

# New Jersey Law Journal

VOL. CLXXXV—NO.5—INDEX 380

JULY 31, 2006

ESTABLISHED 1878

## CORPORATE LAW

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### Choose and Use Experts Wisely

The appropriate use of an expert in a valuation case

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The successful hiring and use of an expert to value a business or corporation in a shareholder dispute represents one of the most critical parts of the litigation process. Valuation is as much of an art as it is a science and, as a consequence, there are a variety of parameters which must be carefully considered and tailored to the needs of your specific case. Valuation experts can be helpful not only in the ultimate assessment of the value of a business or an interest, but also in targeting the course of discovery and the litigation.

Corporations generally cannot be realistically evaluated by a simplistic approach based solely on book value. Rather, there are a variety of critical factors that must be considered, such as: good will; investment value of a business in terms of actual profit; issues relating to discounting the value of a minority interest; and issues of the companies' base capital structure. *Brown v. Brown*, 348 N.J. Super. 466, 477 (App. Div. 2002).

Valuation is a fact-sensitive

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process, and “depends on the experience of the appraiser and the completeness of the information upon which his conclusions are based.” *Torres v. Schripps, Inc.*, 342 N.J. 419, 435 (App. Div. 2001). Thus, it is very important that you provide your expert with critical factual material he needs to fully develop his analysis.

The chosen expert must have specific knowledge of valuation in general and valuation in your industry or business if at all possible. Although valuation skills are transferable, knowledge of the industry is critical to ferreting out the nuances required by your specific circumstances. Many CPAs claim the ability to value corporations, but you generally should require certification in valuation.

Second, you always want to seriously consider your client's ultimate goals. Plaintiffs have one set of concerns and defendants another. In any event, you do not want your experts to take too severe or one-sided a position that will significantly limit their effectiveness because they will be seen as biased by the trier of fact.

Third, your expert should be experienced in a litigation setting. Toward this end, you should interview your experts in person to see what their experience level is, not only in appraising companies, but also in testifying at trial

and in the court room. Examine their appearance and personality — are they personable enough to sell their conclusions? Too often, lawyers forget to ask experts about how many times they have actually testified, both at deposition and in court. Further, you must evaluate your expert's demeanor. An expert must be able to communicate complicated issues simply, so that the trier of fact can understand the testimony relatively easily.

The best experts to value corporations are industry experts familiar with the specifics of the field, outside CPAs and business brokers. However, there is no one clear choice; the choice of the expert should comport with the facts of the case. The expert has to feel comfortable and be knowledgeable in valuing the subject corporation or his findings will not be accepted.

An expert should be hired as early in the litigation process as possible. The expert can help secure the proper financial records, tax returns, financial statements and the technical corporate documents required. Your expert will be your professional sleuth, providing forensic analysis and commentary on a variety of financial documents, including general ledgers, accounts receivable and payable, loans, tax returns (corporate and personal), as well as a slew of other pertinent financial documents tailored to your case and industry. Thus, you need to retain the expert to preserve confidentiality. As early in the litigation process as possible, you should sit

down with your client and expert to create a list of all necessary documents. Your expert can help evaluate the strengths and weaknesses of your case, as well.

An experienced expert can also provide your client with a reasonable expectation of what the case is worth and assist you in gauging the probability of success. Lawyers frequently make the mistake of estimating the value of a case before an analysis is complete, thereby unduly raising client expectations.

Valuation experts generally utilize one of three fundamental and traditional approaches. These approaches are commonly known as the "cost," "market" and "income" approaches. The "market" approach estimates a value for the business through analysis of recent sales of guideline companies or their stock. Generally, the prices of stocks traded in a free and active market are regarded as at least one appropriate measure of fair market value. The market approach is also based on prior transactions with regard to similar companies.

The "asset" approach is based on the assumption that a prudent buyer would pay no more than it would cost to purchase the assets, both tangible and intangible, of the subject company at current market prices. The asset method of value requires reviewing the adjusted balance sheet and excess earnings and then estimating the individual market value of the subject company's assets and liabilities. The "asset" approach is sometimes also referred to as the balance sheet approach.

The "income" approach or "cost" approach considers the likely income potential of a business. The income approach is based on the theory that the value of a business is equal to the present value of the entity's future stream of expected earnings or cash flow. The two primary methods under this analysis are the capitalization of income approach, which is used when income is projected to increase at a fixed rate over time, and the discounted future income method, which is employed when income is projected to change at variable annual

amounts for a certain time. The income approach is based on the present value of the future earnings or cash flows expected to be generated by the business. Earnings or cash flow projections for a future period are discounted or capitalized at a rate commensurate with the degree of risk associated with the subject business. Under the income approach, the current value of a business is based upon the expected future economic performance of a company, as well as the expected future of revenues and cash flows.

An expert's primary job is to opine on the "fair value" of the specific corporation in dispute, an ambiguous concept not clearly defined by the Oppressed Shareholders Statute, N.J.S.A. 14A:12-7, et seq. "Fair value" is not synonymous with "fair market value." *Balsamides v. Protameen Chemicals, Inc.*, 160 N.J. 354, 374 (1999). "Fair market value" is the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Nevertheless, the Oppressed Minority Shareholder Statute, N.J.S.A. 14A:12-7, which governs court-ordered dissolution of corporations, specifically provides that the purchase price shall be a "fair value" "deemed equitable by the court, plus or minus any adjustments deemed equitable by the court if the action was brought." *Balsamides*, 160 N.J. at 377. In other words, the "equities of the case" must be considered when ascertaining "fair value" in appraisal and oppressed shareholder actions. *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 383, 407 (1999). Essentially, there is no inflexible test for determining fair value such that "an assessment of fair value requires consideration of proof of value by any techniques or methods that are generally acceptable in the financial community and otherwise admissible in court. The "fair value" of a company is "factual" in nature, and not a function of law.

The expert also may have to apply a

"marketability discount" to the value of a company relative to the nonliquidity of stock held in a close corporation. A "marketability discount" adjusts for lack of liquidity of one's interests in an entity based on the theory that there is a limited supply of potential buyers for stock in a closely held corporation. On the other hand, a "minority discount" adjusts for lack of control over the business entity on the theory that noncontrolling shares of stock are not worth their proportionate share of the firm's value because they lack voting power to control corporate actions. Marketability discounts reflect the decreased worth of shares of stock in a closely held corporation, for which there is no readily available market.

An expert can also be quite useful in mediation or arbitration should the parties undertake some form of alternate dispute resolution to resolve the matter outside the courtroom. In this less formal arena or structured setting, the expert can often convey the strengths of your client's position. A financial expert can also help explain the specialized tax issues and complicated accounting and finance issue that may arise. Your expert can also be used as a forensic evaluator to review questionable business dealings and/or financial records which will likely have a pejorative impact on the value of the subject corporation.

Choosing the valuation date is critical to the valuation process. You and your expert should work together to attempt to determine the most equitable and appropriate date to ascertain the true value of the company. The date does not need to be the date the complaint was filed or the date the action commenced. Courts in New Jersey have long recognized that the selection of a valuation date is of critical concern in oppressed shareholder actions. *Musto v. Vidas*, 333 N.J. Super. 52, 57 (App. Div. 2000). This is because each business or industry has cyclical issues, peaks, valleys and bubbles. Moreover, certain businesses and industries are seasonal by nature. Thus, the selection of the valuation date is critical to secure a fair and reasonable value, neither too high nor too low because of

economic conditions.

Your expert will have to choose whether you input the appropriate method of valuation (asset, market or cost) as well as apply fair and equitable discounts (marketability and/or minority) based upon the specific case. The "equities of the case" must be considered when ascertaining fair value in oppressed shareholder actions. Further, various factors are considered fundamental in valuing a close corporation, including: the nature of the business; its history; the economic outlook in general; and the condition and outlook of the specific industry in particular.

Generally, in valuation proceedings the corporation must be valued as a going concern, which necessitates not only examination of the corporation's historical earnings, but also consideration of the corporation's future prospects. Most importantly, in evaluating close corporations, decisions must be made on a case by case basis, taking into account the specific facts in question. As the New Jersey Supreme Court observed in *Balsamides v. Protameen Chemicals, Inc.*, 160 N.J. 354, 368 (1999), valuation of close corporations is not an "exact science" and the valuation is "inherently fact-based." Indeed, in the context of oppressed shareholder actions, "careful analysis on a case by case basis is required, with sensitivity and adjustment for the particular circumstances and the flexibility to deal with extraordinary circumstances."

The expert report is a critical part of the process. As an attorney, you should work closely with the expert to target the report and identify the key legal issues. Valuation is an art and lawyers can actually play a significant role in the course of creating parameters for the valuation. The expert should gather data and create his report based upon meetings and discussions with the attorney and the client, a review of the financial data, visits to the business, interviews and pertinent external economic data. It is important that your expert craft the basis of his report well before it is due, because until pen is put to paper, you really do not

know what your expert's position or opinion actually will be, and you will most likely need to work with the expert to develop the report into a persuasive piece.

An expert should not rely on a previous appraisal conducted for business purposes since the appraisal may be too remote in time to be of value; it may have been done for another purpose separate and apart from the instant litigation.

A full scope expert report may include the following breakdowns: the purpose and objective of appraisal; the definition and presumption of value; a summary of the findings, opinion and basis of opinion; a summary description of the equity being appraised, including ownership percentages; history and profile of the corporation; economic factors of influence — international, national, regional, and local; a detailed financial analysis of the company; a description of the method of valuation — asset, market, cost; the basis for and application of discounts and premiums — marketability or minority; a reconciliation of findings, and ultimate conclusion of value in a coherent, concise manner.

It may also very useful to have your expert prepare a Power Point presentation to describe his findings. If a picture is worth a thousand words, a Power Point presentation can literally be worth millions. Your Power Point presentation can "show," not merely "tell," his results in a manner which any trier of fact could understand. Valuation can be complex and dry, and your mission is to make sure that it is interesting and relatively simple to understand. You can literally sell the liability portion of your case through a persuasive valuation-damage report.

Rebuttal reports can be quite useful as well. Rebuttal reports can serve to respond to the strengths and weaknesses in your adversary's expert report. Your expert does not need to be the best or the brightest in the entire field, but he needs to be better than the expert that they are opposing. Therefore, the report needs to be rationale, reasonable, factually based

and accurate. A rebuttal report will give your expert a good forum to respond to your adversary's expert report and assist in adequately preparing your expert for cross-examination at trial.

One issue that arises frequently is the question of whether it is necessary to depose expert witnesses. This is generally a judgment call, and depositions are not always warranted or needed. The expert's position should be adequately conveyed in the expert report itself, and a deposition can also unnecessarily reveal strategy and weaknesses in the report. However, if you need information from an opposing expert, then a deposition may be warranted. In sum, the deposition of an expert is a strategic decision, and it is not always needed or required.

Trial preparation is critical. If depositions have taken place, you should review the potential problem areas with your expert so that he can explain away the warts. However, the expert should be primarily focused on the facts and circumstances of the valuation report and he should be able to reflect on the differences in theory and reasonableness of your adversary's expert report.

Your expert is an advocate and should appear professional, objective and grounded in his task. However, he should not appear aggressive. Too heavy a hand will often lead to rejection of the report. A good expert will understand and communicate the positive and negative positions surrounding the valuation opinion. It is important to note that the trial court is free to wholly accept or reject the testimony of either side's expert, or draw from portions of each.

While it is generally a good idea to hire an expert in a corporate valuation case, there may be distinct circumstances that do not justify the hiring of an expert. An expert may not be necessary if the business is not worth a great deal as a result of the downturn in the market or other circumstances. Second, an expert may not be necessary if the parties are able to stipulate to an essential element of the valuation issue, such as the method of valuation. In such a

case, the parties may want to select a joint expert. This can be especially true if, for example, real estate appraisals are required even for a portion of the valuation.

The selection of an expert is a strate-

gic decision that can make or break your litigation. Therefore, you should canvas the community to pick the best possible expert for your case. You should use an expert who can meet your client's economic and legal needs. The best experts

are not only experienced technically, but also have the ability to communicate their thoughts, beliefs and conclusions persuasively. An expert can make or break your case — so choose carefully. ■