

# Viewpoint on Value



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# What's "fair" in shareholder disputes?

The term "fair value" has many meanings, depending on whether you're complying with accounting standards, divorcing a spouse or separating from a business associate. Here, we focus on its meaning in the context of a shareholder dispute.

## How to define fair value

Sometimes minority shareholders disagree with major decisions made by majority owners — or feel mistreated by controlling shareholders — which leads to shareholder disputes. Fortunately, most state laws provide buyout remedies for dissenting or oppressed minority shareholders. How value is estimated for these buyouts varies from state to state and is based largely on legal precedent.

Appraisal rights statutes generally require controlling shareholders to repurchase minority shares at fair value. Each state has enacted its own shareholder rights laws, but the Model Business Corporation Act (MBCA), promulgated by the American Bar Association, originally defined "fair value" as the shareholder's value immediately before the corporate action to which the dissenter objects, "excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable." The MBCA was updated by the Revised Model Business Corporation Act (RMBCA) in 1984, and most states have adopted this either in part or in its entirety.

In 1999, the RMBCA's definition of fair value was itself revised as "the value of shares immediately before the corporate action to which the dissenter objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction



requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation pursuant to section 13.02."

While few states have incorporated this revision into their statutes, it has been referenced in several shareholder dispute cases as a basis for excluding valuation discounts. Even the RMBCA admits that exceptions may exist that leave fair value calculations at the courts' discretion.

It's important to note that the fair value definition differs from IRS Revenue Ruling 59-60's fair *market* value definition: "the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

## How to estimate fair value

There are no universal formulas for estimating the value of minority interests. Courts recognize the cost, market and income approaches as “current and customary” valuation techniques in shareholder disputes. But often valuers use the discounted cash flow method to estimate fair value.

This technique derives value from management’s projections — before the objectionable corporate action, if possible. Future cash flows are discounted to their present value at a rate commensurate with the company’s risk. Controlling and minority shareholders rarely agree about future projections or risk, so these often become contentious issues in court.

When minority shareholders dissent to a merger or acquisition, the courts also give substantial weight to the actual selling price if the transaction occurs between unrelated third parties. In some jurisdictions, valuers may have to exclude from the selling price any expected synergies from the objectionable corporate action to determine fair value.

## How to address valuation subtleties

Another contentious area in shareholder disputes is valuation discounts. Although no bright line rules exist, legal precedent generally entitles minority

shareholders to their pro rata shares of the company’s value on a controlling basis. Consistent with legal precedent in many states — including Delaware, the state with the most dissenting shareholder judicial precedent — this interpretation excludes discounts for lack of control and marketability.

## Courts recognize the cost, market and income approaches as “current and customary” valuation techniques in shareholder disputes.

The underlying logic is that buyers and sellers in dissension and oppression cases — unlike those under the definition of fair market value — are not hypothetical or willing. Thus, subtracting valuation discounts would award controlling shareholders a windfall for squeezing out or otherwise mistreating minority shareholders.

But marketability discounts are permitted in some jurisdictions, including New York. These discounts can be substantial. For example, the New York

## Hedge your bets with buy-sell agreements

Courts across the country interpret the term “fair value” inconsistently. A buy-sell agreement helps minimize uncertainty and subjectivity by facilitating out-of-court settlements.

Comprehensive agreements address the following potentially contentious issues — *before* shareholder relations sour:

**Standard of value.** Choose a specific definition to use when valuing minority interests, whether it’s “fair market value” or “fair value.” Different definitions may apply depending on the triggering event.

**Valuation date.** Specify the appropriate valuation date for each triggering event. The date of a shareholder’s death or a lawsuit’s filing date may be appropriate, for example.

**Applicable discounts.** Premeditate whether it’s equitable to include discounts for lack of control and marketability when valuing shareholder interests.

Courts consider buy-sell agreements when settling shareholder disputes, but they’re not necessarily binding. Courts rely more on buy-sell agreements that the parties have followed in past transactions, as well as those that are updated on a regular basis. Outdated agreements generally provide little guidance to judges.

Supreme Court accepted a 25% marketability discount in *Matter of Jamaica Acquisition Inc. v. Shea*, a high-profile dissension case. The court didn't allow any discount for built-in capital gains tax, another potentially contentious issue for C corporations.

One more important issue to discuss with valuers *before* estimating fair value is the appropriate valuation date(s). Often judges select the date immediately before the corporate action to which the dissenter objects. But some courts opt for the date the petitioners file suit as the cutoff. Generally, valuers consider only information that is known or reasonably foreseeable on the valuation date.

## Why valuation credentials and experience count

Fair value definitions are often ambiguous and conflicting, leaving judges to decide issues on a case-by-case basis. Possible sticking points include the appropriate valuation methodology, rate of return, projected earnings, valuation discounts and timing. Experts also consider applicable state laws and legal precedent.

With so many nuances, dissenting and oppressed shareholder cases often boil down to a battle of the experts. Independent, credentialed experts who provide rock-solid valuation reports are imperative in shareholder litigation, from discovery to trial. ●

# The nuts and bolts of impairment testing

Today's tumultuous economy has lowered the value of many assets, forcing companies to report impairment losses in accordance with Generally Accepted Accounting Principles (GAAP).

In fact, many public companies — including Ford, GMAC and AIG — have already written off more than \$500 billion in goodwill and financial assets, according to the *Business Valuation Resource* podcast "Goodwill Impairment in a Troubled Economy." More impairment losses are expected as economic uncertainty continues.

## Fair value basics

Valuers test for impairment by estimating "fair value." According to Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements* (now covered under Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements and Disclosures*), fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."



FASB provides a three-tiered hierarchy for valuation input. The most desirable, Level 1 inputs, are quoted prices of identical assets or liabilities. Level 2 inputs include market prices of similar items (or “comparables”). Most private companies resort to Level 3 inputs, which include management’s good-faith estimates and assumptions about cash flows and risk.

## Goodwill impairment

FASB Statement No. 142, *Goodwill and Other Intangible Assets* (ASC Topic 350, *Intangibles — Goodwill and Other*), requires companies that acquire goodwill and other indefinite-lived intangibles to test those assets at least annually for impairment. Before 2002, companies amortized these assets over 40 years. But because internally generated goodwill doesn’t appear on the balance sheet, it’s not tested for impairment.

Impairment testing is a two-step process:

**Step 1.** An appraiser values the company (or reporting unit if multiple product lines or divisions exist). If the fair value of the company (or reporting unit) exceeds its book value (or the value of its assets according to the balance sheet), no impairment has occurred and testing stops. If book value exceeds fair value — or if a sensitivity analysis reveals that impairment is questionable — the appraiser moves on to the next step.

**Step 2.** Much as he or she would allocate a purchase price, the appraiser allocates fair value to the company’s (or reporting unit’s) tangible and identifiable intangible assets. The remainder is the implied fair value of goodwill. To the extent that the book value of goodwill (the amount of goodwill stated on the balance sheet) exceeds its implied value, impairment has occurred and must be written off the books.

## Long-lived asset impairment

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (now found under ASC Topic 360, *Property, Plant, and Equipment*), requires impairment testing on equipment, real estate, capital leases and other long-lived assets. Events that trigger impairment testing for long-lived assets include a history of operating losses, weak industry outlook, or an adverse regulatory action.

To gauge impairment for long-lived assets, an appraiser first evaluates whether the asset’s net book value exceeds its undiscounted future cash flows. If so, impairment equals the difference between the asset’s book value and its fair value.

## A serious task

Impairment testing is designed to give investors, lenders and other stakeholders fair warning of impending financial troubles, obsolete assets or overzealous acquisition strategies, as well as to fairly state balance sheet values.

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Companies are understandably wary of reporting impairment. They don’t want to prematurely alarm investors with changes that may be recoverable. Plus, GAAP prohibits companies from reversing impairment losses, even if asset values eventually recover.

But when a company fails to report impairment and subsequently files for bankruptcy, a shareholder questions reported earnings or a bank pursues incorrect financial information submitted for a bank loan, stakeholders may allege fraud, accounting malpractice or breach of fiduciary obligations.

## A phone call away

Identifying and measuring asset impairment is a complex task that necessitates the use of outside valuation expertise. Valuers can help management estimate reasonable discount rates for each asset type, build cash flow models, and identify comparables, if available. These subjective analyses require careful consideration and specialized training, especially in today’s volatile economy. ●

# The search for hidden income in divorce valuation

Divorcing spouses frequently engage valuation experts to help divide their assets, particularly when the marital estate includes a private business interest. Emotions run high in divorce, and missing income may be a problem in marital dissolution cases. If one spouse owns a business, the nonmoneyed spouse may allege that the business earns more than its financial records suggest.

## Detecting fraud

Valuators may have to watch out (and adjust) for spouses trying to dissipate their businesses' values. For instance, the moneyed spouse may attempt to hide business assets, delay revenue recognition or overstate expenses.

Of course, the nonmoneyed spouse has less experience and knowledge of the business, and such a charge may be baseless. But to determine whether the claim is justified or is completely without merit, valuation — and forensic accounting — expertise can be key.



A lower bottom line benefits a moneyed spouse in two ways. First, to the extent that a company's value is based on its earnings, reduced income lowers value. Therefore, low profits increase a moneyed spouse's share of the marital estate's remaining assets. Some moneyed spouses will even hide physical assets or use fraudulent accounting tactics to lower profits reported before their divorces.

Experts can use several forensic accounting techniques to indicate whether cash is missing and estimate how much the owner isn't reporting.

This requires the valuation expert to look behind the numbers and use forensic accounting techniques to search for unreported income. One approach valuators use to uncover missing income is to search for hidden cash.

## Unearthing buried cash

Business owners sometimes receive unreported income in the form of cash. To avoid detection, the business doesn't record the income in its books or deposit the cash in its bank account. But experts can use several forensic accounting techniques to indicate whether cash is missing and estimate how much the owner isn't reporting.

**Bank deposits method.** The expert reconstructs income by analyzing bank deposits, canceled checks and currency transactions, accounting for cash payments made from *undeposited* currency receipts as well as nonincome sources of cash — such as loans, gifts, inheritances or insurance proceeds.

**Source and funds application method.** The expert analyzes the business owner's personal sources and uses of cash. This method is effective in addressing the question: Where did income and other funds come from, and what were they used for? If the owner is spending more than he or she is taking in, the excess represents unreported income.

**Net worth method.** This method is based on the assumption that an unsubstantiated increase in a business owner's net worth is attributable to unreported income. The valuator estimates net worth using documents such as bank and brokerage statements, real estate records, and loan or credit card applications.

**Percentage mark-up method.** The valuator or forensic accountant estimates net income by applying a benchmark profit percentage to sales or some other

base amount. Valuators usually use this method to corroborate results of other methods.

The expert starts with the amount of gain in net worth, subtracts reported income and adjusts this amount to reflect nondeductible expenditures — such as capital asset acquisitions — and nonincome sources of funds.

The techniques described here are just a few examples of the many ways forensic accounting techniques can produce more accurate valuations.

### Obtaining the best advice

Keep in mind that each state has its own laws and legal precedents in divorce cases. That's why consulting an attorney is essential. But one aspect of divorce valuations seems universal: Family court judges prefer independent appraisal expertise and thorough analysis. ●

## Critique, refute and save with rebuttal reports

In some circumstances, a written rebuttal report can be an alternative to a full-blown written appraisal, reducing the time and cost of obtaining an expert's valuation opinion.

The most common reason experts issue rebuttal reports is to critique someone else's valuation report. For example, a plaintiff or a defendant might hire a valuator to draft a memo that outlines the errors and weaknesses in the opposing expert's report. The rebuttal report also can quantify how the errors affect value.

A rebuttal memo can be entered into evidence as an expert opinion. It also can help the attorney draft cross-examination questions for deposition and trial. In addition, it may serve to expedite legal proceedings.

Alternatively, if two expert opinions differ significantly, the parties may agree to jointly hire an objective third expert to prepare a rebuttal report. Here, the rebuttal would identify specific sources of the discrepancy, citing authoritative references. Third-party rebuttals often help the parties settle their differences outside of court.

An expert may respond to a critique with another rebuttal report that addresses each alleged error. Typically, the expert would acknowledge any legitimate errors and factor them into a modified conclusion. The response would clarify the expert's point of view and defend his or her professional judgment.

It's unnecessary to reinvent the wheel every time an expert appraises a business, especially if time and money are limited. In such situations, a rebuttal report can be useful. For example, a defendant's expert might use a report prepared by the plaintiff's expert as a starting point for his or her analysis. In this case, the rebuttal report would describe how the expert reviewed the original appraisal and agreed with certain facts and analytical procedures.

