

MERCER CAPITAL

# Business Valuations in Litigation: A Guide for Attorneys

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BUSINESS VALUATION &  
FINANCIAL ADVISORY SERVICES

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# Scott A. Womack, ASA, MAFF



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Scott A. Womack, Senior Vice President, has over 20 years of experience in business valuation. During his valuation career, Scott has worked with clients in a wide variety of industries and for purposes including, gift and estate tax valuation, litigation support, corporate valuation, ESOPs, and financial reporting.

As part of his corporate litigation practice, Scott has deep experience in family law litigation (traditional litigated divorce and collaborative divorce). He assists family law attorneys in divorce matters including business valuation, forensic accounting, and division of the marital estate, among others. Scott has testified in several jurisdictions involving family law matters. Scott is a regular contributor to Mercer Capital's Family Law Valuation and Forensic Insights monthly newsletter.

Scott also assists estate planning attorneys throughout the nation in federal and state gift and estate tax valuation matters. In addition, he has testified in Tax Court.

While Scott has provided valuation services for clients in a wide variety of industries, he has significant experience in the auto dealership industry. As the leader of Mercer Capital's Auto Dealership Industry team, Scott provides valuation services to dealerships throughout the U.S. related to corporate planning and reorganization, transactions, employee stock ownership plans, litigation support, and tax issues as well as valuations of intangible assets, and assets subject to specific contractual restrictions. Scott and his team also consult with auto dealer clients in the process of selling or buying. Additionally, Scott publishes research related to the auto dealership industry and is a regular contributor to Mercer Capital's weekly blog, Auto Dealer Valuation Insights.

Other notable industry experience includes heavy equipment dealerships, healthcare, general & specialty contracting, construction, income-producing real estate, distribution, food services, hospitality, manufacturing, retail, technology, and transportation.

Scott is often a featured speaker for auto dealer industry groups, family law associations, attorneys, accountants, business appraisers, and business professionals on various valuation and financial advisory topics.

# Why are Valuations different?

Art vs. Science



# What is the Purpose of a Business Valuation?

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**To protect the  
integrity of the  
transaction or event**

# When & Why a Valuation is Needed?

## Valuation Triggers: 4 Basic Quadrants

(Generally) Not  
Regulatory  
Driven

### Litigation

- Buy/Sell Disputes
- Family Law
- Contract Disputes
- Business Torts
- Tax Disputes
- Dissenting Shareholder Disputes
- ESOP/ERISA Disputes
- Bankruptcy
- Economic Damages

### Transactional

- Sale of Business (Pricing / Negotiations)
- Buy/Sell Agreements
- Stock Exchange / Public Co. / IPO
- Installment Sale
- ESOP's
- Fairness Opinions
- Incentive / Corporate Planning

Regulatory  
Driven

### GAAP / Financial Reporting

- ASC 805 - Allocation of Purchase Price
- ASC 350 & 360 Impairment
- ASC 718 - Equity Based Compensation
- ASC 820 - Portfolio Valuation

### Tax

- Estate & Gift Taxes
- Charitable Gifting
- 409(a) Transactions
- IRC 367(d) "Toll Charge"
- Transfer Pricing
- IRC 197 – Allocation of Purchase Price
- Corporate Reorganizations & Basis Step Ups
- IRC 280G "Golden Parachute"

# What to Look for in an Expert

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1. Excellent reputation
2. A “professional witness?”
3. Ability to provide insights from business and valuation perspectives
4. Valuation experience and credentials
5. Publications and speaking background
6. Testimony experience (plaintiffs, defendants, or both)
7. Communications skills (need to explain complex financial issues in layman’s terms)
8. “Grace under pressure”
9. Does the expert have the time and support to handle the matter under consideration
10. Independence
11. Industry experience?

# Credentials/Licenses

## YES

ASA  
CVA  
ABV  
CFA

## MAYBE

CPA  
CFE  
Economist  
Professor  
Ph.D.

## NO

Business Broker  
CFP

# Assignment Definition

Business Name	ABC Company
Business Interest Under Consideration	100%, XX%, or TBD Non-Controlling Interest
Standard of Value	Fair Market Value
Level of Value	Non-marketable, minority interest
Effective Date	December 31, 2020
Type of Engagement	Appraisal Report



# Date(s) of Valuation

## Why is this possibly ‘tricky?’

- Any Separate/Non-marital Component?
  - Date of Marriage
- State Statue
  - Date of Separation
  - Current/Date of Trial
  - Agreed-upon Date depending on reporting
- Passing of time – lengthy processes
  - Report date > Trial date
  - Update or new valuation necessary?

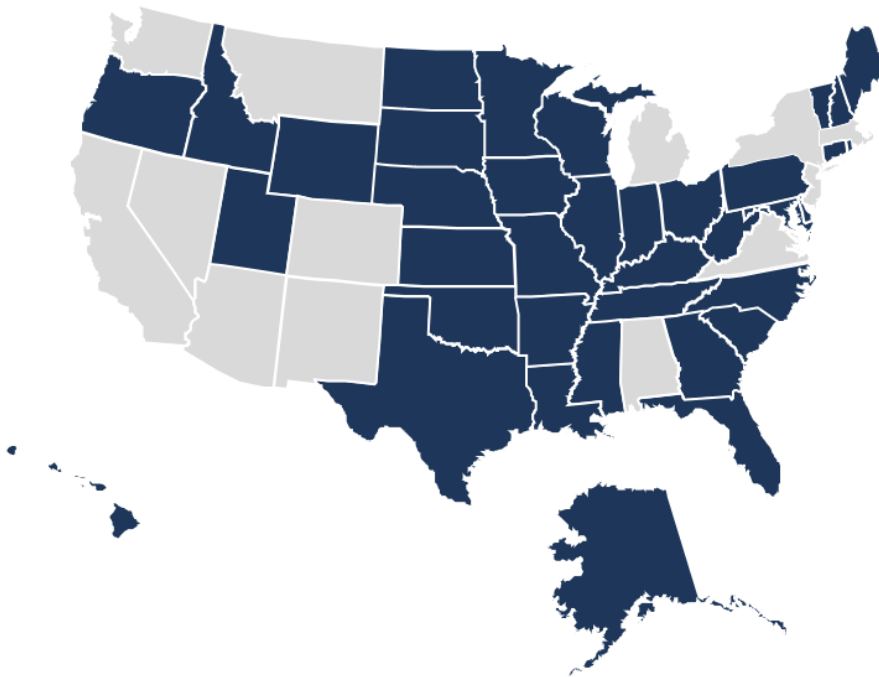


# Standard of Value

Most of us are in Fair Market Value states. Confirm if you are hired out of state (Others include Fair Value and Investment Value)

## Fair Market Value

AK, AR, CT, DC, DE, FL,  
GA, HI, IA, ID, IL, IN,  
KS, KY, LA, ME, MD, MN,  
MO, MS, NC, ND, NE, NH,  
OH, OK, OR, PA, RI,  
SC, SD, TN, TX, UT,  
VT, WI, WV, WY



# Ownership Interest Under Consideration

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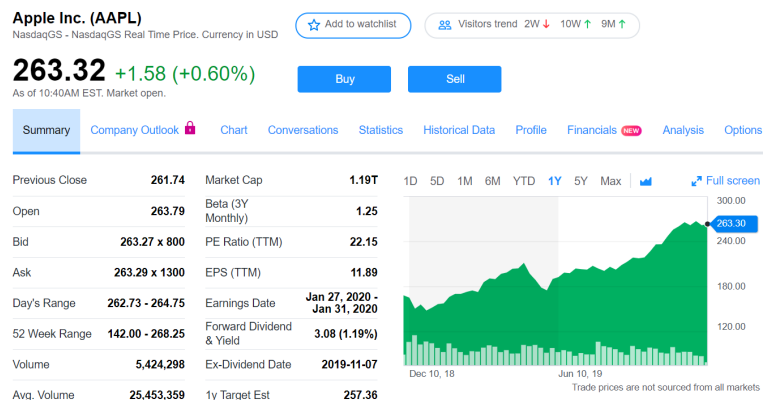
- **Confirm in planning phase**
  - Any changes in owned % interest during marriage?
- **Level of Value**
- **DLOC and DLDM**
  - Confirm with state statute



# Business Valuation

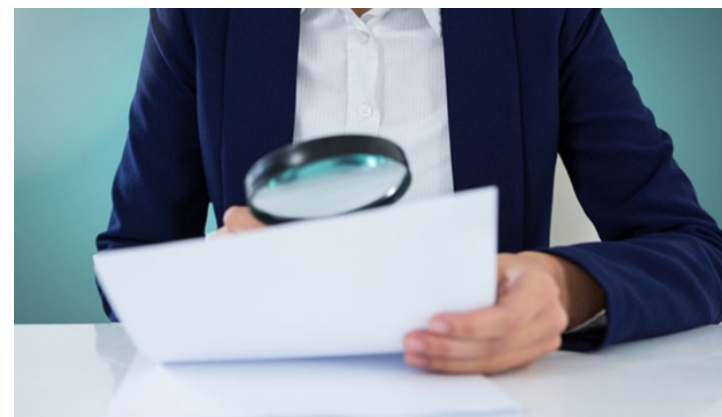
Business valuation is the process of determining the value indication of a business, business ownership interest, security, or intangible asset. The process is similar to the valuation of public interests, and the work product resembles a real estate appraisal.

## Public Company



Traded on an exchange like NYSE or NASDAQ;  
 Price of shares readily available

## Private Company



There is no public market with frequent buyers and sellers;  
 Hypothetical Buyer and Seller

# Valuation Approaches

Real Estate vs. Business/Company

# Valuation Approaches

## Asset-Based Approach

Considers cost or market values of the Company's tangible assets and liabilities

## Income Approach

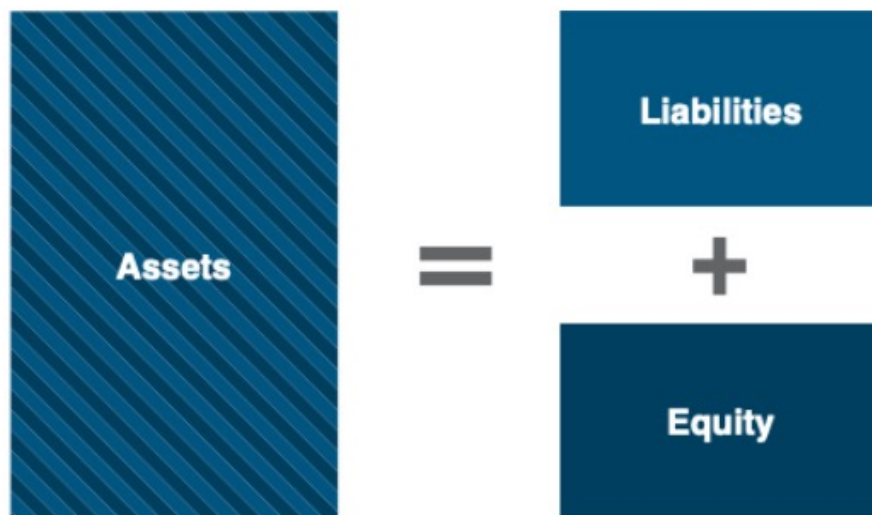
Utilizes expected future earnings, discounted back to present or a single capitalization of one or more earnings measures

## Market Approach

Utilizes pricing metrics from public companies, private company transactions, or transactions within the entity itself

# Asset-Based Approach

The fundamental accounting equation expresses the relationship between the company’s assets, liabilities, and equity



## When May an Asset-Based Approach be Appropriate?

- Asset-intensive businesses
- Asset holding entities
- Recession/Economic Downturns

Note: Further appraisals may be necessary – examples: property appraisal, equipment or inventory appraisal.

**Adjusted Book Value** : A method within the asset approach whereby all assets and liabilities (including off-balance sheet, intangible, and contingent) are adjusted to their fair market values. Common terms referring to this approach:

- Cost approach
- Replacement approach
- Liquidation value

# Income Approach

\* There are **MULTIPLE** methods in this approach

*No matter the specific approach taken, an income approach is a general way of determining the value of a business by converting anticipated future economic benefits into a single present amount.*

## Single Period Capitalization Methods

Capitalization of Earnings Method

Capitalization of Cash Flow Method

## Multi-Period Capitalization Method

Discounted Cash Flow Method



# Theoretical Basis – Single Period Method

**The Gordon  
Growth Model**

$$\text{Value} = \frac{\text{CF}}{(r - g)}$$

**Value = Earnings x Multiple**

?



**Value increases when:**

- Cash flow increases;
- Growth increases; and
- Risk decreases

# Simple Example & Terms to Know

## Application of the Gordon Model Value Indication

Expected Cash Flow ( <b>CF</b> )	\$1,000
Constant <b>Growth Rate</b> of CF ( <b>g</b> )	10%
<b>Discount Rate</b> ( <b>r</b> )	20%
<b>Capitalization Rate</b> ( <b>r-g</b> ) (20%-10%)	10%
<b>Capitalization Factor/ Multiple</b> ( <b>1/r-g</b> ) (1/10%)	10.0x
<b>Value = Earnings x Multiple</b> (\$1,000 x 10.0x)	\$10,000

# Valuation Adjustments in Valuations for Divorce

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- **Importance of Adjustments**
- **Importance of Adjustments in Divorce**
  - Potential for altering the financial position of the business and/or compensation of divorcing party in anticipation of divorce
- **Specifically,**
  - Owner Compensation
    - How is the owner is paid over a period of time not just at the current day?
    - Possible pay-out arrangements?
  - Perquisites
    - Support marital/family lifestyle?
  - Non-Recurring Items: Litigation, Insurance, Hail/Tornadoes
  - Others, ex: rent expense if related-party entities

# Discount Rate Components

- Risk-Free Rate
- Equity Risk Premium
- Market Beta
- Size Premium
- Specific Company Risk

Derivation of Capitalization Factor		
Risk-Free Rate		2.15%
Equity Risk Premium	5.50%	
Guideline Beta	1.00	
Beta Adjusted Common Stock Premium		5.50%
Size Premium		5.22%
Specific Company Risk Premium		6.00%
Equity Discount Rate (Required Rate of Return)		18.87%
- Sustainable/Perpetual Growth Rate in Earning Power		-4.50%
Capitalization Rate		14.37%
Capitalization Factor		6.96
<b>Capitalization Factor</b>		<b>6.95</b>

# Specific Company Risk

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- Economic (National, Local, Regional)
- SWOT Analysis
- Management Depth
- Dependence on Key Man/Relationships
- Customer Concentration
- Supplier Constraints
- Competition
- Labor

# Change in “r”

Derivation of Capitalization Factor	
Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	6.00%
Equity Discount Rate (Required Rate of Return)	18.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-4.50%
Capitalization Rate	14.37%
Capitalization Factor	6.96
<b>Capitalization Factor</b>	<b>6.95</b>

Determination of Value	
Ongoing Earning Power	\$750,000
Capitalization Factor	6.95
Capitalized Earnings Value	\$5,212,500
<b>Indicated Value: Capitalization of Earnings Method</b>	<b>\$5,213,000</b>

Derivation of Capitalization Factor	
Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	2.00%
Equity Discount Rate (Required Rate of Return)	14.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-4.50%
Capitalization Rate	10.37%
Capitalization Factor	9.64
<b>Capitalization Factor</b>	<b>9.65</b>

Determination of Value	
Ongoing Earning Power	\$750,000
Capitalization Factor	9.65
Capitalized Earnings Value	\$7,237,500
<b>Indicated Value: Capitalization of Earnings Method</b>	<b>\$7,238,000</b>

# Change in “g”

Derivation of Capitalization Factor	
Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	6.00%
Equity Discount Rate (Required Rate of Return)	18.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-4.50%
Capitalization Rate	14.37%
Capitalization Factor	6.96
<b>Capitalization Factor</b>	<b>6.95</b>

Determination of Value	
Ongoing Earning Power	\$750,000
Capitalization Factor	6.95
Capitalized Earnings Value	\$5,212,500
<b>Indicated Value: Capitalization of Earnings Method</b>	<b>\$5,213,000</b>

Derivation of Capitalization Factor	
Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	6.00%
Equity Discount Rate (Required Rate of Return)	18.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-2.00%
Capitalization Rate	16.87%
Capitalization Factor	5.93
<b>Capitalization Factor</b>	<b>5.95</b>

Determination of Value	
Ongoing Earning Power	\$750,000
Capitalization Factor	5.95
Capitalized Earnings Value	\$4,462,500
<b>Indicated Value: Capitalization of Earnings Method</b>	<b>\$4,463,000</b>

# Change in “Earning Power”

Derivation of Capitalization Factor		
Risk-Free Rate		2.15%
Equity Risk Premium	5.50%	
x Market Beta	<u>1.00</u>	
Beta Adjusted Common Stock Premium		5.50%
Size Premium		5.22%
Specific Company Risk Premium		<u>6.00%</u>
Equity Discount Rate (Required Rate of Return)		18.87%
- Sustainable/Perpetual Growth Rate in Earning Power		<u>-4.50%</u>
Capitalization Rate		14.37%
Capitalization Factor		6.96
<b>Capitalization Factor</b>		<b><u>6.95</u></b>

Determination of Value		
Ongoing Earning Power		\$750,000
Capitalization Factor	<u>6.95</u>	
Capitalized Earnings Value		\$5,212,500
<b>Indicated Value: Capitalization of Earnings Method</b>		<b><u>\$5,213,000</u></b>

Derivation of Capitalization Factor		
Risk-Free Rate		2.15%
Equity Risk Premium	5.50%	
x Market Beta	<u>1.00</u>	
Beta Adjusted Common Stock Premium		5.50%
Size Premium		5.22%
Specific Company Risk Premium		<u>6.00%</u>
Equity Discount Rate (Required Rate of Return)		18.87%
- Sustainable/Perpetual Growth Rate in Earning Power		<u>-4.50%</u>
Capitalization Rate		14.37%
Capitalization Factor		6.96
<b>Capitalization Factor</b>		<b><u>6.95</u></b>

Determination of Value		
Ongoing Earning Power		\$500,000
Capitalization Factor	<u>6.95</u>	
Capitalized Earnings Value		\$3,475,000
<b>Indicated Value: Capitalization of Earnings Method</b>		<b><u>\$3,475,000</u></b>



# Market Approach

\* There are **MULTIPLE** methods in this approach

## Guideline Public Company Method

A method within the market approach whereby market multiples are derived from market prices of stocks of companies that are engaged in the same or similar lines of business, and that are actively traded on a free and open market.

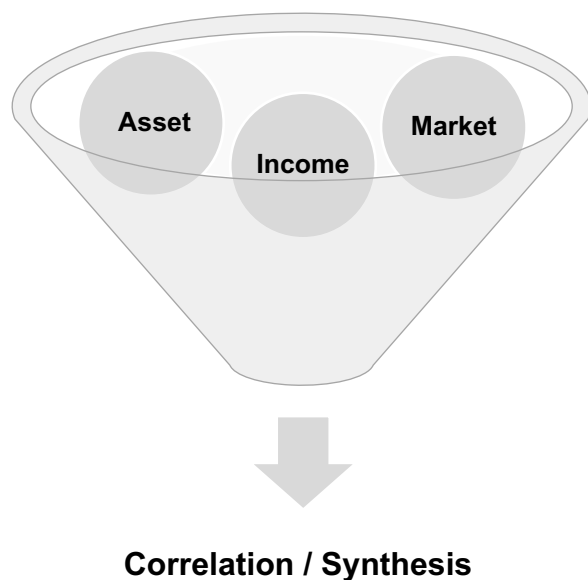
## Guideline Company Transactions Method

Pricing multiples are derived from transactions of significant interests in companies engaged in the same or similar lines of business.

## Transactions Method

Develops an indication of value based upon consideration of actual transactions of the subject company.

# Synthesis of Valuation Approaches



A proper valuation will factor, to varying degrees, the indications of value developed utilizing the three approaches outlined.

A valuation is much more than the calculations that result in the final answer.

**It is the underlying analysis of a business and its unique characteristics that provide relevance and credibility to these calculations.**

# What are some common flaws to look for in Valuation Reports?

# Common Flaws

1. Too much precision in assumptions/conclusions – DL0M, Specific Company Adj.
2. Not using acceptable methodology or ignoring relevant methodology
3. Double counting/biased assumptions
4. Not listing or relying on source documents
5. Inability to defend assumptions and link to source documents



# Double/Triple Counting Example

	1	2	3
	Judgmental Key Person Discount	Incremental Company Specific Risk	Lower Expected Cash Flows and Lower Growth
Long-Term Treasuries	1.80%	1.80%	1.80%
Equity Risk Premium	5.50%	5.50%	5.50%
Beta	1.25	1.25	1.25
Beta-Adjusted ERP	6.88%	6.88%	6.88%
Size Premium	5.50%	5.50%	5.50%
Company-Specific Risk	1.00%	1.00%	1.00%
Key-Person Risk Premium	0.00%	<b>3.07%</b>	<b>0.00%</b>
Equity Discount Rate	15.18%	18.24%	15.18%
Expected Long-Term Growth	-3.00%	-3.00%	
Expected Growth w/o Key Person			<b>-2.50%</b>
Equity Cap Rate	12.18%	15.24%	12.68%
Multiple (1 / Cap Rate)	8.20	6.56	7.89
Net Cash Flow to Equity	\$1,000,000	\$1,000,000	<b>\$831,480</b>
Expected Cash Flow w/o key Person			
Multiple (per above)	8.20	6.56	7.89
Initial Edquity Estimate	\$8,200,000	\$6,560,000	\$6,560,000
Key Person Discount	<b>-20%</b> (\$1,640,000)	\$0	\$0
Marketable Minority/Financial Control Value	<b>\$6,560,000</b>	<b>\$6,560,000</b>	<b>\$6,560,000</b>

# Special Topics

# Separate vs. Marital Component?

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- **Pre-marital ownership?**
- **Inheritance?**
- **Acquiring additional ownership during the marriage?**
- **State Statue**
  - Equitable Division, Community Property or Dual Class
- **Understand involvement of divorcing party**

# Separate vs. Marital – TN Code 36-4-121

- (b)(1)(A) Marital property – defined as all personal property, both tangible and intangible, acquired by either spouse during the course of the marriage.
- (b)(1)(B) Marital property includes income, and any increase in value during the marriage of, property determined to be separate property in accordance with subdivision (b)(2) if each party substantially contributed to its preservation and appreciation. Contribution must be “real” and “significant”.
- (b)(1)(D) As used in this subsection (b), substantial contribution may include, but not limited to, the direct or indirect contribution of a spouse as a homemaker, wage earner, parent or financial manager, together with such other factors as the court have jurisdiction thereof may determine.
- (b)(2)(A) Separate property means all property owned by a spouse before marriage, including, but not limited to, assets held in individual retirement accounts (IRAs) as that term is defined in the Internal Revenue Code 1986 as amended.



# Active vs. Passive Appreciation

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Appreciation – the rise in value of an asset, such as current real estate or business. Increases in value can be attributed to interest rate changes, supply and demand changes, or various other reasons.

# Active vs. Passive Appreciation

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Active Appreciation – the rise in, or increase in value, due to the active, direct and indirect, efforts of one or both spouses.

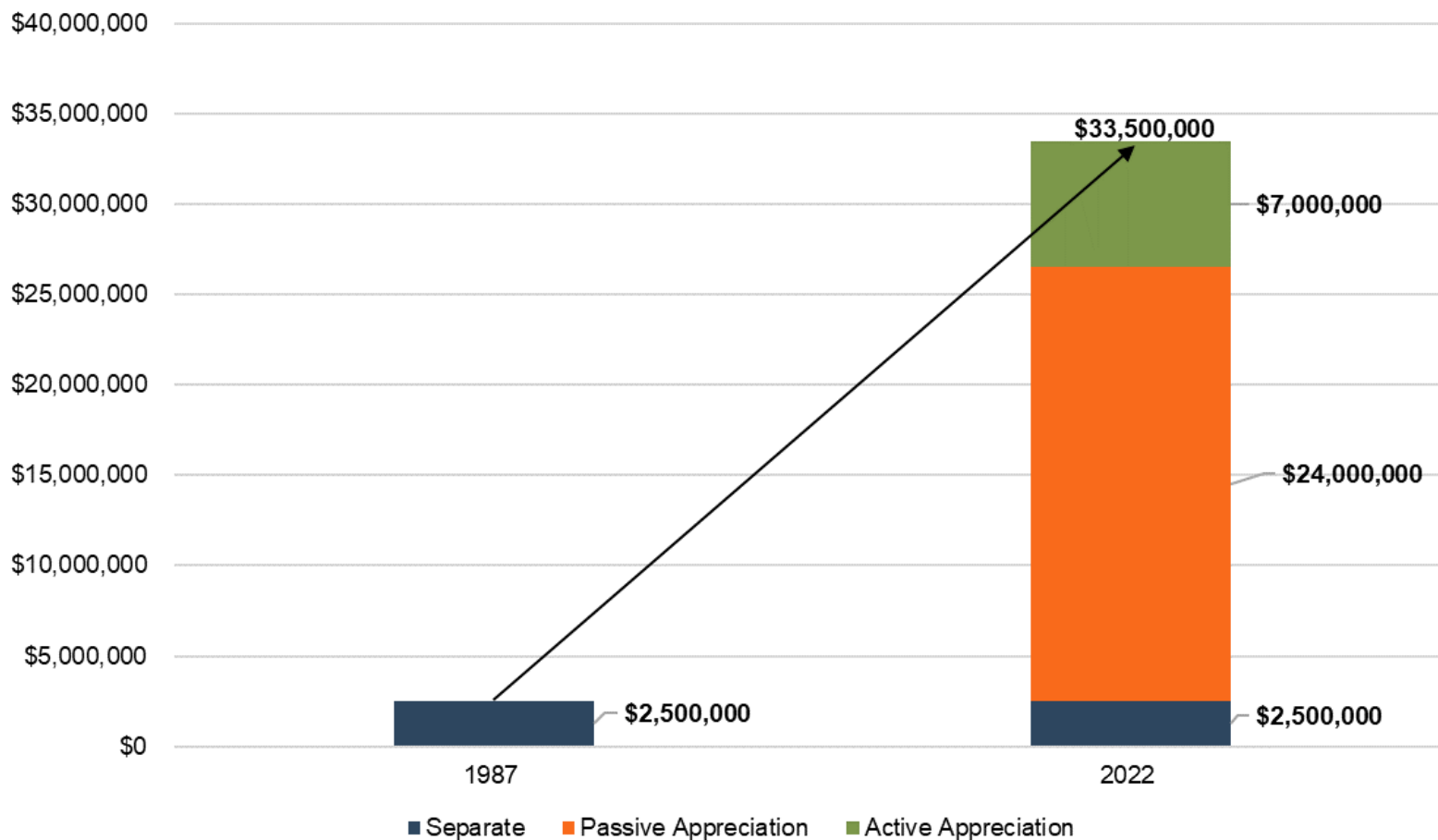
# Active vs. Passive Appreciation

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“

Passive Appreciation – the rise in, or increase in value, due to external factors, such as the market.

# Active vs. Passive - Example



# Personal vs. Enterprise Goodwill

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- Depends on the unique facts and circumstances of the underlying entity and individual
- **Enterprise Goodwill:** derived from characteristics specific to the business, regardless of who operates it.
  - Examples could be franchises, nationally known names of business, others...
- **Personal Goodwill:** derived from characteristics specific to the individual.
  - Examples could be a solo service-provider with limited staff and saleable opportunity, or, another example could be a person with unique, specialized skillset that would be not transferable in a sale if he/she was not present.

# Why is Personal vs. Enterprise Goodwill Important

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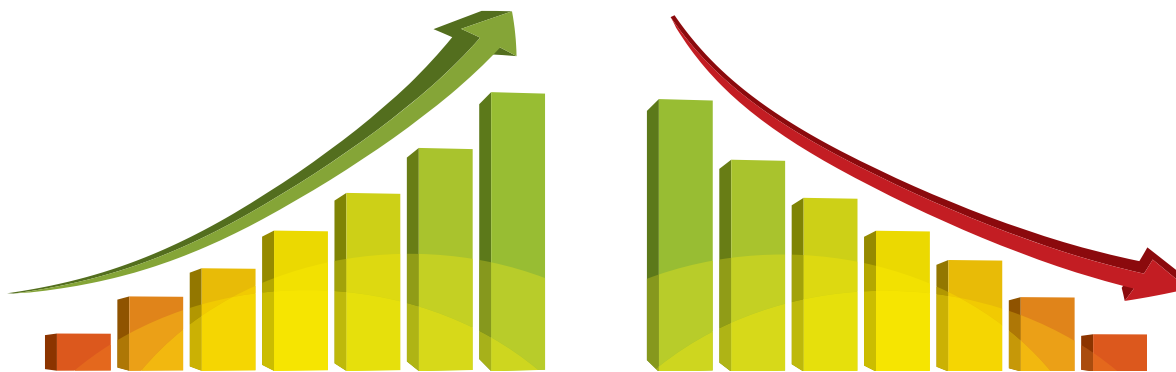
- **Thorough analysis necessary**
  - Various reasonable methodologies
  - Refer to statute and state precedent
  - Work closely with your attorney
- If personal goodwill is present, and you are in a state that treats it as separate, that component (often a % expressed then in dollar amount) becomes non-divisible
- **Often, this is where experts (or clients!) disagree**

# Covid Impact vs. Divorce Recession

- Covid winners vs. Covid losers
- Divorce Recession
- Industry/Economic Factors

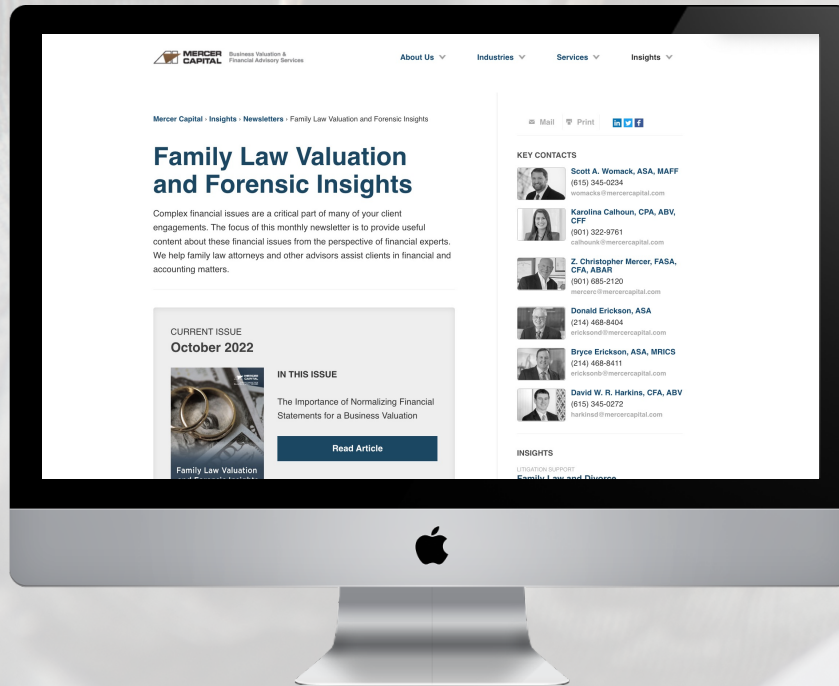
## WHAT is the goal?

To determine the ongoing, sustainable earnings or cash flow of the business



MERCER CAPITAL'S MONTHLY NEWSLETTER

# Family Law Valuation and Forensic Insights



Complex financial issues are a critical part of many divorces. The focus of this monthly newsletter is to provide useful content about these financial issues from the perspective of financial experts.

**SUBSCRIBE**

*We help family law attorneys and other advisors assist clients in financial and accounting matters.*

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# Mercer Capital's Family Law Services

Mercer Capital is a national business valuation and financial advisory firm. We are frequently engaged to provide support in family law and divorce disputes. We bring a team of experienced and credentialed experts and over 35 years of experience to the field of valuations, forensic analysis, and litigation support. Assisting our clients through the entire dispute process, we provide initial consultation and analysis, as well as testimony and trial support. We provide services to litigated divorces, as well as collaborative/mediated divorces.

## Valuation Services

- Valuations of Businesses, Interests in Business Professional Practices, and Sports Teams
- Valuations of Intellectual Property, Tradename, and Other Intangible Assets
- Valuations and Determination of Personal vs. Enterprise Goodwill and Active vs. Passive Appreciation
- Valuations of Stock Options, Restricted Stock, Pensions, Notes, and Other Investment Assets
- Valuations of Compensation Agreements
- Business Damages
- Lost Profits Analysis
- Assist with Depositions, Mediations and Trial Preparation
- Expert Testimony

## Forensic Services

- Assistance with Financial Affidavits
- Equitable Distribution Analysis
- Lifestyle Analysis / Pay and Need Analysis
- Income Determination
- Alimony Scenario Analyses
- Classification of Assets and Liabilities
- Tracing Services
- Dissipation Analysis
- Business Disruption Analysis
- Damages Analysis
- Lost Profits Analysis
- Assist with Depositions, Mediations and Trial Preparation
- Expert Testimony

## Advisory Services

- Expert Witness Testimony
- Serving in Arbitration as Court-Appointed and/or Mutually Agreed-Upon Experts
- Serving as the Financial Neutral in a Collaborative Divorce
- Assistance with Discovery
- Critique of Opposing Expert Reports
- Impact of Transactions on Valuation
- Economic Research
- Public Securities, Market, and Industry Research
- Assistance with Depositions and Cross-Examination
- Preparation of Demonstrative Exhibits for Trial
- Other Consulting Services

# Mercer Capital's Core Services

Mercer Capital is a national business valuation and financial advisory firm

## Valuation & Financial Opinions

- Litigation-Related Expert Witness Opinions
- Succession & Shareholder Planning
- Valuations for Corporate Tax Planning
- Valuations for Gift & Estate Tax Planning
- Fairness Opinions
- ESOP & ERISA Advisory Services
- Bankruptcy-Related Valuation Services
- Valuations for Buy-Sell Agreements

## Transaction Advisory Services

- M&A and Investment Banking Services
- Bankruptcy/Restructuring Advisory
- Fairness Opinions
- Solvency Opinions
- Quality of Earnings

## Litigation Support Services

- Business Damages & Lost Profits
- Corporate Restructuring & Dissolution
- Statutory Fair Value
- Valuation, Labor & Contract Disputes
- Family Law & Divorce
- Tax-Related Controversies
- Initial Consultation & Analysis
- Testimony & Trial Support

## Financial Reporting Valuation Services

- Purchase Price Allocation Services
- Impairment Testing Services
- Portfolio Valuation Services
- Equity-Based Compensation Valuation

## Family Business Advisory Services

- Customized Board Advisory Services
- Management Consulting
- Independent Valuation Opinions
- Transaction Advisory Services
- Confidential Shareholder Surveys
- Benchmarking/Business Intelligence
- Shareholder Engagement
- Shareholder Communication Support



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