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Valuation Report

Business Valuation Trends and Strategies

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Litigation Review

Court Cases Shed Light on Key Valuation Topics

As always, the courts are filled with interesting valuation-related cases. Here's a look at recent litigation that has piqued the interest of valuation professionals.

Gallo v. Gallo
The Case of the Double Dip

One of the valuation issues that commonly arises in divorce is "double dipping." This occurs when the recipient of spousal support "dips" twice into the same asset — once in the equitable distribution calculation and again when it comes to spousal support.

Since 2008, the seminal case regarding double dipping has been *Heller v. Heller*, an Ohio Court of Appeals case which essentially banned double dipping. Earlier this year, the same court ruled in *Bohme v. Bohme* that the Heller ban on double dipping wasn't entirely relevant when using income from a wholly owned professional practice as a measure of both business value and actual income for spousal support.

In *Gallo v. Gallo,* the court again quibbled with the Heller ruling. In this case, the husband, an ocular plastic surgeon, owned one practice and had ownership interests in two surgical centers. Based on an annual income of $700,000, the divorce court ruled that the husband should pay $12,000 per month in spousal support for a period of time.

The husband appealed, alleging that a double dip had occurred when the future profits calculated for his interest in one of the surgical centers were also used to calculate his income for the purpose of support.

The appeals court looked at two issues: Did a double dip occur and does the law prohibit it per Heller? On the first issue, the court disagreed with the Heller definition of double dipping, but found that a double dip had in fact occurred in the Gallo case. Perhaps the most interesting part of the ruling was the court's decision that double dipping was not prohibited under all circumstances.

In fact, the Gallo court said that Heller ignored a provision expressly requiring a court considering spousal support to consider all sources of income, "including income derived from a marital asset divided in the property distribution." Moreover, the court said that in the interest of equity, the disparity in income between the parties may "override the unfairness in double dipping."

Lessons learned: Courts seem to be retreating from the hard double dipping line drawn in the Heller case. In light of the Gallo and Bohme cases, double dipping might be permissible after all.

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Industry Insights

Considerations in Oil and Gas Valuation

The oil and gas industry is notably volatile. For valuation analysts, this provides an interesting challenge when valuing oil and gas reserves.

Valuation is about assessing risk. But in oil and gas, there's risk plus mystery: You can't see or measure what you're assessing until it's produced and sold, and the outcome of each endeavor is unpredictable. One property may produce nothing, yet a nearby property may yield untold wealth.

Many oil and gas valuations are requested for a minority interest for estate or gift tax purposes — usually by those with partial interests in a reserve who are looking to transfer their interest to the next generation. Often, these valuations are of royalty interests typically held by a landowner who receives one-eighth or more of net revenue after certain costs.

The Reserve Report

Given all the unknowns of oil and gas exploration, how does a valuation analyst even begin to estimate fair market value? He or she usually can't rely on comparable transactions because individual reserves have specific factors that affect the market. But there are a few things that help a valuation analyst complete the work.

The most important is a reserve report, prepared by a petroleum engineer. This report typically estimates the quantity and nature of the oil or gas in the ground. It also includes production forecasts estimating what percentage can be extracted and how quickly, the cost of recovery, and the present value of the predicted net cash flow.

Reserves are generally classified by the quality of the reserve — proved, probable or possible — matching standards designated by the Society of Petroleum Engineers. Reserves are also classified by the stage of development: producing, completed or undeveloped.

The reserve report typically includes the future net revenue expected over the life of the property, discounted to present value using various discount rates. This calculation can serve as an important starting point for the valuation analyst to determine fair market value.

For example, "proved producing" reserves are the easiest to value — they might be assessed at 90 percent to 100 percent of future net income. The scale slides down from there, with "possible undeveloped" reserves assessed at perhaps zero to 10 percent of future net income.

Undeveloped Reserves

For undeveloped reserves, another key piece of information is the nature of any associated infrastructure in place to extract and move the oil or gas downstream. Are there pipelines and power generation in place nearby? If so, this might increase the value of the property.

In many cases, and especially with undeveloped reserves, there is no reserve report. In these circumstances, analysts must look for other ways to value the interest. These might include rules of thumb; the income approach using regional historical well production data, estimated production and price curves; and even dollar-per-acre estimates.

While the IRS may challenge these valuations, the government has nothing more to go on than the valuation analyst does. For this reason, it's imperative that the analyst's methodology and assumptions be reasonable and reliable — just like in all valuations ■

Have a question about an oil or gas valuation? We'll be happy to sit down and discuss it with you in more detail.

How Recent Court Cases Impact Valuation

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Friehage v. Friehage Debt: Not Lovin' It

This recent divorce case involved the valuation of an LLC which owned several McDonald's franchises purchased over the course of the divorcing couple's marriage. The LLC was created by the husband and he was the only member of the LLC.

The divorcing spouses each hired a valuation analyst. Both analysts were experienced in valuing McDonald's franchises and were members of a trade association specifically for franchise accountants. Each performed a valuation involving a discounted cash flow analysis, but their valuation conclusions were $10 million apart.

Certain facts weren't disputed: To purchase the franchises, the husband incurred some debt — $3.7 million to a bank and $5.8 million to a family trust. But the two valuation experts had differing opinions on certain key elements of the valuation, including the total debt.

Based on all the data, the husband's experts determined the total value of the LLC was $10 million. After subtracting the cost of reinvestments, excess liabilities, and the debt owed to the bank *and the family trust*, though, they determined that the net value was just $310,000.

Not surprisingly, the wife's expert saw things differently. He determined the LLC was worth $16.1 million, but allowed for only $4.9 million in liabilities — *not including the debt to the family trust*, which the wife characterized as a gift, not a loan. This brought the final number to $11.2 million. Part of his rationale for excluding the trust debt was that McDonald's had chosen to exclude it when calculating total business equity for the LLC.

Ultimately, the court decided that the LLC's value was $10.6 million less debt, which it said included the family trust debt. This brought the "net of debt" total to $1.1 million. While there were several disputes over the calculation in an appeal, the appeals court agreed that the family trust debt was indeed a loan, and upheld the $1.1 million valuation.

Lessons learned: How debt is treated is based solely on facts and circumstances. Though the wife tried to characterize the loan as a gift, the court didn't agree. Nor was the court swayed by the fact that McDonald's itself excluded the family trust debt from the total business equity.

In re: Dole Food Co, Inc. Must an Expert Be a Person?

Is a financial advisory firm as an entity capable of testifying as a valuation expert in a trial? Or is it imperative that the actual individual who prepared the report testify as the expert? These were the questions at issue in the Delaware Court of Chancery as part of a stockholder dispute with Dole Food Company, the multinational famous for its pineapple rings.

In this case, two investment firms challenged Dole's 2013 take-private merger and petitioned for an appraisal of the company. Dole named an investment banking firm, Stifel, Nicolaus & Co., as its expert witness. The valuation report was signed by two individuals as representatives of the firm, but neither signed in a personal capacity.

At the deposition, Stifel's managing director appeared as the person most knowledgeable about the report, with Dole asserting that he was "not the expert," but rather that the firm was the expert. The plaintiffs balked, claiming that an expert witness must be a person, not a firm.

The plaintiffs further asserted that the distinction was important because a human expert witness can only rely on his or her own knowledge — the standard assumption behind a valuation opinion. However, a firm might claim the knowledge of all of the employees of the company.

The court agreed with the plaintiff, noting several requirements set forth by the Delaware Rule of Evidence Rule 702. First, the rule says that "an expert witness must be capable of serving as a witness." The court interpreted this as a "biological person," not a corporation, which the court said only existed "in the contemplation of the law."

Further, the court said that only a person can be "qualified" by demonstrating "knowledge, skill, experience, training or education" and "apply principles and methods." It concluded that "the expertise belongs to the individuals, not the corporation."

Lessons learned: Experts are people. An entity can't testify as an expert witness. ■

Source: BV Update

Our experienced valuation team is at your service. Let us assist you with your valuation litigation and expert witness needs.

DLOM Tool Offers Probability-Based Calculations

Discounts for lack of marketability (DLOMs) are among the most disputed elements of a valuation. "Marketability" refers to the liquidity of an ownership interest, or how quickly and easily that interest can be marketed or converted to cash. A marketability discount applied to the estimated value of a business reflects the reality that no ready market exists for shares in a privately held company.

For many years, analysts have recognized investment volatility and holding periods as key factors affecting the cost of liquidity. In 1995, UCLA professor Francis Longstaff introduced a method for estimating the cost of liquidity based on the look-back option pricing model, known as the "Longstaff formula." Last year, valuation analyst Marc Vianello launched a new DLOM calculator that integrates probability-based time and price volatility variables with Longstaff's formula.

Traditionally, estimating DLOM has involved using restricted stock and pre-IPO studies. But these often include limited sample sizes and don't typically reflect the price risk associated with the time it takes to sell a non-publicly traded asset. Vianello's calculator lets analysts plug in various scenarios based on their assumptions about both the marketing period and price volatility.

For example, analysts can tailor the marketing period based on industry, seasonality, year, employee count, asking price, revenues or other factors. The calculator automatically calculates price volatilities and standard deviations based on guideline companies, indices or the analyst's own metrics. This flexibility results in a DLOM that reflects the probability of each predicted combination of marketing period and price volatility variables.

Of course, Vianello warns that the precise specifications applicable to a specific valuation require the judgment of a skilled professional.

The valuation community is always interested in new ways to consider DLOMs, and many agree that the new calculator is a good tool to aid valuation analysis. It will be interesting to see if and how Vianello's model gains traction. ■