Zivetz, Schwartz & Saltsman CPAs

3rd Quarter 2008

www.zsscpa.com

Fair Value—More Disclosure, More Litigation, More Risk?

Fair value is perceived as more susceptible to fraud and manipulations because judgment is so central to its conclusions. New information enters the market every day, affecting fair value and impacting far more than just the final numbers on the balance sheets. Companies are reclassifying assets and liabilities, recognizing longer holding periods regarding intransigent debt, and reassessing impairment issues more frequently. Even taking assets off the books doesn't remove the obligation for corporate directors and managers to disclose the fair value of the related risks and rewards.

But even if corporate officers, auditors, and financial analysts all follow the rules—in the short term, at least, the situation is going to get more difficult and more litigation rather then less will result. Although during the past couple of years, Sarbanes-Oxley may have helped bring about a brief decline in securities litigation, so did persistent market stability during the same time. But the current market volatility—brought about in part by the effective date of FAS 157 in early 2008 and the introduction of fair value judgments—could prompt a securities litigation boon, because plaintiffs will have strong economic incentives to claim that accounting is responsible for their losses.

Preparers will be at the center

The U.S. Supreme Court's recent decision in Tellabs, Inc. v. Makor Issues and Rights, (2007) has turned up the pressure by essentially telling the lower courts to make an early finding in securities lawsuits whether corporate directors exercised good judgment in good faith. If the courts and the Securities Exchange Commission permit preparers to be liable for good faith judgments that turn out to be wrong, the movement toward adoption of fair value accounting could stall. Auditors, financial officers, and others will find it increasingly difficult to make complex judgment calls when it could expose the company—and their careers—to legal liability.

To mitigate the litigation threat, the SEC could move toward adopting a rigorous professional judgment standard. This would help codify the steps that auditors, management, and boards could take to defend themselves against litigation, claims of fraud and poor judgment. In the meantime, to decrease the risk of liability, corporate managers are well-advised to seek fair value for financial reporting expertise from independent valuation specialists.

Working with Appraisers to Solve Problems in Valuing The Very Small Business

Valuing the very small company can often be more challenging than valuing a large firm or corporation. These types of valuations most commonly arise in the divorce cases, although they also are frequently present in shareholder litigation, partnership dissolutions, and similar litigation. Often, client budgetary restrictions are an overriding consideration. However, attorneys and appraisers can work together from the outset of an engagement to meet client budgets and provide credible valuation. Here are a few areas where communication and cooperation can be the most helpful.

- Valuation standards. Just like attorneys, accredited valuation specialists are bound by standards of professional conduct. However, none of those standards distinguish between a valuation for a small business (and perhaps small budget) and a larger business. Once engaged, appraisers often find themselves caught between performing a complete and credible valuation, complying with the applicable standard(s), and keeping the job within a client's budget. In litigation settings, most appraisers expect to be cross-examined on whether they adhered to the proper standards. If not, a lack of client funds will be no defense, and the appraiser's credibility as well as the client's case could suffer.
- Managing expectations. Proper client screening is just as important in the valuation as in the legal context. Appraisers can help retaining attorneys to inform the client why the appraisal

Continued to next page...

is necessary, its potential costs and the benefits that will inure to the case. Clients—especially in the divorce setting—will often suffer from misplaced expectations or assumptions. These clients need to receive the proper information and guidance from their professionals as to the scope of the valuation engagement, its process and the problems it can solve—as well as those it can't, including creating value in a business when in reality there may not be as much as the client anticipated or hoped. These clients may end up dissatisfied, often transferring their displeasure to an unwillingness to pay professional fees—or worse, filing a grievance or malpractice claim.

- Discovery and access to records. Few things can drive up litigation costs and conflict faster than trying to compel another party to comply with applicable disclosure and discovery rules. At the same time, the other side may be genuinely frustrated by receiving an overly broad and generic discovery request. Appraisers can work with attorneys and the client from the outset of the case to narrow and tailor the scope of production, so that the experts will receive all of the documents they need—and none of what they don't. Documenting clear, successive requests for production to the opposing party will also help in the event a motion to compel or an interim motion for fees becomes necessary.
- Professional protection. Communication and documentation are likewise critical to ensuring that both the attorneys and appraisers meet the appropriate standards of care when valuing a very small business—with perhaps a small client budget to go with it. There are rarely any shortcuts in a valuation procedure that pay off in terms of case outcome or client satisfaction. By documenting every action and notifying each other whenever problems or roadblocks may arise, attorneys and the experts will help maintain their own credibility as well as their client and referral sources.

Lack of Independent Business Valuation Affects Viability of Fraud Claims

Lusins v. Cohen, 2008 WL 662717 (New York) (March 13, 2008)

Clients who opt to save money in the short-term by foregoing a formal business valuation in connection with buy-sell agreements could eventually add considerable cost to any attendant dispute—including claims against the business's attorneys.

Parties initially agree on minimum value

At the time of his death, the decedent was a partner in multiple medical business entities with another physician. The partners had a buy-sell agreement providing that should one of them die, the succeeding partner would be entitled to purchase the deceased's partner's share for no less than $500,000. After receiving information concerning the business' financial condition from their attorney, their CPA, and the succeeding partner, as well as advice from the estate's attorney, the deceased's daughter—acting as executor of the estate—agreed to sell her father's share for $500,000.

Shortly thereafter, a family friend and CPA informed the widow that the value of her husband's interest in the entities "far exceeded" $500,000, and that their financial condition had been "misrepresented." She subsequently sued her husband's former partner, the entities' attorney and their CPA for fraud, negligent representation, and breach of fiduciary duty, and requested an accounting. The trial court dismissed all of the plaintiff's claims except for the accounting request, and she appealed.

Appraisal could have uncovered value

At trial, the estate's attorney testified that the defendants had provided all requested financial and legal documents, and that he, in turn, had sought advice from decedent's CPA, who was "intimately familiar" with the business entities and could assist in their valuation. After reviewing the documents, the CPA believed that "the estate would not be able to establish a valuation greater than $500,000." Significantly, the CPA did not convey any information that conflicted with the defendants'.

More importantly, before the estate accepted the $500,000 payment, the widow could have compelled an independent valuation of the entities, discovering their "true nature" and underlying condition. But because she declined to do so, the widow could not have justifiably relied on any alleged deception by the defendants, and the appellate court upheld the dismissal of the claims against them.

Pre-trial Attack on Expert For Improper Standard of Value and Valuation Date

Bair v. Purcell, 2008 WL 250096 (U.S. Dist.) (January 29, 2008)

Plaintiffs were a former director and minority shareholders of the defendant company. They claimed that the company "squeezed" the director off the board and breached a stock buy-out agreement as well as long-term employment agreements. In

defense of these claims, the company offered expert testimony to determine the fair market value of the outstanding shares of company stock. Before trial, the plaintiffs challenged the expert on three grounds: 1) that he improperly "perceived" the minority stock redemption price to be analogous to the redemption of preferred stock; 2) that he used fair market value rather than the fair value standard; and 3) that he used an improper valuation date.

Expert may need to explain his choices at trial

Without much detail regarding the facts and claims, the federal district court (M.D. Penn.) explained that in making his fair market value determination, the defendants' expert disregarded the stock redemptions by certain minority shareholders as a reference point for pricing the shares. Instead, he treated the holdings as analogous to preferred stock, even though the company admitted that it had never contemplated offering preferred stock to any shareholder. At trial, the expert "will have an opportunity to explain why, in his opinion, these transactions [the stock redemptions] were not accurate indicators of the stock's value," the court said, "and why this opinion comports with the standards of business valuation." But for purposes of the pre-trial motion, the court would not exclude his testimony "based solely on an analogy contained in his report."

Neither would the court exclude his opinion for relying on the fair market value (FMV) standard of value. A determination of "fair value" under the applicable law (Pennsylvania) entitles shareholders to be paid for their proportionate interests in a going concern, the court explained. The inquiry considers "all relevant factors," including market value "and any other facts which were known or which could be ascertained as of the date of the [corporate action] and which could throw any light on future prospects."

As to the final challenge, the court noted that pinpointing a precise date for the corporate action—and hence the appropriate valuation date—was made difficult by the parties' dispute as to when and even whether a "freeze-out" occurred. The plaintiffs argued that the day when the board barred the director from redeeming his shares (July 20, 2002), was the appropriate valuation date. Instead, the expert had calculated the fair market value of the company as of December 31, 2004—or more than six months after the alleged breach of the buy-back agreement and a full year after the director was ousted from the board in December 2003. The "passage of time alone," they argued, should have rendered the expert's valuation irrelevant and unreliable.

But the company was in its "early stages" at the outset of litigation, the court observed, and the expert used the data that was available. The court does seem to suggest that the date of the director's removal from the Board might be the more accurate time to ascertain value. Although it declined to exclude the expert's report on this basis, a footnote suggests that the expert will have additional explaining to do at trial, stating "it would appear that [the expert] could discuss whether and to what extent his conclusions regarding the fair market value of the stock would have differed using December 2003 as his valuation time frame."

The takeaway from this decision, for attorneys and their financial experts: Make sure to prepare a credible discussion and analysis of all conclusions reached in the final valuation reports.

Appraiser Provides Accurate Measure of Debt-Ridden CPA Firm in Divorce

Scott v. Scott, 2007 Va. App. LEXIS 454 (December 18, 2007)

During the Scotts' marriage, the husband was a CPA and one of three shareholders in his accounting firm. Per an informal agreement among the three shareholders, they each received an equal or 33% share of the firm's profits, regardless of his stakeholder interest. By the time the Scotts went to trial over their divorce, the husband owned 20% of the shares. These two disparate values—ownership vs, profit-sharing—formed the crux of this case, which the Virginia Court of Appeals declined to publish, but which exemplifies how good work by an accredited appraiser can make the difference in litigating the value of what appears to have been a badly run accounting business.

A corporation in name only

For example, during the two years prior to trial, the husband's CPA firm had consistently failed to bill its clients. Although annually registered as a corporation, the firm had no stock book, no meetings of the board of directors, and no corporate minutes. None of the stockholders could say whether they had received stock certificates, and only the husband produced one for 18.66 shares dated more than ten years before the divorce.

The husband declined to offer a business valuation expert at trial, relying on his own testimony and that of the other firm shareholders. They pointed to the buy-sell provisions of the shareholder agreement, which entitled an owner, upon departure or dissolution, to receive the increase in receivables and work-in-process from the time of acquiring the stock through departure, multiplied by his ownership interest. Because of the firm's accrued debts, all of the shareholders (and even the wife's expert) agreed

Continued to next page...

that the husband would receive "no money" under the shareholder agreement.

The wife offered a CPA and qualified business valuation expert, who valued the CPA firm after reviewing the employment and shareholder agreements, corporate tax returns, accounts receivables, salary schedules, and shareholders' meetings. Using a capitalization of earnings method, he valued the husband's 20% share between $83,500 and $87,200. In addition, the expert valued the husband's 33% profit interest between $139,200 and $145,200.

The trial court declined to value the CPA firm using the 20% shareholder interest, because—in essence—"no one knows what the stock amounts are." Given the company's failure to recognize corporate formalities since its original stock agreement, the trial court found the firm was a "corporation in name only." Accordingly, it adopted the wife's expert's 33% ownership figure and valued the husband's share at $145,200. The husband appealed both aspects of the decision.

Appellate court seeks intrinsic value

The husband argued that the trial court failed to consider the firm's large debts and its value per the buy-sell agreement, which would be zero. The Court of Appeals found these unpersuasive, noting that the wife's expert specifically deducted the firm's debts in reaching his valuations. Further, any decision based on what the husband might receive upon leaving was "too speculative." Indeed, the husband testified that he planned to stay, due to a non-competition agreement. The court also noted that, absent evidence of an intended sale or departure, discounts did not apply to this intrinsic value.

Next, the husband claimed that even if $145,000 was an accurate valuation, the trial court's assignment of a 33% ownership interest (rather than 20% shareholder interest) was incorrect. The appellate court reiterated that while on paper the husband may have only owned 20% of the business, in reality the three owners equally shared the firm's profits and losses. Under these circumstances, "it was acceptable for the trial court to treat [the firm] as a partnership rather than as a corporation." The number of the husband's shares was not the best measure of the firm's intrinsic value—which, the court stressed, was the appropriate measure when valuing an asset for equitable distribution purposes.

©2008. No part of this newsletter may be reproduced or redistributed without the express written permission of the copyright holder. Although the information in this newsletter is believed to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal or consulting advice.

Zivetz, Schwartz & Saltsman CPAs
11900 W. Olympic Bl., # 650
Los Angeles, CA 90064-1151
www.zsscpa.com

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
NASHVILLE, TN
PERMIT NO. 989