

VALUATION REPORT

BUSINESS VALUATION TRENDS AND STRATEGIES

SPRING 2008

PRACTICE SPOTLIGHT

Specialized Knowledge Crucial in Bankruptcies



**A NUMBER OF
COMPLEX VALUATION
ISSUES MAY BE
INVOLVED IN
BANKRUPTCY CASES.**

Bankruptcies are on the rise in the United States, with predictions of more to come as economic uncertainty prevails. Many valuation professionals specialize in bankruptcy and provide support services in both Chapter 7 (liquidation) and Chapter 11 (reorganization) bankruptcy cases.

These experts are knowledgeable not only about the code regarding this area of practice, but also about recent rulings that may affect how bankruptcy courts regard various cases. Here are a few of the complex valuation issues involved in bankruptcy.

SEEKING ADEQUATE PROTECTION

Filing for bankruptcy triggers an automatic stay, during which creditors are prohibited from taking action against the debtor company. Secured creditors are offered “adequate protection” of the value of their collateral during this time period. If creditors don’t feel that their collateral is adequately protected, they may request that the court remove

the stay so they can take possession of the company’s assets.

Valuation experts are often called upon to determine adequate protection by assessing the value of the collateral assets — both tangible and intangible — and the extent to which they may diminish given the circumstances of the bankrupt company. Is the company likely to reorganize and continue as a going concern, or is it more likely to fold? Determining value depends on whether the company can maintain its income stream and, if so, for how long.

DETERMINING VALUE OF SECURED CLAIMS

It would seem that assessing the value of secured assets would be straightforward, but that is not the case in bankruptcy. Secured assets may be valued differently depending on how they are used by the debtor company and whether the company is regarded as a going concern or not. Going concern value is generally higher than liquidation value.

For example, say the creditor in a Chapter 11 bankruptcy claims a machine used by the business. Note that it has a value as a machine, but it also has a going concern value determined by its role in the company’s

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Valuation Key to M&A Process

It has been a few years since the last big wave of mergers and acquisitions, but as baby boomers approach retirement, the M&A arena likely will heat up again. Valuation services are essential for both buyers and sellers in the M&A process, and valuation experts are critical to the success of a buyer's or seller's advisory team.

ON THE SELLING SIDE

Business owners — particularly those who founded the business — often have an unrealistic idea of the company's value to a buyer. Sometimes it's just false hope or an inflated ego that clouds the owner's vision. More often, however, owners have a number in their head that they believe the company is worth, but can't support that number with data.

For this reason, it's a good idea to have a business valuation performed early in the sale process. This will give the owner a range of realistic values to pursue, based on comparable companies and multiples of EBITDA, sales, book value or other relevant data. If the range is unacceptably low to the owner, it will also give him or her time to make adjustments in the company, increase earnings or address other problems before sale.

Valuation experts also assist business owners in several other areas before and during the sale process:

Confidential Offering Memorandum: The confidential offering memorandum is a formal offer to sell the business. It presents an overview of the company and its management, historical data from audited or reviewed financial statements, and other information of interest, customized for potential buyers.

A business valuation professional plays an important role in the preparation of this document. The valuation expert is tuned into the synergies the

business has with each potential buyer and can tweak the overall presentation of the company's strengths to align them with the needs of targeted buyers.

Data Room Set-Up and Due Diligence Response: As potential buyers respond to the confidential offering memorandum, the valuation expert should be considered as the gatekeeper for the due diligence team. He or she often sets up and monitors the "data room," or online repository of information, as it is made available to buyers.

The valuation expert also plays a role in crafting due diligence responses. His or her input can help sellers avoid problems by revealing too much, saying too little or using language in a way that may have unexpected consequences.

Purchase and Sale Agreement: The design of this legal agreement requires the input of the business valuation expert. He or she can:

- help draft wording that defines the purchase price,
- provide detail for calculations,
- give examples to illuminate the interpretation of legal terms, and
- ensure that the agreement is in conformance with the client's accounting procedures and policies.

ON THE BUYING SIDE

A valuation professional is also an integral part of the buyer's advisory team. For example, a valuation expert has knowledge of the necessary financial information to draft the letter of intent to buy a business. He or she is also involved in determining fair market value, the synergies expected and the purchase price for the target business.

In the due diligence phase, a valuation expert can help the buyer by reviewing the initial valuation and the details of the confidential offering



memorandum. Valuation professionals are also involved in drafting the purchase agreement and translating legal terms into workable examples.

When putting together an advisory team for mergers and acquisitions, choose a valuation expert who knows your business and industry. Given his or her knowledge, the business valuation expert can help ensure that you make the most of the purchase or sale. ❖

For more information about business valuation services in the mergers and acquisitions arena, please contact our firm.

Consider Tax Implications

Buying or selling a business? Consider the tax implications as early as possible before moving forward. A valuation expert, along with gift and estate tax advisors, should weigh in on and identify opportunities for transferring ownership, whether a deal is accomplished or not.

If ownership interests are transferred by gift, a gift tax return (Form 709) may be necessary. Note that a fair market valuation of the transfer of ownership interest must be attached to the return.

Daubert Challenges Impact Expert Testimony

Since 1993, the litigation world has worked within the framework of a standard named for the Supreme Court case that articulated it: *Daubert v. Merrell Dow Pharmaceuticals, Inc.* In this case, the Supreme Court decided that expert testimony must meet several criteria to be admissible.

First, the evidence must be relevant and assist the “trier of fact,” typically a judge or jury, in determining a fact in issue. In addition, the evidence must be “grounded in the methods and procedures of science,” “derived by the scientific methods,” and “supported by appropriate validation.”

While the Daubert ruling — and its later corollary addressing non-scientific testimony, *Kumho Tire v. Carmichael* — specifically did not provide a checklist of criteria for admissibility, it did provide four general guidelines:

1. The expert’s theories and techniques must have been tested.
2. The theories and techniques must have been subjected to peer review and publication.
3. The techniques employed must have a known error rate.
4. The theories and techniques employed must be subject to standards guiding their application and be generally accepted.

In general, experts apply their specialized knowledge to the facts of a case and offer an opinion as to the question of fact. In terms of business valuation, this opinion is an assessment of the value of a business, a shareholder’s interest or other similar asset. A Daubert challenge, made by the opposing side in litigation, is a challenge to the expert’s methods or credibility — not

necessarily to his or her opinion or conclusions.

While most Daubert challenges do not result in the expert or the testimony being excluded, a Daubert challenge is something a business valuation professional wants to avoid at all costs. The potential damage to reputation is substantial.

Recent cases involving Daubert challenges highlight several reasons why a valuation expert or the expert’s testimony could be excluded:

Inadequate Expertise: Experts must be qualified as such by virtue of their knowledge, skill, experience, training or education. Yet, seemingly qualified experts are routinely challenged for a variety of reasons, including a perceived lack of experience in the specific industry in question.

Questionable Reliability: The expert must be neutral and his or her opinion unbiased. Expert testimony has been disallowed for being exaggerated, mistake-ridden, speculative or flawed in some other manner.

Dubious Methodology: Novel methods are not always rejected, but are more likely to be challenged. Even so, the Federal Rules of Evidence indicate that cross-examination, presentation of contrary evidence and careful instructions in the burden of proof are the traditional and appropriate means of attacking shaky but admissible evidence.

The bottom line? Be careful in your choices of expert witnesses. Choose certified valuation professionals who are unlikely to be challenged for any obvious reasons, whose credentials and reputation are impeccable, and whose expertise can stand up to the scrutiny of the court. ❖

Specialized Knowledge

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income stream. If it is essential to the operations of the business — and the business plans to reorganize and continue operating — the machine has high value to the debtor and would be assigned a higher going concern value.

However, if the machine is one of many available to the debtor company and might be useful for other companies, the value might be fairly high both to the debtor and the creditor, but would have little going concern value. If the company’s future looks dim, the machine may be assigned a lower liquidation value.

RECOVERING ASSETS

Companies in trouble sometimes make questionable decisions as their businesses fail. When assets are transferred out of a debtor company in the 90 days prior to filing for bankruptcy, creditors often seek a valuation to determine solvency on the date of transfer.

Creditors have a right to try to recover what they are owed, and are given the opportunity to recover the value of the assets if the company was insolvent at the time of the transfer. For this reason, a valuation is necessary to determine a company’s solvency on the dates when it transferred assets.

Obviously, the valuation issues involved with bankruptcy are complex, and bankruptcy laws change with some frequency. As the bankruptcy valuation discipline becomes more specialized, it is important to rely on valuation professionals with experience and expertise in this specific arena. ❖

For more information about valuation issues in bankruptcy, please contact our firm.

AICPA Defines Valuation Terms

The AICPA's *International Glossary of Business Valuation Terms* includes definitions adopted by five business appraisal organizations. Here are some of the terms defining value:

Fair Market Value — The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Going Concern Value — The value

of a business enterprise that is expected to continue to operate into the future. The intangible elements of going concern value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems and procedures in place.

Intrinsic Value — The value that an investor considers, on the basis of an evaluation or available facts, to be the “true” or “real” value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise (or strike) price of an option and the market value of the underlying security.

Liquidation Value — The net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either “orderly” or “forced.”

Net Book Value — With respect to a business enterprise, the difference between total assets (net of accumulated depreciation, depletion and amortization) and total liabilities as they appear on the balance sheet (synonymous with Shareholder's Equity). With respect to a specific asset, the capitalized cost less accumulated amortization or depreciation as it appears on the books of account of the business enterprise. ❖

Source: AICPA



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