

Valuation Analysis: The Role of the Expert in Litigation

In commercial litigation the valuation expert must balance varying methods and the use of judgment in delivering an optimal result and then must be prepared to defend his own valuation while critiquing opposing views.

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Valuation analysis is a frequent element of commercial disputes and litigation. Valuation professionals are often called to serve as an expert witness in these cases. Whether the venue is Federal or State court, or arbitration proceeding, the expert witness must consider:

- The requirements of the court concerning the role the expert is expected to play, the rules of evidence and procedure the expert must follow, and the standard of reliability and relevancy the work must satisfy;
- The ethical and professional responsibilities to which the expert must adhere;
- The need for effective communication in the form of written and oral testimony.

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However, the key challenge for an expert witness is that the practice of business valuation has no single authoritative source for established standards and analytical methods. The expert must apply and defend the use of judgment and estimates in determining the analytical approach to be applied to each specific case. The expert witness must also be able to effectively critique the approaches, methodologies, and assumptions used by the opposing expert.

Requirements of the Court

The expert witness should consider carefully the requirements and expectations of the court or other venue in which the dispute may be decided or arbitrated.

- The expert's responsibility is to the "trier of fact", which may be the judge, arbitrator, or jury of the case. The expert is expected to be impartial with respect to the litigating parties. The expert is expected to be an advocate for the reasonableness and reliability of his work. However, the expert's role is also to inform the court about the principles and methods of valuation and how they should be applied to the facts of the case.
- The expert is expected to adhere to the rules of evidence and procedures applicable to the case.¹ On a Federal level, the rules of evidence and procedures generally require:
 - The testimony must be based upon sufficient facts or data; the testimony is the product of reliable principles and methods; and the witness must have applied the principles and methods reliably to the facts of the case. Facts or data that would normally be inadmissible may be used if they are "of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject."²

¹ Federal Rules of Evidence, Rules 702 - 705; Federal Rules of Civil Procedure Rule 26.

² For instance in *United States v. Paracha*, No. 03 Cr. 1197 (SHS), 2006 WL 12768 (S.D.N.Y. Jan. 3, 2006), the use of alleged "hearsay" evidence was permitted by an expert who defined his methodology as gathering multiple sources of information, including original and secondary sources, and "evaluating new information to determine whether his conclusions remain consonant with the most reliable sources." Mere hearsay is inadmissible; the expert had to demonstrate that he applied his expertise to evaluate the reliability of the evidence.

- The expert may opine on an issue the trier of fact will ultimately decide (e.g. the value of a business).
- The testimony should be submitted in the form of a written report which includes:
 - A complete statement of all opinions to be expressed with the basis and reasons for each,
 - The data and other information considered by the expert in forming expressed opinions,
 - The qualifications of the witness including all publications authored within the last ten years, and
 - A listing of any other cases in which the witness has testified within the preceding four years.
- The expert is expected to base his or her testimony on sound methodology and to fit the methodology to the facts of the case. In Federal cases, the expert may be subject to a *Daubert* challenge in which the court assesses the reliability and relevancy of the expert's testimony and may exclude the testimony if it is found deficient.³ A recent study by PricewaterhouseCoopers survey found that in 2007 41% of the *Daubert* challenges to financial experts resulted in the exclusion of all or part of the expert's testimony.⁴
- State court requirements are generally consistent with Federal court requirements. However, the expert witness should become familiar with the specific rules and requirements of the venue at an early phase of the engagement.

Ethical and Professional Responsibilities

Ethical and professional responsibilities must guide all work and conduct related to the case. The fundamental first three rules for the expert witness are: "Tell the Truth, Tell the Truth, Tell the Truth". Testimony should be offered in the spirit of personal integrity, good faith, and sincerity. The expert should not be involved in matters in which these basic tenets cannot be maintained.

The expert witness should avoid offering opinions on matters which are outside of the scope for which the witness has been retained. Nor should the expert offer conclusions of law.

³ In *Daubert v. Merrill Dow Pharmaceuticals*, 113 S. Ct. 2796 (1993), the U.S. Supreme Court gave discretion to judges to exclude testimony based on mere subjective belief or unsupported speculation. In *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999), the U.S. Supreme Court extended this discretion to any expert testimony including financial testimony.

⁴ PricewaterhouseCoopers 2000 - 2007 Financial Expert Witness *Daubert* Challenge Study, August 2008.

The expert should be independent of his client in the case, and free of professional or ethical conflicts. Once the expert has an understanding of the case and the scope of engagement, the expert should independently assess all relevant facts and evidence provided by the client (or obtained from other sources and parties). The expert's work and conclusions should be developed independently.

Due care in the preparation and documentation of work should be exercised. While the rules of evidence permit corrections and revisions to testimony if necessary, errors are embarrassing at a minimum and opposing counsel may attempt to use them to discredit the expert if the errors appear to be particularly glaring or frequent.

The expert's compensation may not be contingent on the results of testimony. Compensation may be based on professional rates applied on an hourly basis and subject to retainer. In no event should testimony be presented to the court if payment for services is not current.

The expert witness may be affiliated with one or more professional organizations which promulgate ethical and professional requirements such as the CFA Institute, the American Society of Appraisers (ASA), and the National Association of Certified Valuation Analysts (NACVA). Overall, these organizations have issued guidance which represent a coherent and reasonable set of standards which can be applied to work filed in support of testimony.

All work-product, including drafts, notes and emails may be discoverable. While the ultimate determination of whether or not materials are privileged is a legal conclusion, our practice is to retain copies of such items in the event they must be produced.

Communications Skills

The expert must be able to communicate the results and substance of his or her work through oral and written testimony, and in response to adversarial examination by the opposing party.

The legal process depends on the careful and clear use of language to convey the conclusions and explain the content of one's analysis. The legal process is adversarial. The expert should be expected to make a *positive* case for the validity of his work and conclusions. The expert should also be prepared to respond to opposing counsel's questions and tactics. Accordingly, the expert should seek to anticipate the questions that may be raised during oral testimony and consider potential responses in clear and concise form.

Valuation as a Specialized Field

Valuation is a specialized field which has evolved in response to developments in law, taxation, finance, accounting, and economics. Professional organizations have been established that promulgate standards for valuation and provide certification. There is a body of relevant case law. However, there is no single authority establishing appropriate valuation principles and methods. Instead, several general observations can be made concerning practices that have garnered favorable results by the Federal Courts:

- The written valuation report should be prepared based on the *Uniform Standards of Professional Appraisal Practice (USPAP)* business valuation standards issued by the Appraisal Foundation.⁵ The *USPAP standards*, originally published in 1987, have served as the basis of subsequent standards issued by the ASA, NACVA, and others. The *USPAP standards* were updated in 2008. While there is not an absolute requirement to follow *USPAP*, the expert should be prepared to address the standards and justify the form and extent of documentation ultimately selected.
- If appropriate, multiple valuation approaches should be considered and utilized. If the approaches produce different results in value, there should be an analysis which reconciles the results of each approach in support of the ultimate conclusion of value. In cases where the expert values a company as a “going concern”, the courts have generally expected the application of the “Income Approach”, the “Market Approach”, and the “Asset Approach”.⁶ The theory and implementation of these approaches are all well documented in the valuation literature.⁷
- The expert witness must have exercised reasonable validation of the data and assumptions used in his analysis. Typically the data and assumptions used by the expert will be thoroughly examined by opposing counsel who can be expected to search for unsupported or unreliable data, assumptions, or any indication that the expert failed to consider all relevant facts. Valuation analysis, however, often relies upon assumptions and extrapolations concerning future events and conditions, or requires the analyst to exercise judgment, including:

⁵ USPAP Valuation Standards No. 9 and No. 10 apply to business valuation; Standards No. 1 through 8 apply to real estate and personal property.

⁶ The courts appear to expect that each approach should be evaluated for applicability to the case. The basis for selecting the specific approaches used (and the basis for rejecting those not used) should be documented in the report.

⁷ For instance see Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (4th Ed.)

- The valuation analysis may use management forecasts of the future operating results of a company.
- The expert may exercise judgment in the selection of public companies and M&A transactions which can form a basis of comparison for the subject company
- There can be the exercise of judgment in the determination of estimates of the cost of equity for a company, the appropriate discount for lack of marketability that may apply to a subject interest, and other variables relevant to the analysis.

Concluding Thoughts

Complex civil litigation frequently requires reliance on valuation professionals to provide expert testimony. Successful testimony mandates a thorough understanding of the requirements of the court, a commitment to high ethical and professional standards, clear and concise communication, and thorough, well-supported analysis.