Winter 2010

LITIGATION AND VALUATION ADVISER

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Gazing into the Crystal Ball

How Contingencies Affect the Value of a Business

When a valuator is asked to define the term "fair market value" for a business, he or she would respond that it's typically defined as the amount at which property would change hands between a willing buyer and a willing seller, when neither party is under any compulsion to buy or sell and both parties have reasonable knowledge of the relevant facts.

The kicker is: A host of contingencies are often among the relevant facts, which means that valuators need to look into the future to arrive at fair market value.

Uncertain losses or gains are key

Uncertain losses or gains that will be resolved when one or more future events occur or fail to occur are often a part of business valuations. The accounting treatment of contingent losses (pending or threatened litigation, actual or possible claims, product warranty obligations, debt guarantees) differs from that of contingent gains.

Contingent losses are classified as probable, reasonably possible, or remote. When a contingent loss is probable and the amount can be reasonably estimated, it's accrued by a charge to income. If the loss is at least reasonably possible, it should appear on the company's financial statements.

Contingent gains might include damages recovery in connection with a lawsuit, patent approval, or contract execution. For accounting purposes, contingent gains usually aren't recognized on a company's financial statements — though they may be disclosed in the footnotes.

Why they affect valuations

For an appraiser valuing a business, the treatment of contingencies gets a bit more complicated. Clearly, hypothetical willing buyers and sellers would consider contingencies in arriving at an acceptable purchase price. For a buyer, in particular, a contingent loss increases investment risk and,

therefore, reduces the price he or she is willing to pay.

For the valuator, the challenge is to quantify any contingencies and adjust the company's value accordingly. First, the valuator reviews the company's financial statements and other financial documents. He or she also speaks with management to assess the probability that the contingencies will occur. If a contingency involves

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pending or threatened litigation, the valuator consults with counsel to evaluate potential outcomes (including settlement).

Bear in mind that, when litigation is part of the picture, the valuation report likely will be subject to discovery. Valuators and counsel should approach contingency issues carefully to avoid disclosing privileged or damaging information.

Hypothetical vs. real-life people

Fair market value may presume hypothetical buyers and sellers, but it's real people in real-life situations (who may be hesitant to accept a valuation based on uncertain future events) who rely on business valuations.

An example:
Stephen and Joyce are getting divorced. One of the principal assets to be valued in the property settlement is Stephen's ophthalmology practice.

He's a defendant in a $7 million malpractice suit and has $5 million in malpractice insurance coverage. The parties agree that, apart from the lawsuit, the fair market value of the practice is $3 million.

Stephen's malpractice attorneys believe there's about a 25% chance that the plaintiff will recover the $7 million in damages.

One approach to valuing Stephen's ophthalmology practice for divorce purposes is to adjust the valuation to reflect the risk that he'll be liable for damages beyond the limits of his malpractice policy. Joyce objects to this approach because it would reduce the value of the marital estate based on a contingency that's unlikely to occur.

As an alternative, the parties agree to value the practice at $3 million — its fair market value, without considering the contingency. They also agree to split any future liability Stephen incurs in connection with the lawsuit.

Adjust contingencies before or after

Whether it's better to determine a business's value before or after any contingencies are considered depends largely on the circumstances. For example, in an estate tax valuation, the likely impact of the contingency on the business's value must be considered.

But parties involved in a divorce (such as Stephen and Joyce's example above) might choose to wait until the contingency has been resolved and then make adjustments accordingly.

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