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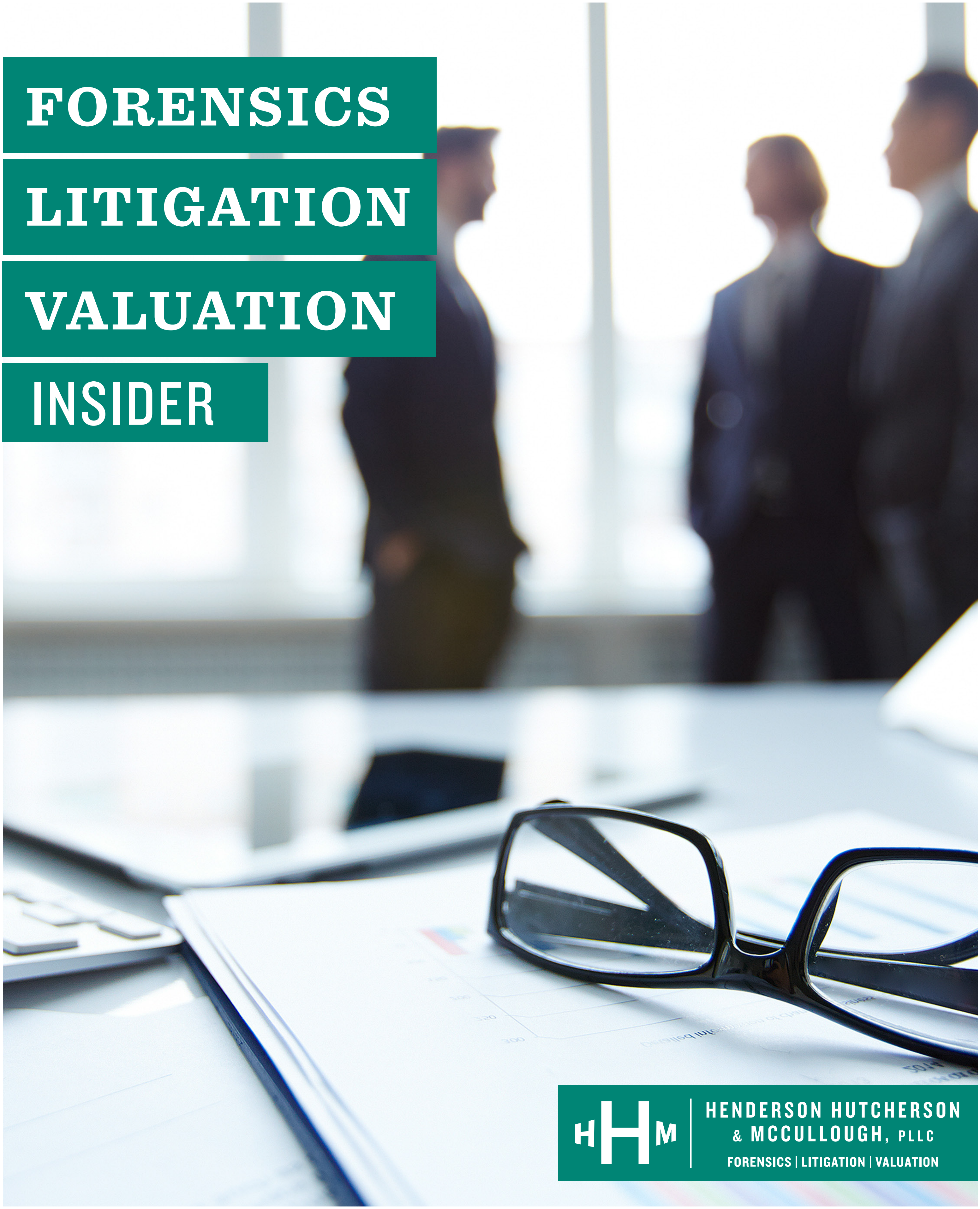
FORENSICS LITIGATION VALUATION INSIDER



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FORENSICS | LITIGATION | VALUATION

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WHAT A DIFFERENCE A VALUATION DATE MAKES

Valuation disputes typically focus on the valuators' methods and calculations or on the availability of discounts. But the valuation date also can have a dramatic impact on the outcome. Consider the case of Wisniewski vs. Walsh, a shareholder oppression lawsuit that dragged on for 18 years.

Sibling Rivalry

Wisniewski involved a dispute over the value of an interest in National Retail Transportation Inc., a trucking and freight consolidation firm owned equally by three siblings — Patricia, Norbert and Frank — who inherited the business from their father.

Beginning in 1995, the siblings filed several lawsuits against each other as they battled for control of the company. Norbert and Patricia each accused the other of shareholder oppression, but in 2000, after a lengthy trial, the New Jersey Chancery Court found that Norbert was the oppressing shareholder. The court ordered Norbert to sell his one-third interest back to the company, or to Frank and Patricia, at fair value. It set the valuation date at Jan. 31, 1996, the day that Norbert filed his complaint.

In 2001, based on reports of the parties' valuation experts but without a hearing, the court fixed the value of Norbert's interest at $12.4 million. In 2004, an appellate court reversed the trial court's decision and remanded the case for an evidentiary hearing to reconsider the valuation date and fair value of the interest.

After a 12-day hearing in 2007, the trial court changed the valuation date to Nov. 29, 2000 (the last day Norbert worked at the company), and increased the fair value of Norbert's interest to approximately $32.2 million.

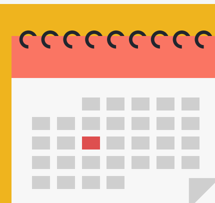
Norbert's Contribution

On appeal, the appellate court considered several valuation issues, including the valuation date, the definition of fair value, appropriate valuation methods and the availability of marketability discounts. While affirming the trial court's determination of the valuation date, it remanded the case for further consideration of the marketability discount and some other issues.

Regarding the valuation date, the appellate court rejected the argument that the trial court had erred in departing from the "statutory presumptive valuation date" (the date of Norbert's complaint). Despite Norbert's oppressive behavior toward his siblings, the court said, he hadn't harmed the company itself. Moreover, as the trial judge observed, while he'd played a lesser role than Frank, Norbert had nevertheless "contributed to the growth of the company." As a matter of equity, therefore, Norbert shouldn't have been deprived of the benefit of the company's growth from the time he filed his complaint until his departure in 2000.

Valuation Date & Value

As the Wisniewski case illustrates, the valuation date can have an enormous impact on fair value in connection with shareholder litigation. As noted here, the presumptive valuation date in these cases is the date the complaint was filed. But a later date might be appropriate if using the presumptive date would be unfair. In Wisniewski, the court chose a later date to avoid unfairly depriving Norbert of his share of the company's growth while he continued to contribute to that growth.



Other circumstances that might call for an alternate valuation date include:

- The unavailability of sufficient market data on the presumptive valuation date
- A contingency or potential liability that won't be resolved until after the presumptive date
- An aberration that temporarily increases or decreases the stock's value on the presumptive date
- Evidence that the plaintiff timed the lawsuit to take advantage of an unusually high or low stock price.

The valuation date is also critical in other valuation contexts. For instance:

Estate planning. Ordinarily, for estate tax purposes, appraisers value assets as of the date of death. But an executor has the option of electing the "alternate valuation date," which is six months after the date of death. Making this election may be beneficial if the estate includes securities, real estate or other assets that have declined in value since the date of death. But once the alternate valuation date is elected, it must be used for all assets in the estate (except for assets sold between the date of death and the alternate valuation date, which are valued on the sale date).

Divorce. In divorce cases, state law usually prescribes the valuation date. Typically, it's the date the divorce action was commenced, but it could also be the trial date, the date of the divorce decree or some other date established by law or agreement of the parties — or set by the court as a matter of equity.

The Best Possible Outcome

Proper valuation date selection involves both legal and financial issues. Consulting a valuation expert will help ensure the best possible valuation outcome. In cases where the date is a litigated issue, be prepared to address the appropriate date and present evidence of value on various dates.

OWNERSHIP TRANSITION: Valuation is key to succession planning.

Most business owners spend a lifetime building their business. And when it comes to succession, they face the difficult decision of whether to sell, dissolve or transfer their business to family members. A business transfer involves several complicated issues, such as how to divvy up the family business into logical pieces, allocate value and tackle complex tax issues.

In planning for succession, the business owner needs to engage experienced financial advisors — starting with a business valuator — to review the company's financials and determine its market position. Valuators can help family business owners and attorneys customize solutions to meet their special needs.

Economic Conditions Affect Value

Before drafting a succession plan, a business owner, along with his or her valuator, must consider how the economy affects market value. When weighing economic conditions, valuators take care not to be overly pessimistic or optimistic. Valuations that double-count risk factors, for instance, could undervalue the business. On the other hand, valuations that don't properly account for risk may overstate value. Some variables that affect value include:

Expected cash flows. According to both the market and income valuation approaches, future earnings determine value. To the extent that a business experiences decreasing, or increasing, demand and rising (or falling) prices, expected cash flows will be affected. Historical financial statements may require adjustments to reflect changes in future expectations.

Perceived risk. Greater risk results in higher discount rates (under the income approach) and lower pricing multiples (under the market approach), which translates into lower values (and vice versa). When selecting comparables, the transaction date is an important selection criterion a valuator considers.

Expected growth. Greater expected revenue growth contributes to value. In addition, there's a high correlation between revenue growth and earnings (and thus, cash flow) growth.

Marketability. Decreased liquidity translates into higher marketability discounts, while increased liquidity reduces marketability discounts. Limited partner and member units may be discounted for their relative lack of control and marketability.

Other factors that affect the magnitude of valuation discounts include:

- Type of assets held
- Financial performance of the underlying assets
- Portfolio diversification
- Leverage
- Owner rights and restrictions
- Distribution history
- Personal characteristics of the general partners or managing members

Discounts vary significantly, but can reach (or exceed) 40% of the entity's net asset value, depending on the specifics of the case.

Transfer Timing Has Value Implications

Whether an owner transfers the business during his or her lifetime, at death or upon a spouse's death also has value implications. For instance, if the owner decides to will the company to a spouse, no estate tax will be due at death because of the marital deduction (as long as the spouse is a U.S. citizen). But the estate tax may be due on the spouse's death, depending on the business's value and current estate tax laws.

An owner may want to consider minimizing the company's value to reduce the future estate tax payment on the spouse's death. But it's important not to drastically understate the company's value. Businesses that appear to have been undervalued in an effort to minimize taxes will raise a red flag with the IRS.

Purpose Affects Value

An owner's heirs also may have different views of the business's proper value. This is particularly true of "inactive heirs," or those who won't inherit the business and whose share, therefore, may need to be "equalized" with other assets, such as insurance proceeds or real estate. The expert needs to clearly understand the valuation's purpose and the owner's estate plans.

When (or if) the owner plans to retire is another major issue to be resolved. If the owner wants his or her children to take over but needs to free up cash for retirement, he or she may be able to sell shares to successors. Several methods (such as using trusts) can provide tax advantages as well as help the children fund a business purchase.

A Good Plan Is An Insurance Policy

There's no time like the present for business owners to start — or revisit — their succession plans. They may find facing the future difficult. But if an owner fails to make a succession or estate plan, the same company intended to fuel his or her family's future could instead become its burden. A valuator can help get the ball rolling.

SUPPORTING A PUNITIVE DAMAGES CLAIM: Does the punishment fit the crime?

Punitive damages may represent a significant portion of a plaintiff's recovery — in some cases dwarfing compensatory damages. State legislatures have considerable flexibility in establishing an appropriate level of punitive damages for various types of cases. And juries in individual cases have a great deal of discretion when it comes to awarding punitive damages.

But in recent years, the courts have found that punitive damages may offend constitutional due process protections if they are "grossly excessive" in relation to the government's legitimate interest in punishment and deterrence.

When Are Punitive Damages Excessive?

In BMW of North America, Inc. v. Gore, the U.S. Supreme Court instructed courts to follow three "guideposts" in determining whether a particular punitive damages award is grossly excessive:

1. The degree of reprehensibility of the defendant's conduct
2. The disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award
3. The amount of civil penalties imposed in comparable cases.

Generally, the first factor is the most important. As the Supreme Court explained in State Farm Mutual Automobile Insurance Co. v. Campbell, courts should assess the reprehensibility of a defendant's conduct by considering whether the harm caused was physical or economic. For instance, did it show an indifference to, or reckless disregard for, the health or safety of others? In addition, courts should consider whether the harmed party was financially vulnerable, and whether the conduct was repeated or was simply an isolated incident. Courts also need to determine whether the harm was the result of intentional malice, trickery or deceit.

Even if a defendant's conduct is reprehensible, punitive damages may be excessive if the ratio of punitive to compensatory damages is too great. There's no magic number, but the Supreme Court in State Farm observed, "In practice, few awards exceeding a single-digit ratio between punitive and compensatory damages will satisfy due process." In a recent California case — Nickerson v. Stonebridge Life Insurance Co. — the court concluded that 10:1 is the "maximum constitutionally defensible ratio."

What Defines "Excessive"?

In Nickerson, the plaintiff successfully sued his health insurer for breaching an insurance contract. The jury awarded him $35,000 in compensatory damages and, finding that the insurer's failure to pay policy benefits was fraudulent, awarded him $19 million in punitive damages. In connection with a motion for a new trial, the trial court reduced the punitive damages award to $350,000 (10 times the compensatory damages award). The court acknowledged that this amount likely would be insufficient to deter the insurer from engaging in similar conduct, but felt constrained to reduce the punitive damages award to 10:1 "based on recent California and federal authority."

The court of appeals agreed. Even though four of the five reprehensibility factors listed in State Farm were present in this case, the court said there was no justification for awarding punitive damages beyond the "constitutional maximum." The court also explained that, while the defendant's financial condition is essential to an analysis of punitive damages, "it alone cannot justify exceeding what due process will allow."

What About Compensatory Damages?

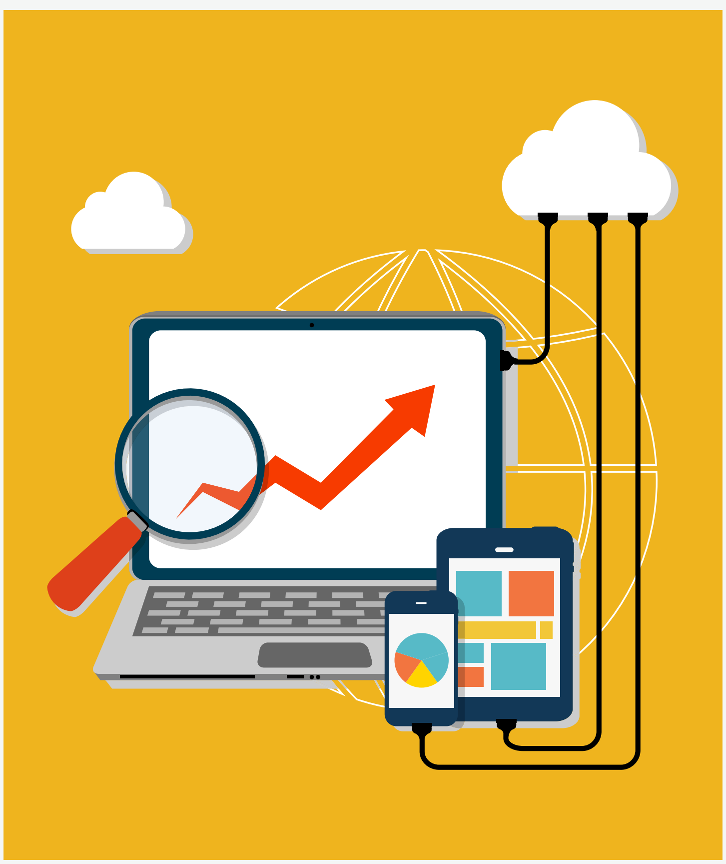
When a defendant's egregious conduct justifies a substantial punitive damages award, it's tempting to focus on punitive damages at the expense of compensatory damages, particularly when compensatory damages are relatively modest.

As recent case law demonstrates, however, the amount of compensatory damages serves as the starting point for establishing a ceiling on punitive damages. Attorneys should consult with their damages experts to insure that all relevant matters to the calculation of compensatory damages have been fully considered.

What Factors Support Damages Claims?

Whether you represent the plaintiff or the defendant, it's critical to understand the factors that support punitive damages, the constitutional limits on those damages, and the relationship between punitive and compensatory damages.

DISCOVERING E-DISCOVERY



In today's digital age, the ubiquity of "electronically stored information" (ESI) has profoundly changed the way litigants conduct discovery — so much so that the Federal Rules of Civil Procedure (FRCP) were amended to address the specific issues surrounding ESI.

For example, FRCP 26(b)(2)(B) provides that a party need not produce ESI it "identifies as not reasonably accessible because of undue burden or cost," though a court may order the party to produce the ESI for good cause. Keep in mind, however, that this rule doesn't relieve a party of its duty to preserve relevant evidence. For example, a litigant might be required to preserve backup tapes that contain relevant evidence, even if it claims that such evidence isn't reasonably accessible.

A recent development involving e-discovery is the concept of "discovery about discovery." These are discovery requests designed, not to elicit relevant ESI, but to elicit information about the procedures or methods a party used to search for responsive ESI. This information is important because, to identify discoverable ESI, a party needs to develop keyword searches or other protocols designed to pinpoint relevant evidence while minimizing the amount of irrelevant materials. In other words, it's difficult to know whether a party has provided all discoverable information unless you also know how the party went about searching for it.

Several recent cases have permitted discovery about discovery. For example, in Ruiz-Bueno v. Scott, an Ohio U.S. District Court ordered defendants to answer interrogatories regarding efforts they had made to comply with discovery requests as well as procedures or methods they had used to search for responsive ESI. In this case, plaintiffs sought specific e-mails from 50 or so defendants. The defendants didn't explain how they had searched for them "beyond the fact that each defendant was asked … to produce his or her relevant e-mails."

The court ordered discovery about discovery, finding that the plaintiffs were entitled not only to the results of the ESI search, but also to information about how the defendants had looked for responsive documents.

The court also noted that, in most cases, these disputes shouldn't be presented to the court. FRCP 26(f) requires parties to confer early in a case and discuss, among other things, "any issues about disclosure or discovery of [ESI], including the form or forms in which it should be produced." Parties should collaborate to resolve issues regarding search terms used and methods employed to identify responsive ESI.

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