Ellin & Tucker, Chartered

E&T

Lawyers' Perspective

FALL 2010

How the recession has impacted business valuation

Quantifying economic losses when mitigating circumstances come into play

New expert discovery rules should reduce litigation costs

What's the life expectancy of a business?

Baltimore
SUITE 1300
100 SOUTH CHARLES STREET
BALTIMORE, MD 21201-2714
410-727-5735 / F: 410-727-1405

Washington
SUITE 250
655 FIFTEENTH STREET, NW
WASHINGTON, DC 20005-5701
202-638-0902 / F: 202-638-4311

Frederick
SUITE 105
30 WEST PATRICK STREET
FREDERICK, MD 21701-5589
301-696-1926 / F: 301-696-1933

Belcamp
SUITE 302
4692 MILLENNIUM DRIVE
BELCAMP, MD 21017-1535
410-272-1680 / F: 410-272-4290

www.etnet.com

How the recession has impacted business valuation

As the economy continues to limp toward recovery, the values of many businesses remain depressed. Valuing distressed businesses should be fairly uncomplicated. Investors are inherently risk-averse but are more so during economic downturns. Generally, private companies experience the same downturn trend as their public counterparts during a recession. But what about businesses that were valued on the eve of the economic downturn? Should they be *revalued* in light of subsequent events? That was one of the issues in the Florida Court of Appeal case of *Mistretta v. Mistretta*.

October 2007 valuation date

Mistretta involved the valuation of a restaurant business for purposes of equitable distribution in a marital dissolution case. The trial court used Oct. 31, 2007, as the valuation date, though final judgment wasn't entered until Aug. 25, 2008. The court valued the business at $845,000 and ordered Mr. Mistretta to make a cash "equalization payment" to Ms. Mistretta based largely on the business's value as of Oct. 31, 2007.

Mr. Mistretta moved for rehearing, arguing that the economic recession that began in December 2007 caused the business to sustain an almost $58,000 loss in 2008 and that this "newly discovered evidence" warranted a new trial and revaluation of the business. The trial court granted Mr. Mistretta's motion on equitable grounds, noting that the "present recessionary economy was totally unforeseen" and that "no one could reasonably anticipate the severity of same."

Changed circumstances not enough

The court of appeal reversed the trial court's ruling, explaining that "newly discovered evidence" sufficient to warrant a new trial "cannot simply show some change in circumstances since the trial." In this case, the alleged new evidence consisted of a recession that began months after the valuation date and financial results that weren't available until well after the trial.

The court also discussed the impact of subsequent events on business valuation. A valuation involves projections of future financial results that depend "not only on known or knowable facts already in existence, but also on assumptions about the future that will not always, if ever, be entirely accurate."

Recessions, the court said, "like other vagaries in the business cycle, are contingencies appraisers must take into account in valuing a business." But the fact that the future turns out differently than business appraisers assumed is *not* a basis for a new trial.

Moreover, there was no reason to believe that a revaluation of the business would be any more reliable than the original. The trial court emphasized that the recession's impact "was essentially unknown to … various experts who provided testimony," but it didn't explain, the appellate court observed, why those experts "were more likely to predict future economic conditions accurately on rehearing."

For example, the appellate court said, "The parties' experts might not have predicted the precise economic conditions on April 6, 2009, the day the order under review was entered, or, for that matter, the reported improvements in economic conditions since."

Are subsequent events ever relevant?

Mistretta confirms that, when valuing a business, appraisers generally shouldn't consider events that take place after the valuation date. This principle is supported in various published valuation standards.

The AICPA's Statement on Standards for Valuation Services, for example, instructs valuators that "subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or conditions." (Different standards apply to financial reporting; see "Accounting for subsequent events" at right.)

Some courts and valuation experts believe that subsequent events are properly considered in valuing a business if they were reasonably foreseeable on the valuation date or, even if they weren't reasonably foreseeable, they provide *evidence* of the business's value on the valuation date. An example of the latter might be a post–valuation-date sale of the business being valued or of a comparable interest in a guideline public company, provided market conditions haven't materially changed since the valuation date.

Critics of this approach argue that fair market value is based on what willing buyers and sellers know or reasonably should know on the valuation date and that subsequent events, by definition, don't fall within that category. They also point out that market conditions change on a daily basis and depend on a variety of internal and external factors, so it's difficult to determine whether market conditions have changed (and if so, how much), even shortly after the valuation date.

Handle with care

Even in courts that accept evidence of subsequent events, the circumstances under which they're relevant to business valuation are limited. So it's important for you and your valuation experts to consider this issue carefully before relying on events that take place after the valuation date. ◆

ACCOUNTING FOR SUBSEQUENT EVENTS

The Financial Accounting Standards Board (FASB) has its own standards regarding the treatment of subsequent events for accounting purposes — that is, events occurring after the balance-sheet date but before financial statements are issued or finalized.

The standards, found in Accounting Standards Codification (ASC) 855, identify two types of subsequent events:

1. Recognized subsequent events (such as settlement of litigation pending on the balance-sheet date), which provide additional evidence about conditions that existed on the balance sheet date, and
2. Nonrecognized subsequent events, which provide evidence about conditions that arose after the balance sheet date.

Recognized subsequent events are recorded in the financial statements. Nonrecognized subsequent events are not, but may need to be disclosed to prevent financial statements from being misleading.

Quantifying economic losses when mitigating circumstances come into play

It's easy to focus on quantifying a plaintiff's economic losses during a trial and overlook the *duty* to mitigate damages. But the plaintiff does bear some responsibility for taking reasonable steps to avoid or minimize damages. The case of *R.R. Donnelley & Sons Co. v. Vanguard Transportation Systems, Inc.*, emphasizes this fact.

Truckline error leads to litigation

Whenever one party has committed a tort, breach of contract or other legal wrong against another, it's incumbent on the injured party to take reasonable steps to avoid or minimize the damages. A plaintiff isn't entitled to recover damages for a loss that he or she reasonably could have avoided.

R.R. Donnelley contracted with Vanguard to deliver Macy's after-Christmas sales brochures to a Donnelley distribution center in Atlanta no later than 2:00 p.m. on Dec. 16. After that, Donnelley was to deliver the brochures by Dec. 21 so they'd be mailed to consumers in time for Macy's sale on Dec. 27.

Vanguard eventually delivered the shipment on Dec. 27 — 11 days after the promised delivery date. By that time it was too late to mail the brochures to Macy's customers.

Court takes a hard look

Because Donnelley had to credit the cost of the brochures to its customer, Continental Web Press, at the bench trial, Donnelley sought damages from Vanguard. After completing discovery and going to trial, the U.S. District Court (Northern District of Illinois) took a hard look at Donnelley's failure to take action and mitigate its damages. The court noted, "All that would have been entailed was the minimal cost of renting a truck from a local cartage company and driving the half hour to the Vanguard lot to pick up the load and delivering it to the Atlanta facility." Thus the court ruled in favor of Vanguard.

Duty extends to other instances

This duty to mitigate damages applies in virtually every type of litigation. For example, suppose a manufacturer suffers a business interruption. The company could minimize the impact by resuming operations at a temporary location or outsourcing production to another company if possible.

Here are some other examples of how a plaintiff could avoid or minimize damages:

- A wrongfully terminated employee could make a reasonable effort to find another job.
- An antitrust plaintiff prevented from entering a particular market might explore opportunities to invest in alternative markets.
- A plaintiff in a breach-of-contract case could make a reasonable effort to replace the business lost as a result of the defendant's wrongdoing.

Keep in mind, however, that the plaintiff is entitled to recover any expenses incurred in the effort to mitigate damages — even if unsuccessful.

Duty to mitigate must be "reasonable"

For a damages expert, evaluating mitigation opportunities can be as challenging — or even more challenging — than measuring the plaintiff's loss. This is particularly true when it's alleged that the plaintiff has failed to fulfill its duty.

Even when calculating the plaintiff's out-of-pocket loss is relatively straightforward, estimating the impact of various mitigation alternatives requires the expert to exercise considerable professional judgment. He or she must thoroughly understand the plaintiff's business and industry to determine whether a mitigation opportunity is reasonable. And, if so, the expert estimates its impact on the plaintiff's revenues and costs.

When evaluating opportunities to mitigate damages, the key term is "reasonable." The duty to mitigate doesn't require a plaintiff to take steps that are unreasonable, impractical or unduly risky or burdensome. For example, it would be unreasonable to expect a wrongfully terminated college professor to take a job pumping gas.

The duty to mitigate doesn't require a plaintiff to take steps that are unreasonable, impractical or unduly risky or burdensome.

Get the facts

Determining whether a plaintiff has done all it can to mitigate or avoid damages is a key component in litigating a case. To ensure your legal team is armed with all the facts, work with a valuation expert. He or she can not only help you quantify economic losses, but also calculate appropriate damages awards. ◆

New expert discovery rules should reduce litigation costs

Proposed amendments to the Federal Rules of Civil Procedure (FRCP) will likely have a big impact on the attorney-expert relationship. The amendments were approved by the U.S. Supreme Court on April 28, 2010, and submitted to Congress. Unless Congress rejects the amendments (which is unlikely), they'll take effect on Dec. 1, 2010.

One of the most significant changes is amended Rule 26, which will extend attorney work-product protection to draft reports by testifying experts and, with certain exceptions, to communications between experts and retaining counsel. This is a dramatic departure from the current version of the rule, which is generally interpreted to allow discovery of such drafts and communications.

Needless costs under current rule

In its report to the Supreme Court recommending approval of the amendments, the Judicial Conference observed that, as currently written, Rule 26 has caused attorneys and experts to engage in "artificial and wasteful discovery-avoidance practices," such as engaging separate consulting and testifying experts and taking "tortuous steps" to avoid expert notes, preliminary analyses or draft reports. The result: additional discovery costs, inefficient use of experts and, in some cases, lower quality work.

At the same time, the report notes, attorneys often take elaborate steps to obtain the other side's drafts and communications and make a great effort to show how opposing counsel shaped an expert's opinions. The most effective way to discredit an expert's opinions, the Judicial Conference found, is to challenge them on the merits through cross-examination and presentation of contradictory evidence.

Amended Rule 26 is designed to avoid needless discovery costs, encourage attorneys and experts to communicate freely, and focus the parties' discovery efforts on learning the strengths or weaknesses of a testifying expert's opinions. Also, by eliminating the disadvantages of preparing draft reports, it may improve the quality of experts' work.

Some critics of the amended rule worry that it will become more difficult for a party to uncover undue influence and, therefore, make it easier for attorneys to influence their experts' opinions. But the Judicial Conference has found that practitioners' experience doesn't support this concern.

3 important exceptions

The Judicial Conference report recognized that, while protecting draft reports and attorney-expert communications serves an important purpose, it's critical to allow litigants to discover the bases of an expert's opinion. Therefore, amended Rule 26 will allow discovery of communications between an attorney and testifying expert regarding:

1. Compensation for the expert's study or testimony,
2. Facts or data provided by the attorney that the expert considered in forming opinions, and
3. Assumptions provided to the expert by the attorney that the expert relied upon in forming an opinion.

The report also notes that, in some cases, parties may be able to overcome work-product protection by showing need or hardship.

FRCP Rule 26(a)(2)(B) requires a party to provide the other side with a written report from any witness "retained or specially employed to provide expert testimony in the case or one whose duties as the party's employee regularly involve giving expert testimony." Under the amended rule, if a witness will provide expert testimony but isn't required to provide a written report, the attorney relying on that witness must disclose the subject matter and summarize the facts and opinions that the witness is expected to offer.

Keep an eye on state rules

Even though amended Rule 26 will apply only in federal court, some states already have similar rules regarding discovery of expert reports and communications. In addition, states whose rules of procedure are based on the FRCP will likely adopt the new rules as well. ◆

What's the life expectancy of a business?

Good question! Typically, valuators use a two-step process when valuing a business according to the discounted cash flow (DCF) method: First, they calculate the present value of expected cash flows over a specific time horizon — say, five or 10 years. Then, they add a "terminal" or "residual" value, which is the present value of the business's estimated value at the end of the initial forecast period. Residual value assumes that the business's cash flow will grow at a constant rate into perpetuity.

Let's get real

In reality, of course, businesses — like people — don't live forever. But while financial experts use mortality tables and life expectancies to estimate a person's future income, standardized "mortality tables" for businesses don't exist. In a recent article, author James R. Morris, a finance professor at the University of Colorado–Denver, suggests that applying life expectancy concepts to businesses would result in more accurate valuations.

Morris illustrates his point with tables that show the "valuation errors" that result when valuators assume that cash flow grows forever rather than stopping after a specific number of years. Take, for example, a 10% discount rate and a 6% growth rate. Applying a perpetual growth model, as is the standard now in business valuations, to a business expected to last 10 years would overvalue the business by 220%!

Morris reviews data from several studies that indicate the "death rates" of businesses in certain industries and analyzes the rates at which companies "exit" their businesses. This data reveals that only a minority of companies live more than 10 years, but those that do get past the first decade face a declining likelihood that they'll die as they age and grow.

Time will tell

Additional work is needed before mortality becomes a routine part of the business valuation process. For example, current data doesn't reflect the impact of the economy, the relevant industry, or company-specific factors such as size, growth rate, asset and liability structure, and management quality. It also doesn't make a distinction between companies that "die" and those that disappear for other reasons, such as merging with another company.

As research in this area continues and better data is developed, business mortality might become a major component in the valuation process, which could lead to what some experts consider more accurate valuations. ◆

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2010 VLBso10

Ellin & Tucker, Chartered

CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS CONSULTANTS

BALTIMORE WASHINGTON FREDERICK BELCAMP

SUITE 1300
100 SOUTH CHARLES STREET
BALTIMORE, MD 21201-2714

www.etnet.com

RETURN SERVICE REQUESTED

PRESORTED
STANDARD
U.S. POSTAGE
PAID
PERMIT #2996
BALTIMORE, MD

EXPERIENCED. CREDIBLE. RESPONSIVE.

Let Ellin & Tucker's experts assist you and your clients in adding clarity and credibility to complex business and legal issues.

Business Valuation and Litigation Services

> Business Valuations
> Commercial Damages
> Intellectual Property
> ESOPs
> Domestic/Shareholder Disputes
> Bankruptcy and Insolvency
> Gift/Estate Taxes

For additional information, please contact David Bogus, Steven Manekin, Larry Pullen, Chris Rosenthal, or Ed Tucker.

Forensic Accounting Services

> Civil Fraud Investigations, including Securities Fraud
> Criminal Fraud Investigations, including Embezzlements and Money Laundering
> Internal Corporate Investigations
> Sarbanes-Oxley Compliance
> Misappropriation of Corporate Assets
> Director and Officer Negligence and Self-dealing
> Accountant Malpractice
> Marital Dissolution/Examination of Personal Financial Representations

Law Firm Services

> Auditing and Accounting
> Business Planning
> Compensation Studies
> Practice Management
> Practice Start-up Services
> Profitability Analysis
> Tax Consulting

FREE CLE

Ellin & Tucker provides 1-2 hour CLE courses on valuation and forensic accounting issues at no charge. If you would like additional information, please contact Debbie Remeikis, dremeikis@etnet.com or at 410-727-5735, x3007.

OUR MISSION

We, as a firm, are committed to maintaining and growing our successful accounting, tax and consulting practice, while adhering to our core values. We strive to be recognized as leaders and as the standard of excellence with our clients, employees, community and profession.