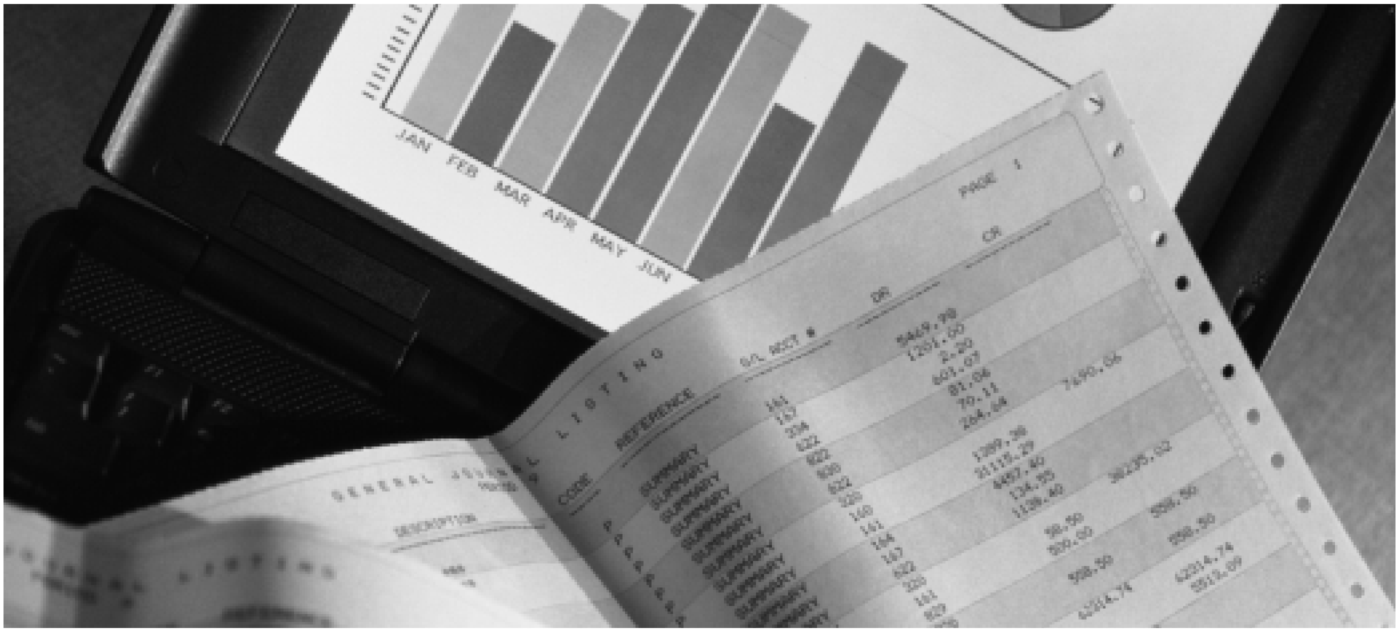
Business Valuations in Litigation: A Road Map

by James C. Joyce, Jr. and Kevin W. Holt



The need for business valuations arises in a variety of types of litigation—from domestic relations to minority shareholder suits, from disputes over the sale of a business to taxation and estate litigation. In all such cases, the issues are the same—how much is the business or ownership interest in it worth, and how can they be measured?

In an effort to explore general expert witness issues in the specific context of valuations for purposes of litigation, this article reviews the different types of valuations and the methodologies of performing them. It also explores difficult and interesting issues associated with business valuations including valuing intangible business assets, such as goodwill and professional degrees, and valuing interests in not-for-profit corporations.

The article is intended to be a basic guide for lawyers who, increasingly, are encountering the need to value businesses in litigation. Accounting manuals and other sources provide far greater detail about the accounting and financial intricacies of business valuations.

Getting the Documents

Placing a value on a business is as much an art as it is a science. Valuing a business depends on the business' financial history and the nature of the industry or trade and the business' location, among other considerations.[1]

A lawyer must first examine the company's financial history from the client or from the opposing party through discovery. Basic financial documentation includes balance sheets, income statements and cash flow statements. Relevant documentation also includes the most recent income tax returns, statements of partners' capital accounts (if applicable), inventory lists, aged accounts receivable and accounts payable lists, employment agreements, customer agreements, loan agreements, copies or descriptions of employee benefit plans, leases, equipment lists and depreciation schedules.[2]

In a closely held company, the most recent financial statements alone may not determine a business' current value. The most recent financial documents may need to be updated to accurately reflect a company's current value. For example, since the last financial statements, a company may have received a significant insurance or litigation settlement or other unusual one-time payment. Conversely, a company may have incurred sizeable research and development costs or unusual payroll expenses (such as wage increases) since the most recent financial statements.[3] The financial documentation must be supplemented with information about these payments or liabilities.

The lawyer, in preparing for a valuation, should gather information beyond that reflected in a company's financial statements. The experience and skill level of the business' management and key personnel are important. Obviously, a company with proven, veteran management personnel is worth more than a comparable business with untested leadership. A company's intangible assets—its intellectual property, including patents, trademarks and copyrights—or its proprietary manufacturing processes are important to any valuation.[4]

The nature of the industry or the future economic prospects of the geographic area in which the business is located also affect a company's value and are not found in the company's financial documentation. Relevant industry information frequently can be found in the annual reports or securities filings of publicly traded companies similar to the one being valued.[5] Economic information can be obtained by contacting the municipal government offices or a college or university in the area in which the business is located. The lawyer, prior to the valuation being performed, should obtain such reports, filings and information.

Hiring the Expert

Hiring an expert business appraiser is the next step in valuing a business for litigation purposes—regardless of the type of case. As in hiring other experts, the lawyer hiring an expert business appraiser should consider the prospective expert's credentials. His or her degrees, experience, publications, speaking engagements, testimony experience and references are important. Frequently, a lawyer should consider hiring an appraiser as a consulting expert to assist in discovery and in researching economic data or damages, such as lost profits.

Very early in the relationship, the appraisal assignment must be carefully defined. The lawyer must inform the appraiser of the business or business interest to be appraised, the effective date or dates of the valuation and the applicable valuation standard and methodology. The statutes and caselaw concerning the type of litigation will dictate the valuation's standards and methodologies.

Additionally, the appraiser's fee amount and terms of payment need to be determined. The amount of the appraiser's fee should not be (or appear to be) dependent upon the result of her valuation. Thus, the appraiser should be compensated on a flat-fee or hourly basis to negate any suggestion by opposing counsel in a deposition or at trial that the expert has an interest in the outcome of the litigation.[6]

Types of Valuation

To value a business, finding the worth of the business (or an ownership interest in it) is fundamental. Measuring the value of a business or the financial benefit of owning an interest in it can be done in several ways by the expert appraiser. For example, value can be determined by looking at earnings or cash flow (either from operations or investment dividends or interest), the liquidation of assets or the sale of an ownership interest in the company.

"Fair market value" and "fair value" are standards of valuation. A lawyer should tell the appraiser which standard applies. "Fair market value" is the most common standard. The Supreme Court of Virginia defines fair market value as "the price the property [or business] will bring when offered for sale by a seller who desires, but is not obliged, to sell and bought by a buyer under no necessity of purchasing." *Board of Supervisors v. Telecommunications Indus., Inc.*, 246 Va. 472 (1993). Similarly, the Internal Revenue Service describes fair market value as:

> The amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.[7]

The "fair value" standard applies most often in the context of fixing the value of a dissenting shareholder's stock under a state's business corporation act, such as Virginia Code Ann. § 13.1-730. Under the statute, a shareholder is entitled to dissent from the sale of the corporation and obtain payment of the fair value of his or her shares. Fair value is the stock's intrinsic value. The stock's market value, net asset value, investment value and earning capacity help determine the stock's fair value. *Lucas v. Pembroke Water Co., Inc.*, 205 Va. 84 (1964). Evidence of the price at which stock recently was sold will be instructive—whether or not the company is publicly listed. *Id.*

Methods of Evaluation

The most recognized valuation methods consider earnings or cash flow capitalization, book value, capitalized excess earnings, comparable companies and the peculiarities of the particular industry.

Very early in the relationship, the appraisal assignment must be carefully defined.

Valuation based on a company's earnings (current or historical) or cash flow capitalization essentially involves an annuity calculation. The value of a company's expected future earnings is calculated and reduced to present value based on an expected rate of return. The rate of return is variously called the discount rate, the interest rate or the capitalization rate.[8]

Book value is the information shown in a company's books of account. A business' net worth is calculated from that information. This valuation method does not give a true value of the business because it fails to take account of a business' intangible assets not shown on the books.[9] The book value approach, therefore, tends to underestimate a company's worth.

The capitalized excess earnings method accounts for these intangible assets. The value of assets not disclosed on company books can be substantial, particularly "going concern value," goodwill, leaseholds and intellectual property rights. This value is added to the value of the company's disclosed assets and the total value represents the value of the business as a whole.[10]

The values of comparable companies can be found, in the case of publicly traded companies, in SEC filings. Particular industries have developed rules of thumb concerning rough approximations of value. For instance, service businesses are often valued at a multiple of their gross receipts. A client knowledgeable in his or her business will be familiar with those rules of thumb in the specific industry.[11]

Premiums and Discounts

In the case of valuing shares of stock or other ownership interests in a business, premiums or discounts may need to be applied to determine the shares' true value. The premiums and discounts reflect the degree of control (or lack of control) that the stockholder or other company owner has. Discounts also take account of the difficulty a minority shareholder would have selling his or her ownership interest in the business.

The principal premium is the "control premium." The two main discounts are the "minority interest discount" and the "discount for lack of marketability."

A controlling ownership interest in a company is more valuable than a minority interest because with a controlling ownership interest come the prerogatives of electing directors, determining officers' compensation, declaring and paying dividends and setting overall business policy and direction.[12]

The two discounts—the minority interest and the discount for lack of marketability—reflect that a minority owner in a business has less control over its management. The stock's value is initially discounted to account for the lack of control. Because minority ownership interests are generally more difficult to sell or transfer, the value of such an interest is further reduced for its lack of marketability. Typically, business appraisers employ a combined 40% discount for the minority interest and lack of marketability. In other words, the value of the stock is determined and then reduced by 40% to reflect the minority ownership position.[13]

Difficult Cases: Valuing Intangible Assets

Challenging cases of business valuations can occur in the context of equitable property distribution in divorce cases, particularly when intangible assets, such as professional degrees, licenses and goodwill are concerned.

Beginning in the 1970s, spouses in numerous cases sought a share of the professional degrees and licenses obtained during marriage by their soon-to-be former spouses.[14] The majority of cases decided have held that professional degrees and licenses are not marital property. A minority of jurisdictions, however, has determined that degrees and licenses are marital property subject to equitable distribution in a divorce proceeding.

The seminal case of *O'Bryan v. O'Bryan*, 489 N.E.2d 712 (N.Y. 1985) held that a medical degree and license acquired during marriage is marital property subject to equitable division. The cases that have followed *O'Bryan* over the years and adopted its rationale have held that virtually any career advancement or degree obtained during marriage is marital property subject to division upon divorce.[15]

Another intangible asset difficult to value in the property distribution context is goodwill. Virginia has adopted the majority position that goodwill is an asset of a professional practice, subject to valuation as marital property upon divorce. *Russell v. Russell*, 11 Va. App. 411 (1990). For such purposes, the Virginia Court of Appeals has defined professional goodwill as "the increased value of the business, over and above the value of its assets, that results from the expectation of continued public patronage." *Marion v. Marion*, 11 Va. App. 659, 667 (1991). More recently, the Virginia Supreme Court has defined professional goodwill as "the difference between the price a business would sell for and the value of its non-goodwill assets." *Advanced Marine Enterprises, Inc. v. PRC, Inc.,* 256 Va. 106, 120 (1998).

From an accounting perspective, there are two methods used to value goodwill. The first method involves the capitalization of either net profits or excess earnings. The second method measures goodwill at the time a business is sold as the difference between the sales price and the market value of the business' tangible assets.[16]

Of Particular Concern to Lawyers: Goodwill in the Context of a Partnership Agreement

Many law firms operate under partnership agreements. Valuing a law firm's goodwill in a divorce proceeding presents especially thorny issues.

Many partnership agreements prohibit partners from receiving payment for goodwill upon their withdrawal or retirement from the firm, their disability, their death or the firm's dissolution. When, however, a partner's divorcing spouse seeks the equitable distribution of the partner's partnership interest, including the partner's interest in the firm's goodwill, courts have tended to look beyond the partnership agreement and award some measure of payment for goodwill.

In a recent opinion, the Supreme Court of Virginia did just that. In *Howell v. Howell*, 31 Va. App. 332 (2000), the court looked beyond a law firm's partnership agreement to award a divorcing spouse a share of the partner's interest in the firm's goodwill. The firm's partnership agreement provided that a partner would receive only the balance in his or her capital account and a share of the firm's net income upon the partner's termination or death.

In the divorce proceedings, the husband, a partner in the firm, maintained that the partnership agreement fixed the value of his partnership interest for purposes of equitable distribution. He argued that the agreement expressly precluded goodwill from being included in the value of his partnership interest.

The Supreme Court announced that the terms of the partnership agreement were relevant, but not controlling, in determining the value of the husband's partnership interest. The agreement was only one factor among many to consider in determining the intrinsic value of a partnership interest. The court commented that intrinsic value "is a very subjective concept that looks to the worth of the property to the parties." The court then affirmed the trial court's valuation of the partnership interest that assigned a value to the firm's goodwill. The trial court had assigned a value to the firm's goodwill in finding that the husband's partnership interest had "intangible value." Thus, the trial court's finding that the value of the husband's partnership interest was more than $300,000 (as opposed to the $85,000 in his capital account) was upheld.

Into the Great Unknown: Valuing Nonprofits

Occasionally, litigation may necessitate a valuation of a non-profit business entity. Such a valuation is inherently difficult to perform because: by definition and design, non-profit entities do not have ongoing profitable earnings (if they did, the IRS likely would revoke their tax-exempt status); there are no shares of stock or ownership interests in not-for-profit businesses; and the assets of a non-profit cannot be sold or distributed upon dissolution. Under the Internal Revenue Code, at dissolution a non-profit corporation's assets must go either to another non-profit pursuing the same charitable purpose or escheat to the state.[17]

On one hand, to qualify and continue as a non-profit, a business must demonstrate that it cannot consistently have an excess of revenues over expenses. Rather, non-profits are subsidized by tax-deductible contributions from the public because they otherwise would be money losing ventures. Finally, at dissolution, the assets of a non-profit, by law, go to another non-profit or to the state. In light of these factors, one can argue that the non-profit entity has no value at all.

On the other hand, an expert can perform a standard capitalized income or cash flow valuation of the corporation (*see* above). The expert can reduce to present value the expected future income of the entity and arrive at a substantial value for the non-profit.

The wide disparity between the two valuations indicates that business valuations are inherently difficult and uncertain in the context of non-profit corporations. Traditional methods of valuation must be modified due to the peculiar legal and financial aspects of non-profit business entities.

Conclusion

The need for business valuations is increasingly common in litigation. Understanding the methods of valuing a business can aid an attorney in preparing an expert appraiser or in cross-examining the opposing party's appraiser. Business valuations, particularly in the case of intangible assets like professional goodwill or intellectual property, can significantly increase the worth of a company beyond the assets shown on its books and, thereby, make the value of a case increase correspondingly. Valuation, therefore, is a subject a lawyer ignores at his or her peril.


© Youngblood Photo

James C. Joyce, Jr. is a partner at Gentry Locke Rakes & Moore in Roanoke and head of the firm's litigation section. He practices primarily in the areas of civil litigation and mediation. Joyce represents individuals, businesses, and corporations in a wide range of litigation matters. He has extensive experience litigating claims in federal and state courts. A trained mediator, Joyce has experience in alternative dispute resolution. Joyce is a past president of the Virginia Association of Defense Attorneys, a member of the Defense Research Institute and the International Association of Defense Counsel. Joyce was educated at the University of Virginia Law School and Wofford College.

Kevin W. Holt is an associate at Gentry, Locke, Rakes & Moore. He practices in the areas of commercial litigation and employment litigation, and currently serves as co-chairman of the Young Lawyers Committee of the Litigation Section of the Virginia State Bar. Holt received his law and undergraduate degrees from the University of Virginia. After law school, he clerked for The Hon. James H. Michael, Jr., Senior United States District Judge for the Western District of Virginia.

Endnotes

1 Horwich, Willard D., *Professional's Guide to Purchase and Sale of a Business: Taxation, Valuation, Law, and Accounting* (New York: Panel Publishers, 2001) at ¶4.1.

2 Pratt, Shannon P., *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 2nd Ed. (Homewood, Ill.: Dow Jones-Irwin, 1989).

3 Horwich at ¶4.4.

4 *Id.* at ¶4.5.

5 *Id.* at ¶4.3.

6 Poynter, Daniel F., *Expert Witness Handbook* (Santa Barbara, Calif.: Para Publishing, 1987).

7 Revenue Ruling 59-60, 1959-1 C.B. 237.

8 Horwich at ¶4.6.

9 *Id.*

10 *Id.*

11 *Id.*

12 Pratt at pp. 55-56.

13 *Id.*

14 *Ain, Sanford K., and Jackson, Anne Marie, Professional, Personal & Celebrity Goodwill Valuation: Forecasting An Uncertain Future,* American Academy of Matrimonial Lawyers presentation, November 1998, Annual Meeting, Chicago, Illinois.

15 *See, e.g., Savasta v. Savasta,* 549 N.Y. S2d 544 (Fam. Ct. Nassau Cty. 1989) (spouse awarded a portion of doctor's internal medical license's value though the doctor never actually practiced as an internist).

16 Partman, Allen, *The Treatment of Professional Goodwill and Divorce Proceedings,* 18 Fam. L.Q. 213, 214 (1984).

17 Treas. Reg. § 1.501(c)(3)-1(b)(4).