



IN RE MARRIAGE OF ROSS

Court Analyzes Appropriate Earnings Period to Use in Valuation of Law Practice

In re Marriage of Ross, 2010 WL 1693552 (Cal. App. Dist 2) (April 28, 2010) (unpublished)

The husband was a successful attorney, grossing over \$700,000 per year prior to the couple's separation in 2003 and over \$1 million afterward. At the couple's divorce trial, both parties presented qualified expert business appraisers, who both used the law firm's year-end financial information closest to the date of separation. Both experts also used the capitalization of excess earnings method to determine goodwill. In fact, the only significant differences between the two valuations were: 1) the time period used to calculate the husband's income; and 2) the inclusion of the husband's capital account.

For instance, the husband's expert did not include the capital account, valued at \$456,000, because the husband had no property interest in it; the operating partnership agreement did not permit the husband to take the account with him upon withdrawal or retirement. The husband's expert also used average earnings over the five years prior to separation (in 2003) to calculate a range of values for the law practice, from approximately \$205,000 to \$473,000.

The wife's expert included the value of the husband's capital account, because the partnership agreement made the funds available to the husband throughout his employment. In 2000 and 2002, for example, the husband's K-1s showed that he'd received partnership distributions in amounts exceeding his share of the law firm's income and that his capital account was reduced accordingly. Likewise, the husband took less than his share of law firm income in 2003 and received a commensurate credit to his capital account.

Further, the wife's expert used the husband's 2003 income as the "most representative" of his earning power at the end of the marriage. He ultimately valued the husband's interest in his law firm at just over \$1.2 million. In its final orders, the trial court said that it would utilize the calculations by the wife's expert, including the husband's capital account, to value his interest in the law firm at \$941,000. The husband appealed, essentially arguing the trial court should have used his expert's calculations.

Earnings should 'reasonably illustrate' current rate. The appellate court began by stating that applicable law (California) permits the use of the capitalization of excess earnings method to value an interest in a private professional practice. "Pursuant to this method, one first determines practitioner's average annual net earnings (before income taxes) by reference to any period that seems reasonably



illustrative of the current rate of earnings." The excess earnings methods not the only measure of goodwill, the court added. Any "legitimate method that measures its present value by taking into account some past result" is acceptable.

The husband claimed his income "fluctuated wildly" during the marriage, and thus the trial court should have used an average of earnings to calculate value instead of using the wife's expert's calculations. But the trial court did not adopt these figures in full, the appellate court pointed out—it only "utilized" them as the basis for its own determination, which was roughly \$256,000 less than the value by the wife's expert. Further, before settling on his five-year average income base, the husband's expert calculated potential range of goodwill values based on two and three-year averages of just over \$545,000 to nearly \$600,000. Adding this figure to the value of the capital account produced values exceeding \$1 million. Thus, substantial evidence supported the trial court's determination, the court held.

Similarly, the appellate court rejected the husband's claims that the "goodwill value" of his capital account should not have been included in the final value of his law practice. The partnership agreement only addressed his rights departure; it did not deprive him of a "present, possessory interest" in the account. The trial court determined the value of the husband's interest in the law practice—not his contractual right son withdrawal—and the appellate court upheld the \$941,000 valuation.

CVS Comment: In family law disputes involving service and professional practices, including medical practices, we often see disputes over internal corporate buy/sells as related to their accrued capital accounts and FMV of the Subject Interest. There are cases in Illinois that do provide that if an appraiser can demonstrate FMV is higher than the corporate buy/sell agreement, that the courts can consider the higher FMV.



Defendant Uses *Daubert* to Deconstruct Expert's DCF in Beer Distribution Case

Warren Distributing Co. in InBev USA, LLC, 2010 WL 2179167 (D. N.J.) (May 28, 2010)

In 2006, New Jersey passed the Malt Alcohol Beverage Practices Act—a “watershed moment in the history of brewer-distributor relationships... that led to a new world of rights and inherent value,” according to the federal district court. In particular, the law precludes a successor brewing company from terminating its predecessor’s wholesale distribution agreements without paying fair market value to the wholesalers for any terminated brands.

The act came into play when Anheuser Busch purchased several domestic and European brands from a large national brewer (In Bev U.S.A.), but decided to use its existing distribution network rather than its predecessors. Pursuant to the new law, and based on a market multiple formula, Anheuser Busch offered the former distributors 2.5 times gross margins for their domestic brands and 3.3 times gross margins for the European brands. Three distributors turned down the deal, and Anheuser Busch sent notice of termination along with checks totaling \$25 million for the terminated distribution rights, based on multiples of 2.45 and 3.25, respectively, for domestic and foreign labels. Anheuser maintained that market multiples had been used for years in the local industry and that no transaction had ever topped a multiplier of 3.3.

Nevertheless, the three distributors sued for breach of contract and damages in federal court. Their expert witness not only “deconstructed” one of the largest payoffs to a cooperative distributor, claiming that Anheuser had in fact used a market multiple of 7.32, but he calculated total damages due the plaintiffs under a discounted cash flow analysis of over \$45 million, or the equivalent of an 8.4 multiplier. Anheuser filed a *Daubert* motion to exclude the expert’s report, arguing his deconstruction was unreliable and his DCF was a poor analytical fit to this case.

May an expert engage in “mindreading,” market participants? Although the defendants raised the issue indirectly, the court initially considered the expert’s qualifications. Despite having valued beer distribution only once before in his 30-year accounting and consulting career, the court found the expert, a CPA/ABV, had sufficient credentials and experience to testify.

The bulk of the defendant’s *Daubert* challenge went to the expert’s dissection of their one transaction with the cooperative distributor. In particular, the expert claimed the deal occurred under duress, contrary to the fair market value standard. The defendants argued this was impermissible “mindreading,” and the court agreed. An expert cannot testify about a person’s intent, motive, or state of mind, it held, and struck any portions of his testimony regarding whether the deal involved willing seller (a question of fact which the plaintiffs could establish through other witnesses). At the same time, the court admitted the expert’s ultimate conclusion that the deal involved a 7.32 multiplier (rather



than a 3.3 multiplier), because it was not based on the parties' states of mind, but on the value of two side transactions.

These side transactions took place on the same day that Anheuser closed the deal with the cooperative distributor and consisted of "inducements...of considerable value," the plaintiff's expert said. The first was a retention of distribution rights for an entire portfolio of current beer brands; it also received a "right of first offer" for new brands and a tax liability inducement. The defendants claimed that any value the expert attributed to these inducements was speculative and unreliable, but the court only agreed with respect to the first. Although the retention of distribution rights had "real value," it said, what the expert "fails to appreciate" is that because of the enactment of the new law, the distributor was already entitled to retain the distribution rights to its former brands or receive fair market value reimbursement. Accordingly, the court excluded the expert's testimony regarding these rights, but permitted his opinions regarding the value of the two remaining inducements, finding them based on his analysis of historical evidence and his expert judgment whether certain events would occur. "Any shortcomings ... can be exposed during cross examination," the court held.

Market approach is the only approach? The defendants also alleged that a DCF analysis was "per se inadmissible" for determining appropriate payments to wholesalers, simply because in these cases the market multiple approach had been used "So many times, including ... several times by the plaintiffs."

But, "This is simply not so," the court held. Provided a DCF is otherwise reliable, it can be used to calculate the value of distribution rights. "Moreover, DCF does not seem to be wildly different from the market multiples approach in that it, too, ultimately provides a multiplier, albeit one based on a number of different variables."

The defendants also challenged the expert's DCF for its use of a "flawed" discount rate and "unsupported data." Specifically, he arrived at a 10.6% discount rate in part by relying on a consulting expert who had a stake in the outcome of the case. Plus, he "arbitrarily" assumed a 40/60 debt-to-income ratio when he should have used something closer to a 10/90, the defendants said. Finally, he used "highly speculative" long-term sales projections derived from the "say-so" of the plaintiffs.

The court dismissed all three arguments. The expert's report gave sound, well-articulated reasons for how he arrived at the discount rate, after examining the plaintiff's debt-to-income ratios as well as industry ratios. Likewise, his report "clearly spelled out" the six different sources (including the plaintiff's internal projections) he relied on to reach his forecasted sales. Any allegations of bias or inappropriate assumptions could be better examined at trial through cross examination, the court held, and admitted his DCF analysis under *Daubert*.



More Support for Using More Than One Method (DCF) in Current Valuations

In re Chemtura Corp., 2010 WL 4272727 (Bkrcty. S.D. NY.)(Oct. 29, 2010)

The Chemtura Corporation, a specialty chemical maker and its affiliates, filed for bankruptcy in March 2009—becoming the third major U.S. chemical manufacturer to succumb to the recession. A year later, the debtors proposed a plan of reorganization and settlement of claims. No creditors objected except the equity shareholders, who claimed it substantially undervalued the company. The bankruptcy court held an independent valuation hearing, in which both the equity committee and the debtors presented expert evidence of total enterprise value (TEV), and the creditors presented a rebuttal expert to critique their approaches. The debtors' expert valued the company from \$1.9 to \$2.2 billion, with a midpoint at \$2.05 billion, and the shareholders' expert concluded a range of TEV from \$2.3 to \$2.6 billion, with a midpoint at \$2.45 billion. All the experts were from large investment banking firms, which played various advisory roles during the restructuring. In a 78-page opinion, the court discusses each expert's approach, their assumptions as well as their possible bias, to determine whether the debtors' TEV exceeded the value underpinning the proposed reorganization plan.

Adjustments to DCF for aggressive forecasts. To reach their respective total enterprise values, both the shareholders' and the debtors' experts used a discounted cash flow (DCF) analysis, with a similar range of discount rates, from 11.6% to 13.75%. Both relied on forecasts from the debtors' long-range plan (LRP), which assumed the national economy would recover to pre-crisis levels by 2011 and the company's earnings would grow during all five years of the forecast period. In their terminal value calculations, however, the experts differed significantly in selecting the earnings to which their multiples applied.

The shareholders' expert applied its multiples to the earnings for the final forecast year, to reach a DCF value between \$2.47 billion and \$2.9 billion. By contrast, the debtors' expert applied multiples of 6.5x to 7.5x from peer group averages and mid-cycle and normalized EBITDA to reach a TEV of \$2,175 billion to \$2.57 billion. The expert's debated the extent of the debtors' cyclicalities, with the shareholders' expert claiming that normalized earnings drove the present value down and the debtors' expert saying the final year forecasted EBITDA—which exceeded all historic levels—led to a significantly overstated value. The creditors' rebuttal expert agreed, believing the long-range forecasts were "overly" aggressive, based on unsupported assumptions of short-term economic growth, and requiring appropriate risk adjustments.

The court shared this skepticism regarding the company's and the country's growth. Although it might be more common to use final year cash flow projections to calculate terminal value, it said, in this case, the slow economic recovery plus the cyclical nature of the debtors' business (or at least, the seasonality of its customers for agricultural and pool chemicals) supported the use of adjusted cash



flows. "Taking the business cycle into account makes for a better analysis," the court added, quoting Prof. Aswath Damodaran (NYU Stern School of Business) (*Ups and Downs: Valuing Cyclical and Commodity Companies*, 2009 ed.)

.At the same time, the best normalization analysis would capture an entire business cycle—which the debtors' expert did not do, the court pointed out. Despite this flaw, it found the debtors' DCF analysis to be, on balance, more persuasive. If the economy were more stable, then it might consider the use of the final year's cash flows to be "perfectly ordinary, if not preferred." In the current economy, however, "relying on the very high terminal value in the last year of an admittedly aggressive string of growth projections is... too aggressive," the court said. In addition, it was "troubled" that the shareholders' expert made no effort to "address cyclicity at all."

"Market approach provides more than just a reality check. The court was also troubled that, unlike the debtors' expert, the shareholders' expert did not conduct a comprehensive analysis of comparable companies and comparable transactions to provide an independent value indicator, but simply used the market approach merely to tote the reasonableness of its DCF.

"That's disappointing," the court said, especially as it found the comparable companies analysis to be more meaningful in this case than either the DCF approach, which is generally susceptible to uncertain projections, or the comparable transactions approach, which can be subject to control premiums, synergies, bidding wars, and hostile deals. For these reasons the court assigned the comparable companies approach the greatest overall weight in the case. In particular, it found the debtors' analysis had "substantial" weight, based on the following:

1. The debtors' expert examined 10 domestic comparables and five foreign, because the latter operated in the same global markets as the debtors and were subject to similar tax and regulatory environments. In addition, 50% of the debtors' revenues came from foreign markets. Yet despite including foreign comparables in his "sum of the parts" and comparable transactions analysis, the shareholders' expert left them out, here, further undercutting his criticism of the pool selected by the debtors' expert.
2. The shareholders' expert included two large multinational chemical corporations in his pool, but excluded a smaller specialty chemical company, which effectively inflated the overall multiples. The debtors' expert excluded the large multinationals, because their sales, earnings, and enterprise values "dwarfed" the debtors', but he included the smaller specialty company, which was more similar to the debtors in its size, product lines, and end-markets
3. Both experts conducted a "sum-of-the-parts" analysis, but the debtors' expert used the 2010 actual and projected numbers to derive its multiples and the shareholders' expert used the more reliable multiples derived from 2011 earnings forecasts.



In addition, both experts applied the comparable transactions approach. The debtors' expert reviewed 14 deals conducted between 2004 and 2010, worth between \$1 billion and \$10 billion. Given the material adversity caused by the global economic and capital markets crisis, however, the debtors' expert ultimately relied on only three transactions occurring after September 2008 (when Lehman Bros, collapsed). Using their mean EBITDA multiple of 6.2x as a midpoint, the expert determined the debtors' appropriate multiple range was 5.75x to 6.75x and applied this to Sept. 30, 2010, EBITDA to arrive at a range of TEV from \$1.97 billion to \$2.315 billion.

The shareholders' expert examined 19 deals, which all closed prior to September 2010 with a much wider range of value, from \$290 million to \$18.66 billion, and a mean EBITDA multiple of 9.7x. But he did not calculate a TEV range from these multiples; instead, he took its estimated TEV range for the debtors to back-out EBITDA multiples of 6.9x and 7.9x. Since these back-calculated multiples were less than the 9.7x multiple for the comparable transactions, the shareholders' expert concluded his TEV estimates did not exceed the debtors' actual value.

Overall, the court found the shareholders' expert's heavy reliance on pre-Lehman transactions "was a serious flaw." Advanced economies are "fundamentally different today," the court observed, and "relying on multiples from a time period before the crash is inappropriate." It also found flaws with the comparables selected by the debtors' expert, noting that it included one with "dubious comparability" but omitted another which plainly should have been considered. However, with two post-Lehman comparables registering a 6.2x earnings multiple in the wake of the financial crisis, the court felt relatively comfortable in giving some weight to this methodology, especially since the upper end of the debtors' transaction analysis was still well below the shareholders' range of value under the DCF

Market pricing and possible bias. If the court had to find a specific value for the debtors, it would have chosen an amount at the low end of the debtors' range, it said. But to confirm the proposed reorganization plan as fair and reasonable, it needed only to find that the debtors' TEV did not exceed the TEV underlying the plan, or \$2.05 billion.

Based on all the expert evidence and analysis, "I so find," the court said. Market information also supported its decision. During its restructuring attempts, the debtors cooperated with the equity committee in trying to find a buyer for the company, contacting nearly 20 potential investors using the committee's \$2.2 billion to \$2.7 billion range of value. "But there were no takers, or offers, at that price or at any price that might ultimately lead to such a value," the court said. Nor were any members of the equity committee—mostly hedge funds—willing to invest their own money into the debtors at that or even a lower price.

Moreover, under the proposed plan, the overwhelming majority of creditors and bondholders elected to take their recovery in cash rather than company stock. Once again, these stakeholders were highly sophisticated hedge funds and other "distressed debt" investors with the ability to dispose of stock. If they thought the plan undervalued the company, they would have "snapped up" the stock at the price offered by the equity committee, the court said. If they believed the valuation offered by the



committee's expert, "they really would have snapped it up," it added, with emphasis. Their failure to do so and their preference for cash suggested they didn't believe the stock was worth as much as the shareholders contended.

The court also found "exceptional" instances of witness bias in this case. The opinions of all the experts were influenced to some extent by their prior activities with the debtor, the circumstances under which they testified, and inconsistent testimony. In particular, the equity committee's expert indicated a strong bias. To secure the engagement, he promised to be "aggressive in valuation" and to achieve "maximum value for the equity." The terms of his engagement agreement provided, in addition to a monthly fee, a hefty "transaction fee" that turned on his ultimate valuation of TEV.

Similarly, both the debtors' expert and the creditors' experts received million-dollar fees upon the consummation of a plan. Although these fee provisions are fairly common ways to incentivize the investment bankers—and in this case, the court authorized their payment—the court couldn't ignore the fees when the same bankers testified, finding the payment terms "materially" and "adversely" affected the experts' credibility.

"Finally, failures by both [the debtors'] and [the shareholders' expert] to change the midpoint of their valuations after the passage of time and in the face of seemingly different circumstances tend to undercut the persuasiveness of each," the court held. For example, in June 2010, the shareholders' expert valued the debtors within the range of \$2.2 billion to \$2.7 billion, with a midpoint of 2.45 billion. Three months later, it issued its trial valuation opinion within a narrower range—\$2.3 billion to \$2.6 billion—but with the precise same midpoint. The debtors' expert likewise issued two separate valuations with the exact same midpoint, despite the company having achieved solid earnings in the interim coupled with the easing of uncertainty in national and global markets.

In both cases, the court found the coincidences were improbable, prompting it to be more "proactive in making [its] own valuation judgment rather than to accept [any] of the proffered ones." As a final matter, in addition to finding the proposed reorganization plan fair and reasonable, the court declined to disband the equity committee, leaving it intact to appeal this decision, if need be.

CVS comment: Bankruptcy valuation engagements tend to have appraisals provided by parties related to the Company having provided prior professional services to the Company. In the above case, the Shareholders' expert witness included a performance fee for their services. This optically looks bad and is a violation of Uniform Standards of Professional Appraisal Practice (USPAP) – which wasn't mentioned in the case capsule. It is important to hire an independent appraisal for all material litigation engagements. The number one issue we see in both *Daubert* challenges and poor testimony results is a lack of independence.