Valuation on Trial – A Slice of Life

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Often, from the valuation expert's point of view, and as an instructional tool, trial testimony can be routine and nothing to write home about. That is because many times there are no real fireworks in the testimony, perhaps it's a one-sided situation, perhaps the differences are rather minor. Whatever, you can almost sleep through the testimony. Fortunately, once in a while we come across a situation which is truly interesting, where the issues raised have some heft.

Not long ago, this author was involved in testifying in a divorce case where the key issues revolved around a few aspects of valuation, and where both of the experts were knowledgeable about theory and procedure, and presented their arguments well. Essentially, there were four items of particular interest in the testimony – three clearly involving valuation, and one touching on same. These involved reasonable compensation, the use of the industry specific factor from Morningstar in the build-up of the cap rate, the choice of a growth rate in the development of the cap rate; and also, relevant to concerns as to ultimate equitable distribution allocation, the latent or hypothetical tax inherent in the assumed values. Let us briefly deal with each of these issues.

<u>Reasonable Compensation</u> – by far, the single biggest issue being litigated in this matter was the determination of reasonable compensation, with the two experts $250,000 apart. Both experts used, in part, the same source data, and in part an additional source data by one of the experts. To further fine-tune the area of disagreement, it essentially revolved around two arguments – the use of a median versus an upper percentile compensation level; and the extent that the sources chosen relied on owner income as contrasted with hired employee compensation.

- <u>Median versus selected percentile range</u> – one expert used the median compensation, whereas the other expert used the 75th percentile. The arguments in favor of the median essentially ran along the lines of, barring a true star, the need is to replace the business owner with someone who could fill his/her shoes, do the job, run the business and succeed of course in giving a return on investment to the hypothetical buyer. That argument continued along the lines that we are looking not necessarily to replace the particular individual, but rather to fill the position in a fashion that would enable the business to continue in the fashion it had in the past. The argument relevant to a high percentile was that this business was doing better than its peer group, and it was felt that was attributable to the superior performance of the current owner. Thus, so went the argument, it would take a greater reasonable compensation to replace him/her. Further, that using a median failed to do justice to the higher level of return that the current owner accomplished; and further would put the company in jeopardy of not being as successful in the future because of using "only" an average person in that role.

The counter response to those arguments was that the source data implicitly and explicitly used data relevant to individuals qualified to run that type of business, and that part of the superior performance (which was indeterminable with any greater specificity) was location and the presence, or absence, of a certain level of competition. Thus, the position could and should be filled adequately by the so-called average, and to use anything higher would be to impute some of the goodwill return of that business to the owner's compensation and thus in a sense perversely penalize the company's value for its greater performance;

- Owner versus employee compensation – the other aspect litigated very hard on the reasonable compensation issue, and to a degree connected to the preceding, was to address the concern as to what extent the sources of data relied on owner income figures for their study, as contrasted with an arm's length employee level of compensation. The expert arguing in favor of the use of median compensation posited that the sources relied too heavily on owner income figures, and thus started out with a bias that was already on the high side, and distortive of the concept of replacing an owner with an arm's length hired arrangement. The expert favoring the higher reasonable compensation (the 75^{th} percentile) countered that the data sources were not that clear as to what percentage of their pool of information came from owners as contrasted with employee data, and that the overriding issue still was the matter of recognizing a higher level of reasonable compensation under the circumstances of a higher performing business operation. That expert also took the position that the person whose business we were valuing had a high, and even superior, level of education and training, which therefore in turn entitled that person to a higher level of reasonable compensation. The other expert in response to that last item countered that while the high level of education and training was true, from the literature and information available it appeared the data pool used by the sources were comparing equals, and that subject's level of education and training was typical for the position being considered.

The Judge decided in favor of the higher reasonable compensation, with apparently the major logic for that being that the company's higher level of profitability and successful performance warranted a higher level of reasonable compensation.

Cap Rate – The second major area of dispute involved the development of the capitalization rate, with two issues argued in respect to same. The first was the proper use of the industry specific premium, and the other was the appropriate growth rate.

- Industry specific premium – one expert used the industry specific premium, which in this case was a several point adjustment to the cap rate. The other expert did not use the industry specific. Thus, there was a several point difference in the cap rate due to this one item – which represented a significant degree of the difference between them in their valuations. The argument in favor of its use was that information was available from the same data source used by both of them (Morningstar), and it was on point to the industry at hand. The expert against its use argued that there were two shortcomings in using same – the size of the company and the degree of comparability. As to the size, it was pointed out that the company being valued was much smaller than any of the companies within the industry specific category. The difference was in the order (in terms of sales) of a multiple of thousands. In addition, that expert argued that the company being valued was not sufficiently comparable to those in the SIC Code referenced by the industry specific category, and thus it was using a factor that was not intended for this specific type of business. The expert favoring the industry specific countered by pointing out that the source book itself referenced that the size of the business is not relevant, but rather the economic forces that act upon it. That is, the source book illustrated an example where even a multiple of 10,000 times in size did not preclude (in the eyes of the promulgator of this source) the use of same – the argument being that these much larger companies were not being used for purposes of comparability in a market approach to value, but merely in the development of the cap rate. In addition, the argument went that the economic forces impacting the industry in general were the same economic forces impacting this business which operated in only one part of this broad industry.

- Growth rate – one expert used a 3% growth rate – explaining that in the absence of an industry specific supportable growth rate, it was customary to use long term inflationary expectations. That expert also argued that the subject business had essentially reached its maximum capacity, and therefore it was unlikely that it could grow at greater than a 3% rate. The other expert used a 5% growth rate, pointing to the company's history of growing greater than 5% per year, and that (as both experts agreed) the outlook for this specific company and the field in which it operated was very positive, and that there was an above average demand for its product/services. Neither expert was able to come up with an industry specific research report that would support any specific growth rate. As an interesting sidebar, since the litigation stretched out over a period of time, tax returns were available for two years subsequent to the date of the valuation, and they were brought in for, among other things, purposes of supporting/refuting assumptions made relevant to growth. The subsequent returns showed that in the year following the valuation date, the company's sales grew by over 20% (and the bottom line even more), and then in the second year following the valuation date sales were flat, maintaining the immediately prior year's higher level of sales and net.

The Judge found in favor of the use of the industry specific premium; and also found in favor of using a 3% growth rate.

The final area being covered in this article dealt with the presentation, for the Court's consideration, of the tax basis relevant to the proposed values. The expert representing the business owner was not asked to provide any information; the other expert was – and for obvious reasons. The business owner's attorney argued that it was necessary to take into account the anticipated taxes on the value in determining the appropriate allocation in equitable distribution. That attorney suggested to the Court that the appropriate tax rate should be applied to the totality of the value. The expert representing the non-business owner spouse was asked to explain what the tax would be were it to actually happen, so that the

Court could work with real hypothetical numbers. As that expert illustrated, because the business at hand was an S corporation, and because a fair amount of earnings had been retained within the company, the shareholder's/owner's basis was rather substantial. Thus, regardless of which value was to be used, and that expert illustrated taxes based on both values, the amount of the tax was not all that significant. When it came to allocation for equitable distribution purposes, the difference between applying the tax to the total value in contrast only to that in excess of basis, was hundreds of thousands of dollars. As a sidebar comment, this area is probably overlooked all too often. Typically clients, as well as attorneys, do not realize how substantial the basis may be, and thus how low the taxes on that value may be.

The cliché about every case being different and each standing on its own merits is of course true. Nevertheless, the issues raised and arguments presented in this case, and the lessons learned during the give and take between the experts, are of value in the broader world of valuation, rather than merely to this one limited case. This was just one case involving two experts, two attorneys and one judge, and one specific business. It is conceivable that a different judge, with a different business and different experts, would rule differently as to various, or even all, of the disputed elements of the case.

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