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In a World of Diverse BV Standards, Credentials and Competency are Critical

The lack of unified standards has become one of the most controversial—and critical—topics for the business valuation profession. As a result, BV litigation experts may be more susceptible to intense examination regarding compliance with the appropriate professional standard(s), an area they (and their attorneys) should be prepared to expect—and use to their advantage, when cross-examining an opponent's expert.

Standards from diverse sources

Many believe that professional standards for business valuation "began" with IRS Revenue Ruling 59-60. Issued in 1959 and applicable by law to federal estate and gift tax valuations, Rev. Ruling 59-60 still remains the seminal guidance on valuation of ownership interests in closely held businesses. Its influence carried over into the BV standards that began to appear in the 1980s and 1990s: first, with The Appraisal Foundation's issuance of the Unified Standards of Professional Appraisal Practice (USPAP) in 1987, followed by standards from the American Society of Appraisers (1992), the Institute of Business Appraisers (1993), and the National Association of Certified Valuation Analysts (1993).

More recently, this past summer the American Institute of Certified Public Accountants (AICPA) issued its Statement on Standards for Valuation Services No. 1 (SSVS 1). As a result, BV professional standards are currently dispersed among five different organizations, plus continued federal guidance. The U.S. Tax Court has recognized USPAP and so has Congress, in legislation such as the Financial Institution Reform, Recovery and Enforcement Act (1989) and the 2006 Pension Protection Act. In 2006, the IRS issued Notice 2006-96, which cited USPAP as a generally accepted appraisal standard.

Multiple standards feed multiple questions

The pressure to adhere to these emerging standards is currently impacting all BV professionals, irrespective of their accrediting organizations. Beginning in January 2008, for example, when SSVS 1 became effective, many of the AICPA's approximately 300,000 members became bound by the standards when they perform valuation-related engagements.

In the litigation arena, appraisers who hold multiple credentials can expect to hear questions such as: "Which standards are best?" and "Do they ever conflict?" To maintain their credibility, experts should be prepared to answer these questions as they relate to their credentials and also their competency—that is, whether the opinions set forth in their reports comply with the appropriate standards. By the same token, accredited BV experts can help guide attorneys in developing the same questions for cross-examining their opponent's expert, identifying areas where credentials or compliance may be lacking.

New Study Finds Daubert Challenges up By Two Hundred Percent

The U.S. Supreme Court's Kumho Tire decision in 1999 extended the Daubert admissibility criteria to non-scientific expert testimony—and since then, Daubert challenges to all types of expert witnesses have increased almost 200%, according to the latest study by PricewaterhouseCoopers (PwC). The 2000-2006 Financial Expert Witness Daubert Challenge Study examines nearly 3,000 federal and state court opinions and finds the following trends:

- The number of Daubert challenges to all expert witnesses increased by more than one third between 2005 and 2006—the second consecutive annual increase exceeding 30%.
- Despite increases in the number of challenges—and exclusions—in the past seven years, the percentage of expert exclusions is remaining fairly consistent, at around 47%.

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- Approximately 519 Daubert challenges targeted financial experts; of these, 106 took place in 2006—an increase of 14% over 2005.
- Of the 519 challenges to financial experts, 30% were completely excluded, 18% were partially excluded, and 49% were admitted.
- Five federal circuits (2nd, 3rd, 5th, 6th, and 7th) together heard 60% of all financial expert challenges. In the 9th Circuit, 68% of expert testimony was excluded in whole or in part, compared to only 24% in the 1st Circuit.
- Although plaintiffs' experts are the most frequent targets, once defendants' experts are challenged, exclusions are in equal proportion (47% plaintiffs vs. 48% defendants).
- Economists, accountants, and statisticians comprise 50% of all challenges—but they also survive Daubert attacks more successfully than other financial experts.

The most common cause of a financial expert's exclusion was a lack of reliability, followed by a finding of lack of relevance and an expert's lack of qualifications, according to the study. Further, flaws in a financial expert's methodology or misuse of accepted financial or economic methods also frequently lead to exclusion. Less common was a "maverick" use of novel or untested methods. In the business valuation arena, failure to consider a discounted cash flow (DCF) analysis was the basis for expert exclusion in three notable cases, most recently in In re Med Diversified bankruptcy (2005) and Celebrity Cruise Inc. v. Essef Corp. (2006).

To access the free Daubert study from the PwC website, go to: *http://www.pwc.com/extweb/pwcpublications.nsf/docid/b5b7c01ed69db8598525732f0075615b.*

Recent Daubert Case Emphasizes Correct Measure of Damages

Dering v. Service Experts Alliance, LLC, 2007 US Dist. LEXIS 89972 (December 6, 2007)

In a suit over the purchase and sale of their heating and air conditioning business, plaintiffs presented expert testimony to support their breach of contract claims. In particular, the plaintiffs' expert calculated: 1) the lost profits of the air conditioning business; 2) the amount of the defendants' unjust enrichment; 3) the diminution of the business' value; and 4) the amount of punitive damages.

In reaching his lost profits figure, the expert first projected the defendants' service revenue based on historical growth. He then deducted this figure from their actual service revenues to arrive at the plaintiffs' projected service revenues. Multiplying this figure by "the percentage of revenue that becomes income," he arrived at lost profits of $353,000. He calculated lost profits in this manner for a ten-year period, and reduced the total amount to present value for a final lost profits figure of $1.93 million.

The unjust enrichment figure was even more significant: $2.65 million. This was projected over a period of ten years and again reduced to present value. Defendants challenged his opinions under Rule 702 of the Federal Rules of Evidence (FRE) and the applicable Daubert standard.

Discovery failures trump Daubert

While noting that his "methods [were] reliable and his opinions relevant," the U.S. District Court (N.D. Ga.) did not have to directly address the expert's methodology, due to defendants' failure to provide plaintiffs with "any information that might [have aided the expert] in calculating the percentage of business revenue" that plaintiffs' business would have captured absent the defendants' wrongful conduct. Because their failure to provide information made a definitive calculation "impossible…[the defendants] cannot now complain that this supposed deficiency renders [the expert's] calculations inadmissible."

The court did, however, give closer scrutiny to the appropriate measure of damages. The expert compared the value of plaintiffs' business at the time of trial (the "as is" value) to the value the business would have had absent defendants' wrongful acts (the "but for" value). This diminution translated to the business losing net income of $143,000. Using a summary of actual and projected net income amounts, the expert concluded a total lost business value of $1.8 million.

Correct measure of damages is critical

While plaintiffs argued that, under applicable law, the "but for" method of calculating damages was correct, the district court disagreed. "Under Georgia law, the measure of damages for a diminution in the value of a business is the difference in the market value of the business before and after the occurrence of the injury." The court excluded the expert's testimony on diminution of value, as it did his opinions on punitive damages. "The amount of punitive damages is to be determined by the enlightened conscience of an impartial jury," the court held, and an expert opinion on these would invade the jury's "sacrosanct role."

Valuation Experts Required To Have Clear Credentials, Experience, and Methods

Rosvold v. LSM Systems Engineering, Inc., 2007 U.S. Dist. LEXIS 82061 (November 6, 2007)

A graduate degree from one of the top business schools in the country may not be enough to qualify an expert to testify in business valuation. To support his breach of contract claim, the plaintiff in this case proposed a well-educated business executive to testify regarding the value of a 6% corporate interest. In a pre-trial Daubert hearing, the U.S. District Court (E.D. Michigan) assessed the expert's level of "knowledge, skill, experience, training, or education" under Rule 702 of the Federal Rules of Evidence.

> *"Other than his personal experience of 'acquiring several companies' and having earned his…master's degree from the Wharton School of Business at the University of Pennsylvania…, [the expert's] resume fails to incorporate any professional experience in valuation analysis."*

Further, the expert was not enrolled or active in any of the "recognized organizations or institutions that establish the standards or rules to which their members must adhere when preparing a business valuation." While not dispositive, the expert acknowledged that this was the first time he'd been asked to provide testimony in litigation. He also admitted that he had not written any articles or books relating to the challenged subject matter. More importantly, the methodology the expert used in his report was not clear, and the court excluded his testimony under Rule 702 for failing to be "the product of reliable principles and methods."

Lost Profits Calculus Must Also Include Reasonable Expenses

Building Materials Wholesale, Inc. v. Triad Drywall, LLC, 2007 Ga. App. LEXIS 1095 (October 10, 2007)

When a commercial drywall and ceiling installer sued a supplier for breach of contract on a construction project, all went well during trial to establish lost profits to a "reasonable certainty." The supplier failed to deliver materials at the contract price, and as a result, the drywall company lost the project. The operations manager was able to show that the company expected $300,000 in profits from the project, based on a planned profit margin of 30%. The expected profits were based on the contract price, cost, and profits of four specific prior projects where the profit margins ranged from 29% to 33%.

The operations manager was also able to show that the company used all labor, material, equipment, and some overhead costs in determining its profit—but he did not testify as to the anticipated costs of the specific project at issue in the case. In fact, when asked on cross-examination if he could provide the specific cost figures, the operations manager responded: "I don't have that in front of me."

They could have used a lost profits expert

The jury returned a $160,000 verdict in favor of the drywall company—but on a motion for a new trial, the supplier argued that the lost profits calculus lacked a major component. It wasn't enough to show that the drywall company was a well-established, profitable business with a proven track record in its industry. "[The plaintiff] was also required to introduce evidence of expenses associated with its work on the Project." Having failed to provide its expenses with a reasonable certainty, the plaintiff's proof failed as a matter of law—and it was sent back to retry the matter, perhaps this next time with the help of an experienced damages expert.

Lost Profits Evidence Turns on Key Expert Assumptions

Mood v. Kronos Products, Inc., 2007 Tex. App. LEXIS 9243 (November 28, 2007)

After eleven years in business together, both parties in this case breached material portions of their exclusive distribution agreement. Defendant Kronos terminated the agreement without adhering to the sixty-day notice provision, and sued to recover a past due amount on the plaintiff's (Mood's) account in excess of $188,000. The plaintiff counterclaimed for lost profits resulting from the defendant's unauthorized sale to one of its customers and for damages arising from breach of the notice requirement.

At trial, plaintiff presented no direct expert testimony on the first of his claims. Rather, he presented: 1) invoices from the defendant over a period of nearly two years; 2) plaintiff's average gross annual sales to the customer that the defendant began to deal with directly; 3) a general assertion that plaintiff's "usual" profit margin was 20%; and 4) an expert witness's assertion that about 80% of plaintiff's sales were from defendant's brand of products.

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The plaintiff did present an expert to calculate damages for breach of the notice provision. His expert attempted to predict lost profits over the course of ten years, 2004-2014, using a "discrete revenue forecast" based on recent years' net income and applying a 17% discount rate. His calculations showed total lost profits of $1.1 million.

The jury awarded the plaintiff damages totaling approximately $580,000, $30,000 of which was for lost profits. On reconsideration, however, the trial court vacated the jury's awards and entered a "take nothing" verdict, and the plaintiff appealed.

Assumptions must be correct

On review, the appellate court ratified the trial court's decision. In particular, evidence of the defendant's gross sales to the one customer provided insufficient evidence of lost profits, as they did not clearly indicate that the defendant was selling the same product at the same volume or pricing scale as the plaintiff. The reliance on gross sales was equally misplaced, as that figure came up during a hypothetical statement by counsel at trial, and was "no evidence" of actual sales. Likewise, general statements that the company operated on a 20% gross profit margin and that 80% of its overall sales came from one product lacked sufficient factual basis.

Further, in calculating damages for breach of the notice provision, plaintiff's expert based his analysis on historical financial data and sales figures during the distributorship period. However:

> *"It did not differentiate between profits lost as [defendant's] sole distributor in the exclusive territory during the sixty-day notice period (direct damages) and those lost from other contracts or damaged business relationships (consequential damages)."*

Instead, the expert simply assumed that business would continue for the next ten years; he didn't limit his calculations to lost profits resulting from the inadequate notice. Based on these errors and omissions, the appellate court found the damages evidence speculative and insufficient to support the jury's award, and it confirmed the trial court's "take nothing" verdict.

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