

# VALUE ADDED™

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## Focus On **Litigation**

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# About Mercer Capital

Mercer Capital is one of the largest independent business valuation and financial advisory firms in the nation serving both private and public companies, financial institutions, and high net-worth families. We offer a broad range of services including gift and estate tax valuation, corporate valuation, financial reporting valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting.

Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation in connection with engagements involving their clients.

## Mercer Capital's Core Services

Business Valuation	Financial Institution Valuation
Litigation & Expert Testimony Consulting	Financial Statement Reporting Valuation
Employee Stock Ownership Plan Valuation	Fairness Opinions
Estate & Gift Valuation	M&A Representation & Consulting

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# Personal Goodwill Can Have a Big Impact on Fair Market Value

When WADL-TV 38 founder Franklin Z. Adell died, he left behind what would prove to be a complex estate. The estate, handled mostly by Adell's son Kevin, isn't a stranger to legal battles. In the years since Adell's death, the heirs have faced a number of legal issues, including a dispute between Kevin and his two sisters regarding distribution of assets from the estate.

This is a bellwether case on personal goodwill and its impact on fair market value of a business. Is it worth \$92 million dollars like the IRS' initial estimate or \$4.3 million dollars liquidation value as opined to in the estate's second valuation?

This is the range of the valuation opinions on this case. The key takeaway in all of this?

Make sure your appraiser understands all key agreements because they can be critical to the value proposition.

The facts of the case are as follows: A religious non-profit corporation (The Word Network) transferred virtually all their revenues via a service agreement to a for-profit entity (STN.com, Inc.) owned 100% by Franklin Adell. This was the only customer of STN.com. Mr. Adell's son Kevin was very active in the company and also had strong personal relationships with the trustees of the non-profit. He had no non-compete or employment agreement with the STN.com.

After his father's death, Kevin Adell, formed a mirror corporation and all the employees but one, moved to a new corporation as did the service agreement from the Word Network and its associated revenues.

The IRS' initial valuation assessment was \$92 million dollars for the enterprise of STN.com. A national appraisal firm's expert appraiser's, hired by the Estate of Mr. Adell, initial assessment was \$9.3 million. In this valuation, consideration was given to the personal goodwill of the son, Kevin Adell. The estate's appraiser believed there was significant inherent risks associated with Kevin's personal goodwill for the business which warranted a substantial discount.

In a subsequent valuation by the estate's appraiser, he concluded that he had not fully considered the restrictive terms of the service agreement with the non-profit. In this reevaluation he concluded that a valuation of STN.com, Inc. was \$4.3 million dollars. To arrive at this conclusion, he used the adjusted book value and gave no market value for intangible assets. The IRS' expert adjusted the initial assessment of \$92 million and testified that the value was \$26.3 million dollars at the date of death.

The judge found that the estate's substantially inconsistent positions regarding the valuation and therefore the burden of proof remained with the estate. Since STN was historically profitable and an economic

charge of \$8 to \$12 million dollars for Kevin's personal goodwill was deducted from the valuation in the first appraisal, the court concluded that the first appraisal from the estate's expert was reasonable and selected \$9.3 million dollars for the fair market value.

In summary, performing valuations for estate tax purposes is a serious matter as the audience for these reports is the IRS which will challenge an opinion of value where the facts are not clearly communicated and risk is not adequately disclosed. In the above case, an IRS challenge resulted in a trial and multiple valuations.

This is an expensive by-product of not understanding the facts of the case at the outset. An attorney and their appraiser need to fully understand the facts and key agreements driving a business in the initial phases of an engagement. This case was not unique in its complexity. The concept of personal goodwill is logical and supportable, and the valuation implications are real. The valuation impact can be significant on fair market value.

## SERVICES

# Litigation Support

**Complex commercial litigation requires the insight of experienced professionals who understand the practical application of traditional and emerging financial theories.**

Mercer Capital brings analytical resources and over 30 years of experience to the field of dispute analysis and litigation support. We assist our clients through the entire dispute process by providing initial consultation and analysis, as well as testimony and trial support.

Mercer Capital has been engaged by some of the premier professional firms in the country, including national, regional, and local law firms and their public and private clients, trust departments of financial institutions, and governmental agencies such as the Internal Revenue Service, Federal Deposit Insurance Corporation, Resolution Trust Corporation, Department of Labor, and Department of Justice.

Contact a Mercer Capital professional to discuss your needs in confidence.

## Key Contacts

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# Five Litigation Support Services We Provide That Might Surprise You

Business appraisers provide support to attorneys working on cases involving valuation and business damages. When a business valuation is called for in a valuation-related dispute, we provide necessary opinions. If the case involves corporate damages, we provide the necessary opinions regarding alleged damages. These services are fairly obvious uses of business appraisal expertise.

The focus of this article, however, is on some not-so-obvious services that business valuation professionals can provide in the context of business-oriented litigation.

In litigation involving business valuation or economic damages issues, business valuation professionals are capable of providing a surprisingly broad assortment of litigation support services. These services can begin before a decision is made to file a litigation, and can continue throughout the discovery, deposition, trial preparation and trial processes. Attorneys are increasingly learning that the effectiveness of business valuation and damages-related litigation support services is enhanced by retaining experts as early in the process as possible.

In litigated matters, business valuation professionals are often assigned to:

- » Determine the value of a business on a given basis (i.e., fair value, fair market value, or value as prescribed by a buy-sell agreement).

- » Measure the amount of economic damages allegedly incurred by the plaintiff.
- » Consult legal counsel with respect to business and valuation issues, which may include the review and analysis of reports prepared by other business valuation professionals.

These assignments are customary not only to business valuation professionals, but also to litigators handling matters which involve issues of business valuation or economic damages. However, the toolbox of business valuers includes a number of not so customary litigation services, or additional services that are only beginning to be considered by litigators, including:

- » Analysis of the work product of other experts prior to the filing of litigation
- » Analysis of alleged damages prior to the filing of litigation
- » Mediation prior to the filing of litigation
- » Assistance during the discovery process
- » Preparation for deposition of other experts or fact witnesses

Some attorneys request these services at the outset of engagements. Others could potentially make their jobs

easier and leverage their legal expertise by engaging competent business valuation litigation support services earlier in the litigation process.

## Pre-Filing Analysis of Work Product of Other Experts

The work product of a business valuation or corporate damages professional can be the basis of a dispute. In other cases, existing business appraisals may provide important information to support a lawsuit in disagreements regarding valuation. Consider two real-life examples.

1. Company A agrees to merge with Company B. Company A is controlled by Mr. X. Company B is entirely owned by Mr. X. The basis for the exchange rate in the merger are appraisals of both companies prepared by an industry broker who has done business with Mr. X on a number of occasions. The minority shareholders of Company A believe that Company A has been undervalued and that Company B has been overvalued. The result is that they believe that their ownership interests in the combined company are being unfairly diluted.
2. The board of directors of Company C engages in a reverse stock split, the effect of which is to squeeze out minority shareholders owning 15% of the company. Company C based the offer price to minority shareholders on an opinion of the fair market value of Company C's shares prepared by a qualified business appraiser, but for gift tax planning purposes. The minority shareholders believe that their shares have been undervalued.

In both cases, the minority shareholders engage attorneys to represent them in discussions with the respective companies. In both cases, the attorneys and their clients could benefit from discussing the matters with a business valuation professional. In cases like these two examples, the business appraiser who is consulted early can review the reports prepared by the other experts, and,

### NEW BLOG

## The Financial Reporting Blog

Mercer Capital is pleased to introduce the Financial Reporting Blog, a weekly update on financial reporting topics curated by our Financial Reporting Valuation professionals.

Providing meaningful information to investors in today's fair value era requires study, simulation and synthesis of market participant behavior. In this blog, we compile insights from the markets and perspectives on the evolving reporting landscape for the benefit of financial managers and industry leaders.

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in the process, can identify potential shortcomings of the subject valuation, or affirm their reasonableness.

The purpose of this early review is to assist counsel in assessing not only the probability of successfully trying the case, but also the potential valuation differential (the potential payoff). Keep in mind, however, that any perspective offered by a business valuation professional at this stage in an engagement is preliminary and potentially subject to significant changes. Let's tell the rest of the story from the first example above:

*The minority shareholders of Company A retained counsel. The attorney obtained the appraisals prepared by the industry broker and sent them to us, asking that we conduct an informal review of both of them and the implied exchange rate.*

*The companies were of similar size and earnings, but Company A was valued materially lower than Company B. We concluded, based on our preliminary, informal review, that the exchange rate was substantially dilutive to the minority shareholders of Company A. Based on this analysis, the attorney advised the shareholders of Company A to dissent to the transaction under the state's dissenting shareholder statutes. They did so, demanding the fair value of their shares according to their statutory rights.*

*An appraisal process was initiated, and we provided our opinions of the fair value of Company A and Company B, and the fair value of the exchange ratio. The appraisals bore out the initial calculations. There were depositions of the experts in the matter. When Mr. X realized that his expert would be unable to sustain his valuations, he offered to buy out the shares of Company A owned by the minority shareholders at our appraised price, thus ending the litigation and avoiding the expense, publicity, and angst of a trial.*

## Pre-Filing Analysis of Alleged Damages

The determination of economic damages often involves a complex analysis with many variables. While it is

not possible to provide an opinion of alleged damages without a thorough review of the facts and circumstances of a case, it is sometimes possible for business valuers to develop a reasonable range within which a conclusion is likely to lie. We are also able to help attorneys develop initial damages theories prior to the filing of damages litigations.

By contacting a business appraisal expert before filing litigation, attorneys and their clients have a sounding board for developing their approach to the matter and are likely to better articulate their claim. Before taking legal action, attorneys and their clients should perform a thorough cost-benefit analysis of a damages litigation to ensure the reasonableness of moving forward with their claim. Discussing the facts of the matter with a business valuation professional can enhance an attorney's understanding of both sides of a cost-benefit analysis: the potential cost of preparing and defending an opinion of damages and the potential amount of awarded damages. For example:

*We received a call from an attorney regarding a potential business damages matter. His client was a manufacturer who had entered into a joint selling venture with another company. After introducing the joint venture partner to its customer base, the partner hired a key employee of the manufacturer who used company records to establish new customer relationships for the joint venture partner.*

*The attorney's client was incensed, and had suggested to the attorney that damages were in the range of \$15 million or more. They had been wronged and they knew it and they wanted to extract maximum punishment from their former partner.*

*We were then provided with some basic documentation regarding the joint venture and the company itself. It was almost immediately apparent that the client's expectation of \$15 million in alleged damages was unreasonable and would be unsupported. A lawsuit was filed asking for damages in the range of \$4 million.*

*The expectations of the client and the attorney were much more realistic as result of our early work. The case settled following a round of depositions, including those of the experts.*

Every damages case is unique, and typically a relatively brief conversation with a business valuation professional can go a long way toward helping counsel understand the merit of a potential damages claim.

## Mediate Before Filing Litigation

In some matters, formal litigation, and its significant costs, may be avoided altogether by engaging a business valuation professional to be an independent voice of reason, jointly retained by the two sides of a dispute. In this context, the business valuation professional reviews the relevant documents, conducts research, holds discussions with representatives of one or both sides of the matter, and ultimately offers a reasonable and independent estimate of value or damages.

From the outset, the two sides may agree to make the business valuation professional's opinion binding or non-binding. Further, the business valuation professional may be asked to prepare a full appraisal or economic damages report, including a detailed narrative and financial analysis, or the work-product may instead be limited to calculations (lacking a detailed narrative) and/or a presentation with descriptive slides.

*As an example, we were engaged in a dispute between a company and a departing shareholder, whose interest was to be purchased by the company pursuant to a buy-sell agreement.*

- *The governing agreement called for an appraisal by a particular business valuation firm, which had already produced a report and provided an opinion of value before we were engaged.*
- *The purchase price was to be paid in the form of (1) an initial cash payment and (2) an amortizing note with annual payments over three years.*

- *The company (represented by its remaining shareholders) claimed the departing shareholder's interest was overvalued.*
- *The buyout would force the company to take on a relatively large amount debt, which could ultimately jeopardize the company's ongoing operations.*

*Before litigation was filed, we were given the opportunity to conduct an on-site management interview and review a number of relevant documents (such as the shareholders' agreement and the appraisal which established the purchase price). Within the existing appraisal, we identified arithmetic errors and internal inconsistencies which contributed to an overvaluation of the subject interest. We also prepared our own valuation, including a leveraged buyout analysis that evaluated the feasibility of taking on significant debt to fund the purchase of the departing shareholder's interest.*

Our analysis, in tandem with our critique of the original appraisal, led to a relatively swift settlement and saved both sides from the costs and risks of battling in court. While our work ultimately led to a reduced price, favoring the company, the departing shareholder understood that the initial appraisal was based on mathematical and other errors. Further, by agreeing to a reasonable purchase price which did not require the company to overextend its capital structure, the departing shareholder and soon-to-be creditor of the company could be confident in the company's ability to satisfy the note issued in conjunction with the buyout.

## Assistance in the Discovery Process

There are few pieces of information about a given company and its economic context that a business valuation professional would not like to review before issuing an opinion of value with respect to such company. In the same vein, there is a good deal of information about a given company and its economic context that a business valuation professional must consider before an unqualified opinion of value can be issued.

In order to comply with prevailing professional standards, business valuation professionals are required to perform adequate due diligence. In a litigation context, making the most of the discovery process is essential to satisfying due diligence requirements and delivering credible expert testimony and supporting work products.

Even seasoned litigators are unlikely to request all of the documents a business valuation professional will need to prepare an appraisal or economic damages report. It is important to engage a business valuation professional early in the discovery process, if not before it begins, to ensure that he or she will have a chance to request necessary documents.

In the discovery process, we typically cast a wide net from the outset, review the documents produced in response, and then issue crucial follow-up requests. Without pre-existing familiarity with the subject business, it is virtually impossible to cover all important information needs in a single request. That is one of the reasons it is important to engage a business valuation professional early in the process and keep him or her up to date with respect to the key dates of the discovery process schedule.

*We once worked in a damage litigation involving a hospital. The period of damages was historical, and ownership of the hospital had changed. During the damages period, the hospital had been a subsidiary of a publicly traded hospital management company. Discovery had not yielded important financial and operational information regarding the hospital over a several year period. The plaintiffs (the former corporate owner of the hospital) claimed that they did not exist.*

*We told counsel that, based on our experience with other hospitals and management companies, the monthly reports had to exist. Substantial public companies do not run subsidiaries without adequate and regular financial and operational reporting. The only possible explanation for their lack of existence would have been that they were destroyed.*

*Armed with this information, counsel was able to once again request the missing information. We obtained the information and were able to use it successfully in our analysis on behalf of the defendant.*

## Preparation of Deposition Questions for Other Experts (and Fact Witnesses)

Business valuation professionals are well-positioned to help attorneys prepare questions for the deposition of opposing business valuation experts and certain types of fact witnesses.

Attorneys deservedly take pride in their ability to ask questions and to extract information from witnesses. However, even expert questioners can use a little help when taking on expert witnesses. Expert witnesses in the field of business valuation speak the language of business valuation, have a keen eye for spotting and honing in on work product weaknesses, and are able to distill an analysis to a handful of key assumptions which drive an expert's opinions. These attributes make business valuation professionals well-equipped to aid counsel in the questioning of other business valuation professionals. Attendance at the deposition of opposing experts can also be helpful at times. The attending expert has an opportunity to see the opposing expert in action and can, if circumstances permit, provide additional lines of questions for counsel based on responses heard.

Another reason for hiring experts early in the litigation process is for assistance in deposing management fact witnesses. Too often, attorneys go through the deposition process before hiring their experts. Then, when the expert needs certain questions asked, the witnesses are no longer available.

In some cases, we have been denied direct access to the management of the subject company in litigation. In this context, the deposition of the subject company's management team members (i.e., fact witnesses) is an imperfect, but nonetheless invaluable forum for

enhancing our perspective of the company and delivering more credible expert opinions.

Experienced litigation support professionals will not only provide a list of questions for the witness. Many questions have one or more likely answers, each of which naturally leads to follow-on questions. If an attorney is armed with good questions and multiple options for follow-up on key issues, the usefulness of depositions can be enhanced. By having conditional lists of questions, the deposing attorney will be in a stronger position to deal with witnesses who attempt to sidestep questions or are generally uncooperative.

## Conclusion

The potential benefits of these not-so-customary services referenced, include:

- » Making the attorney's job easier and leveraging his or her expertise.
- » Developing realistic expectations for damages and/or value in the preliminary stages of litigation (and assisting with managing client expectations).
- » Enhancing the understanding of the strengths and weaknesses of the opposing expert's position(s).
- » Facilitating settlement of litigation with the benefit of early, focused analysis.
- » If appropriate strategically, pointing out errors or logical problems in the opposing expert's work at the deposition stage.
- » Enhancing the prospects of timely settlement.

For more information about Mercer Capital's litigation support services, visit our website at [www.mercercapital.com](http://www.mercercapital.com). To discuss a valuation or litigation-related issue in confidence, contact us at 901.685.2120.

### MERCER CAPITAL

## Industry Newsletters

Mercer Capital's industry publications are listed below. Having built a substantial client base in various industries, we have formalized our research efforts to provide a regular, detailed overview of pertinent issues and relevant current events in each covered industry. These industry newsletters also offer a regular perspective on valuation issues pertinent to various industry groups and sectors.

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