issues in a final valuation report. If appraisers' preliminary reports are vetted by the parties before they became final reports, the courts would receive better-reasoned and more error-free reports.

Equity would clearly be served if courts encouraged a more open and free-flowing discussion between counsel and a neutral appraiser ahead of trial. To avoid claims of undue influence, the courts could simply require that any attorney wishing to communicate with an independent appraiser about the preliminary report must include his or her adversary in any meetings, telephone calls or correspondence.

Methodology Concerns

The first question any evaluator must consider is what exactly is being valued. That may sound obvious, but it is particularly relevant in matrimonial matters where an intangible "asset" is more an intellectual construct of the courts and the evaluators than a traditionally accepted "thing of value." Intangible assets such as enhanced earning capacity, the increase in value of separate property, the value of a non-marketable license or career or partnership, have particular and precise elements that are important to understand and define. The appraiser needs to analyze and understand the nature of the interest being valued. The definition of the interest being valued should be clearly communicated to both sides in the report since this definition frames all of the subsequent choices made by the appraiser, starting with which valuation methodologies will be used.

Once the interest being valued is clearly understood, one of the first questions to ask is whether the appraiser used an appropriate standard of value to value that interest. A standard of value is a definition of the kind of value the appraiser is seeking to obtain. Fishman, Pratt, and Morrison write in *Standards of Value* that there are two "premises of value" – "value in exchange" and "value to the holder" – which underlie every standard of value.[1] Value in exchange is defined as "the value of the business or business interest changing hands, in a real or hypothetical sale," whereas value to the holder represents "the value of a property that is not being sold but instead is being maintained in its present form by its present owner."[2] The fair market value[3] standard, perhaps the most commonly used standard of value, falls under the value in exchange premise and should be used to value businesses that have a likelihood of being sold. The investment value standard, another commonly used standard of value, which represents the value of an asset to its owner, falls under the value to the holder premise of value and is used for companies that will remain in the owner's hands after the case is over.

The standard of value used by an appraiser will depend on the unique facts of the business being analyzed and the purpose of the appraisal. For example, it is appropriate to value an interest in a publicly traded company using the fair market value standard but that standard may not be suitable to value a non-marketable interest in a private professional practice such as a law firm or a medical practice. A better standard of value for valuing non-marketable professional practices might be the investment value standard of value.

Once the attorney understands why a particular standard of value was chosen, the next question is, Did the appraiser use an appropriate valuation approach and underlying methodology? There are three primary valuation approaches: (1) the asset-based approach; (2) the income-based approach; and (3) the market-based approach. Within each of these approaches there are various techniques or methodologies an appraiser can use to calculate value. It is up to the attorney to understand how these methodologies work and to be able to evaluate their effectiveness in establishing a fair and reasonable valuation of the subject business.

Most appraisers will use two or more valuation methodologies in determining a final value for a business. Sometimes the appraiser considers one particular method to be the most reliable but uses additional methods as a reality check against the favored one. If it is not readily apparent, the attorney should question the appraiser about the weight given to each methodology used. The attorney should carefully examine any language in the report that credits or discredits the reliability of a particular methodology, especially if a discredited methodology still appears to have been used in determining the final result.

> The appraisal process is not an exact science, and independent or court-appointed appraisers can misunderstand the relevant facts.

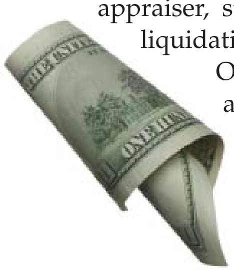
If the appraiser is using a value in exchange standard of value, such as fair market value, it is often appropriate to apply certain discounts, such as a lack of marketability discount, in the valuation analysis. Conversely, a value to the holder analysis might not include such discounts because the holder is, in theory, retaining the business interest. Such discounts and premiums are highly subjective and can have a major impact on the final valuation, so their presence or absence must be seriously evaluated by the advocate. For example, if an attorney can persuade an appraiser that a 40% discount rate should have been applied to the client's business interest the attorney can, with one blow, substantially change the effect of the appraisal and consequently the cost of the divorce or, in a tax case, the taxes payable.

Sometimes an appraiser will factor in a discount or premium within his or her cost of capital rate, making it difficult for the attorney to segregate the appraiser's independent assumptions. The attorney must understand the reasoning underlying any such discounts used by the appraiser and, when necessary, vigorously question, challenge or defend their use.

Asset-Based Valuation Methods

An asset-based valuation method focuses on determining the value of a business by valuing its underlying assets. Asset-based methodologies are useful for businesses that have a significant amount of their value tied up in their tangible assets and are highly appropriate for businesses in which the underlying assets represent the true value of the company, such as for a real estate holding company.

The most commonly used asset-based methodology is the net asset method, also known as the asset accumulation method. Under this method an appraiser adjusts the cost basis values of a company's assets and liabilities, which are found on its balance sheet, to the appropriate value based on the standard of value used by the appraiser, such as, for example, fair market value or liquidation value.[4]



Once the appraiser determines the appropriate values of the assets and liabilities on the balance sheet, he or she will deduct the total liabilities from the total assets to arrive at a net asset value for the company. Fair market values are appropriate if the company is being valued as a going concern. If, however, the company is to be liquidated and the assets sold off separately, then the standard of value would be a liquidation value. In such a case, the assets and liabilities would be adjusted to liquidation values. Liquidation values can be either orderly liquidation values or distressed liquidation values, depending on the specific circumstances of the company being liquidated.

The net asset method is appropriate when the projected income for the company is not a good indicator of the company's true value. One of the shortcomings of the net asset method is the difficulty in valuing intangible assets, such as goodwill, that may be on the balance sheet. The net asset method also does not take into consideration intangible assets that were never recorded on the balance sheet. A hybrid valuation methodology, the excess earnings method, which combines the net asset method with the capitalized income method (discussed in the following section), is sometimes used to value companies with significant intangible assets or goodwill. Attorneys should be aware that the excess earnings method, while still accepted by the courts, is currently disfavored by the Internal Revenue Service, which created it, and by many appraisers. While the current issues being debated among appraisers are beyond the scope of this article, it behooves the attorney to understand not only how certain methodologies work but also why they may or may not be in vogue within the appraisal community.

Income-Based Valuation Methods

When a company has a history of positive earnings, and its future expected earnings represent a substantial part of the company's estimated value, an income-based valuation approach is usually a suitable methodology. The two primary types of income-based methodologies are a discounted future income method and a capitalization of income method.[5] The discounted future income method should be used when a company's future income is expected to differ significantly from current income; the capitalization of income method should be used when a company's income in the future is expected to closely resemble the past.

Discounted Future Income Method

When using the discounted future income method the appraiser forecasts, or uses management's forecast of, several years of projected future earnings, or cash flows, and then discounts these projections back to present value using an appropriate discount rate. The advocate should make sure that the appraiser's forecast of projected future earnings uses a realistic terminal year growth rate. Make sure that the company projections go far enough into the future to a point where the company can realistically be forecasted to have reached a steady and sustainable long-term growth rate. Forecasts that show the subject company growing at an above-average growth rate into perpetuity should be a red flag for the advocate.

The discount rate is, essentially, the appraiser's best estimate for the rate of return an investor in the subject company would require, given the risk associated with his or her investment. The attorney should pay special attention to the discount rate used by the appraiser because the discount rate will be a big driver of the business's overall valuation. The higher the discount rate the lower the net present value of the cash flow will be. All else being equal, a more risky company with less predictable future cash flows will have a higher discount rate and a lower valuation than a company with more predictable cash flows.

An appraiser determines a discount rate by combining a risk-free rate, such as the return for U.S. treasury bonds, with one or more risk premium estimates. Discount rates are highly subjective and can vary widely depending upon the underlying assumptions employed by the appraiser.

Most business appraisals of closely held companies use some variation of the build-up method to arrive at a discount rate. The build-up method literally "builds up" a discount rate by starting with the risk-free rate and then adding on risk premiums such as the equity risk premium, the small company risk premium, an industry risk premium and a company-specific risk premium. Equity risk, small company and industry risk premiums can be derived using public market data while the company-specific risk premium is based solely on the professional judgment of the appraiser. It is the most subjective of the risk premiums.

The advocate should always question the appraiser's basis for his or her selection of risk rates and risk premiums. If an appraiser fails to provide the attorneys with any details as to how he or she arrived at a particular discount rate it may be a sign that the appraiser may not be able to justify the risk premium assumptions. Certainly it is incumbent upon the advocate who is most harmed by the chosen discount rate to challenge the appraiser's underlying assumptions and, if those assumptions are not clear in a preliminary draft, to demand a detailed explanation in the final report.

Capitalization of Income Method

An appraiser using the capitalization of income method will take a base year estimate of the company's normalized income and then multiply that single income estimate by a capitalization rate to arrive at a valuation. A capitalization rate is essentially the discount rate appropriate for that company minus the company's estimated long-term growth rate.

By using a single estimate in the capitalization of income method, the appraiser is assuming a constant income stream which will grow at the same rate into perpetuity. This reliance on a single income estimate places a higher premium on accuracy and is a reason why this method should be used only for companies whose future income is highly predictable and not expected to differ from the immediate past.

Built into the capitalization rate is the appraiser's estimate for any long-term growth in the business. The practitioner should make sure that the long-term constant growth rate used in the capitalization method is reasonable. Most appraisers tend to use long-term growth rates between 0% and 3%; anything higher than 3% should be questioned by the attorney as being overly optimistic and unsustainable.

Keys to Effective Valuation Advocacy

- Demand a draft or preliminary report
- Make sure the interest being valued is accurately defined
- Understand the standard of value – value to whom?
- Analyze the valuation approaches used and understand why other approaches were not used
- Understand how present value discount rates were calculated
- Question the appraiser's basis for the selection of risk rates and premiums
- Always respond to any draft or preliminary reports before they are finalized
- Use your analysis to advocate for a more favorable valuation appraisal
- Persuade the appraiser that adopting your reasoning in a final report will be easier to defend at trial

Normalized Income Estimate

No matter what valuation method is used, an appraiser's determination of normalized income should be a reasonable estimate of what a company's sustainable level of income will be in the future. This analysis should involve a careful examination of a company's historical income while taking into consideration estimates for growth and margins in the overall industry. In some cases the most recent years may be the best proxy for future income but in other cases the appraiser may want to take a weighted average of a few years of historical income. The attorney should make sure that the appraiser's assumptions regarding past income are reasonable in light of future expectations. For example, if future income is expected to be more like that of the recent past, then using an equally weighted average of the income from the previous five years may be inappropriate. The appraiser should also eliminate from historical income any non-recurring income, expenses or one-time events, and smooth out recurring income or expense items where necessary, thereby "normalizing" the income.

The attorney should be on the lookout for any questionable choices the appraiser made in his or her normalized income estimate since even small adjustments made to historical income will be magnified when growth and capitalization rate assumptions are applied to that estimate.

Market-Based Valuation Methods

Market-based valuation methods can be very persuasive because they are relatively easy to understand and rely on actual market transactions. An appraiser using such a method will apply one or more valuation multiples, derived from either public or private market transactions, to the subject company to arrive at a valuation for that company.

The most important criterion in a market-based valuation analysis is the extent to which the subject company can reasonably be compared to other public or private companies for which transaction data exists. The more distinct a subject company is from its comparables the less reliable a market-based methodology will be. Sometimes an appraiser will find enough comparable companies in the same industry as the subject company but often the analysis will also use comparable companies from a similar industry. Good comparisons can be hard to find for small, privately held companies that may have unique characteristics. One of the most commonly used market-based methods is the guideline company method.

Guideline Company Method

For a business that has good public market comparisons the guideline company method may be quite useful. An appraiser using this method should provide an exhaustive analysis of how the subject company compares to the guideline companies to which it is being compared. The appraiser should examine and compare all the relevant financial metrics of the group of companies to determine which are the most relevant. Once the most relevant financial metrics are determined, these metrics are applied to the publicly traded prices for the guideline companies to determine a series of relevant market multiples – for example, price-to-sales. An appraiser will typically take an average or median market multiple and apply that multiple against the relevant financial metric of the subject company to arrive at a value for that company.

Sometimes it is not appropriate simply to use the average or a median market multiple. Multiples might need to be adjusted downward or upward before they are applied to the subject company depending on how comparable the subject company is to the group on the metric being considered. For example, the subject company may have only $10 million in sales whereas the guideline group averages $50 million in sales and has an average price to sales ratio of three times. It might be more reasonable to apply a lower multiple to the subject company than a three times multiple given its significantly smaller size relative to the comparable group. These types of decisions are highly subjective and therefore must be carefully scrutinized by the advocate.

The closer the subject company is to the group, in terms of key financial ratios and other relevant metrics, the fewer adjustments will have to be made and the less subjective the valuation will be. The advocate must make sure that the appraiser properly considers all the relevant and unique characteristics of the subject company. If the appraiser has to make large adjustments to the average or median market multiple it is a good indication that either the multiple is not very useful or the group is too different from the subject company on that particular financial metric.

Market-based methods should always be questioned if they produce a broad range of valuations depending on the different market multiples being applied. For example, if an appraiser finds that a price-to-sales multiple produces a vastly different valuation than a price-to-cash multiple, then it would appear that a market-based valuation needs more fine tuning because the multiples are not able to adequately capture all of the subject company's unique qualities.

Conclusion

Business valuation is often described as part art and part science because many of the techniques used by business appraisers require the use of subjective assumptions. Understanding when those subjective assumptions are being used and being able to evaluate their reasonableness is essential to a solid understanding of the business valuation process. Fortunately for those in the legal profession the underlying math used in most business valuations is not complex, and a solid understanding of the process can be attained with a modest amount of effort. The reward for that effort is the ability to question, and when necessary challenge, the choices made by the business appraiser. ■

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1. Jay E. Fishman, Shannon P. Pratt & William J. Morrison, Standards of Value, 20–21 (2007).

2. *Id.* at p. 21.

3. Fair market value is the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts. IRS Publication 561, *Determining the Value of Donated Property*, p. 2 (Rev. Apr. 2007).

4. Assets and liabilities are typically, but not always, entered on financial statements at their purchase/acquisition costs under the "cost-based" method of accounting. An asset-based approach is therefore frequently referred to as a "cost-based" approach.

5. An appraiser will use either earnings (net income from the income statement) or cash flows (from the cash flow statement) as the preferred measure of economic income. While an appraiser's use of either earnings or cash flows may be appropriate in certain cases, the practitioner should be aware that cash flows tend to be more reliable and less subject to manipulation than earnings from an income statement.