



Litigation &

V a l u a t i o n

REPORT

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Judgment call

What's the value of litigation?

Litigation is fraught with uncertainty. Valuers are often asked to navigate this maze of uncertainty and estimate the potential monetary value of damages in pending litigation. This value may be relevant to the litigation itself — to determine the reasonableness of a proposed settlement, for example — or it may have an impact on the business's value.

Litigation matters

For accounting purposes, a pending claim or lawsuit is a contingent asset (for the plaintiff) or a contingent liability (for the defendant). Under Generally Accepted Accounting Principles (GAAP), contingent assets aren't recorded on a company's financial statements until they're recognized. A contingent liability is recorded if it is probable that a liability will be incurred and the amount of the loss can reasonably be estimated.

But regardless of whether an asset or liability is recorded for financial statement purposes, pending litigation has an impact on the value a hypothetical buyer or seller would place on the business because it may increase the risk associated with that business. Even if a judgment or settlement is less than probable, a buyer or seller would consider the contingency in arriving at a price.

To estimate litigation's value, appraisers must work closely with attorneys involved in the case to determine the probabilities associated with various outcomes as well as the estimated costs. For instance, if a plaintiff would have to invest \$100,000 in litigation costs to obtain a \$100,000 judgment or settlement, pursuing litigation would have no value.

Litigation as an investment

One of the most effective approaches to valuing litigation is to view it as an investment. As with other investments, a party must weigh the cost of pursuing litigation against the potential returns, taking into consideration the relevant risks.

In evaluating an investment in litigation, one technique that can be illuminating is real options analysis (ROA). ROA increasingly is being used in the corporate finance world to analyze capital investments and research and development projects. ROA invokes many of the same principles used to value financial options (such as stock options).

A stock option gives the holder the right to purchase stock for a fixed price within a specified time period. The holder will exercise the option only if it becomes profitable to do so — that is, if the stock's market price surpasses the exercise price — and will let the option expire unused if the opposite happens.

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Similarly, as a project progresses and the facts and circumstances change, a business has “real options” to pursue various strategies, including adjusting the project's scope or direction or even abandoning it altogether. By placing a value on management's flexibility to adapt to changing circumstances and new information, ROA can provide meaningful insight into an investment's true worth.

A more traditional discounted cash flow (DCF) analysis values a business investment by forecasting the most likely outcome — or an average of possible outcomes — and reducing it to present value using a risk-adjusted discount rate. DCF — which typically assumes that investing in a project is an all-or-nothing proposition — has a limited ability to capture the value of management's ability to adapt to future developments. ROA, on the other hand, recognizes that most investments involve a succession of decision points — at each of which

management has the option to change course or abandon the project.

Litigation analysis

ROA is particularly well suited for litigation. In litigation, uncertainty is resolved gradually over time as the parties discover new information and the court rules on legal issues. By recognizing the flexibility of litigants and their attorneys to adjust their strategies as new information is revealed, ROA can often produce more accurate litigation values. Here is a hypothetical case that illustrates how this method works:

Sapp Co. is considering a lawsuit against Disappearing Inc. for fraud and breach of contract. Sapp's biggest obstacle is the statute of limitations. There's some uncertainty over when the statute of limitations began to run, and Sapp's lawyers believe that the company has a 40% chance of surviving a motion to dismiss. They also estimate costs of \$100,000 (discounted to present value) for the discovery and pretrial motion phase of the case.

Assuming the case goes to trial, the outcome also will depend on whether the court allows Sapp to pursue its fraud claim or limits it to breach of contract. According to Sapp's lawyers, there's a 50% chance that the company's fraud claim will be allowed. They also predict that the company would obtain a judgment with a present value of \$1 million for fraud, but only \$100,000 for breach of contract. A trial would cost around \$400,000 (discounted to present value).

Applying a traditional DCF analysis, Sapp has a 40% chance of generating a \$150,000 net recovery. The net recovery is the average of the two possible outcomes should the case go to trial (\$1 million or \$100,000) less \$400,000 in trial costs. The value of the opportunity, therefore, is 40% of \$150,000, or \$60,000. Because the initial investment needed to create that opportunity is \$100,000 (pretrial litigation costs), this analysis suggests that litigation isn't worth pursuing.

ROA, on the other hand, recognizes that Sapp and its lawyers have the option of dropping the case after the pretrial phase if the court disallows its fraud claim. The company probably would not invest an additional \$400,000 to recover a \$100,000 judgment. Viewed this way, there's a 50% chance that litigation would generate a net recovery of \$600,000 (\$1 million fraud judgment less \$400,000 in trial costs) and a 50% chance the company will abandon the litigation with no additional cash outlay.

At the end of the pretrial phase, the value of a trial is the average of the two equally probable outcomes, or \$300,000. Sapp can recover, however, only if it survives the motion to dismiss, so the value of litigation is discounted to \$120,000 (40% of \$300,000). Under ROA, litigation is worth pursuing, because a \$100,000 initial investment would generate an expected income stream worth \$120,000.

A calculated risk

This example is simplified for purposes of illustration. Even relatively simple litigation involves multiple decision points with multiple options, so arriving at a monetary value requires more sophisticated decision-tree analysis or computer simulation.

Litigation is always a calculated risk. But by incorporating real options into the valuation process, the calculations can become more accurate. □



From data to damages

Calculating lost profits for an unestablished business

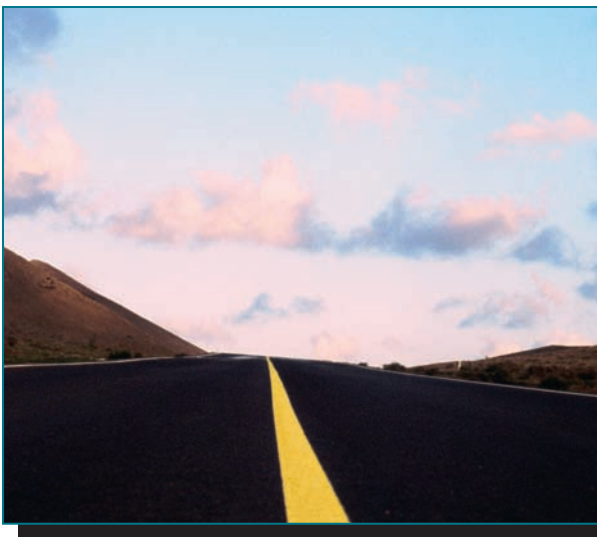
Lost profits are a common measure of damages in commercial litigation. But when an injured business is new or unestablished, calculating lost profits — and, perhaps more important, proving those damages in court — can be an enormous challenge.

An accurate calculation isn't enough: Lawyers and financial experts must work together to create a road map that guides the court from the underlying data to the ultimate damages conclusion. If the route isn't clear, those damages may be lost.

Rules of the road

Historically, courts invoked the “new business” rule to prohibit unestablished businesses from recovering lost profits. The rationale was that, without a track record of earnings to support a forecast, lost profits were too speculative.

But over the past few years, courts in most states have rejected the new business rule. Most courts now allow unestablished businesses to recover lost profits if they can establish the amount of damages with reasonable certainty. This change was driven, in large part, by the view that it's unfair to allow a defendant to escape liability simply because the damage amount is uncertain.



The methods financial experts use to calculate damages for new and unestablished businesses are essentially the same as those used for established businesses. But with less information available, the expert will likely need to make more assumptions — and demonstrate to the court that those assumptions are supportable.

Courts determine the route

The recent case *Parlour Enterprises Inc. v. The Kirin Group Inc.* illustrates the importance of creating a road map of financial data for the court. The case involved breach of contract, fraud and other claims related to an agreement to subfranchise Farrell's ice cream parlors. At the time the agreement fell apart, the plaintiff had opened only one franchise but had specific plans to open three more stores.

A jury awarded the plaintiff more than \$6 million in damages for lost profits and franchise fees, but a California appellate court threw out the award, finding the testimony of the plaintiff's financial expert to be too speculative. The court allowed the plaintiff to recover just over \$200,000 in development costs.

The expert's calculations were based, in part, on the plaintiff's prelitigation projections. But the expert was unable to identify the source of the projections or the qualifications of the person or persons who prepared them. Testimony at trial revealed that the projections were from an offering circular given to potential investors. They were pro forma projections based on management's five-year assumptions rather than actual operations and contained disclaimers stating that income and expense estimates may not reflect actual results.

The officers who prepared the projections had extensive restaurant industry experience, but “neither testified to any particular qualifications that would allow them to predict income, expenses or profits for a Farrell's, as opposed to any other restaurant.”

In addition, there was no evidence as to how the projections were calculated. The officers did not testify, for

example, that their predictions were based on the operations of the plaintiff's one existing store or on "any other actual numbers that would be a reliable indicator of future income, expenses, or profits of a Farrell's located in another city."

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The plaintiff's expert also analyzed market data from a competing 300-store chain, but he failed to offer any evidence that the other business was sufficiently similar to the plaintiff's to be relevant for purposes of proving lost profits.

In addition, the expert considered financial information from two existing Farrell's franchises. One was owned by a third party, and the expert admitted that he didn't use the actual number from that location as a starting point

for his calculations. As to the other — the plaintiff's one operating franchise — the expert testified that he spoke to the plaintiff's management about that store's revenues, expenses and profits. But he provided no evidence "regarding what those numbers were or how they impacted his calculations."

The court found that a valuator must be prepared to explain his or her valuation methods and support the opinion with evidence that has a "substantial and sufficient factual basis" rather than consisting of "mere speculation and hypothetical situations."

Regardless of the type of evidence relied on, the "underlying requirement ... is a substantial similarity between the facts forming the basis of the profit projections and the business opportunity that was destroyed."

Arrive at the destination

The *Parlour Enterprises* case is instructive for lawyers and their financial experts. Perhaps if the expert had provided the court with a road map showing where he started and how he arrived at his destination, the court would have found his testimony more convincing. □

Court blurs the line between foresight and hindsight

A well-established valuation principle states that a valuator should not consider events that occurred after the valuation date. In other words, valuation should be based strictly on foresight — not on hindsight.

This rule is derived from the traditional definition of fair market value 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."

While the terms "known," "knowable" and "foreseeable" are often used in reference to subsequent events, the law

is less clear as other legal considerations and issues blur the "as of the date of valuation" line.

In *Boyce v. Soundview Technology Group*, the U.S. Court of Appeals for the Second Circuit refused to impose a bright-line test, opening the door to hindsight evidence — but only under specific circumstances.

Stock option agreement breached

In *Boyce*, the jury found that the defendant had breached a stock option agreement with the plaintiff, a former employee. The agreement gave the plaintiff the option to purchase 800,000 shares of the defendant's stock for \$1 per share.

During late 1998 and early 1999, the defendant sold more than 43 million shares of its stock in a series of private placements, selling most of that stock for \$1.50 per share. In mid-March 1999, the company announced its intention to conduct an initial public offering (IPO) of its shares and filed a registration statement with the SEC.

The registration statement didn't include a per-share offering price, but it indicated a "proposed maximum aggregate offering price" of \$80 million. Based on the number of shares the company's board had resolved to sell, this translated to a per-share price in the neighborhood of \$9.

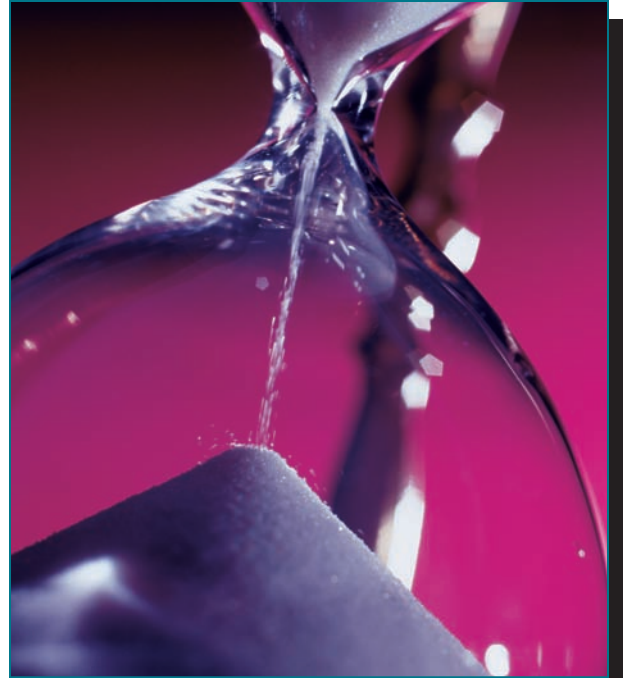
In anticipation of the IPO, the plaintiff attempted to exercise his option on March 31, 1999, sending the company an option exercise form and a check for \$800,000. The company rejected both, claiming that the option had expired. The company went public on June 4, 1999, selling 7.4 million shares of stock at \$8.37 per share. The stock price closed at \$14.875 per share on its first day of public trading.

Court crosses the line

The trial court permitted evidence of the defendant's anticipated future performance in the eyes of a "knowledgeable investor" at the time of the breach. But it excluded all evidence related to events after April 5, 1999.

The Second Circuit rejected this bright-line approach. "In drawing its line," the appellate court explained, "the [trial] court made too broad a stroke. By attempting to exclude evidence based on hindsight, the district court also excluded admissible evidence tending to show economic conditions and performance during the relevant time period."

For example, the trial court excluded an amended registration statement the defendant filed in May 1999. But the registration statement contained the company's first-quarter financial statements — "permissible forward-looking evidence that would aid a knowledgeable investor in anticipating the future conditions of the company and in valuing [the] stock on April 5."



This finding seems consistent with the traditional rule that permits consideration of subsequent events that merely shed light on the stock's value on the valuation date, but do not *affect* its value. But the appellate court's language seems to go further, inviting consideration of additional postbreach facts and circumstances. Ordering a new trial on damages, the court said that the "jury should have been able to make its valuation determination on all relevant elements of the case, whether dated pre-April 5, April 5, or, perhaps, some short time period thereafter."

The court acknowledged that arm's-length transactions involving the defendant's stock generally would provide the best evidence of value, but noted that the pre-IPO sales relied on in this case — primarily to institutional investors and insiders — may not have been reliable.

No rigid rules

The Second Circuit observed that, while the "willing buyer-willing seller" test usually provides the best evidence of fair market value, it's not the only approach. The court suggested that considering postbreach events may be appropriate when rigid application of the traditional rule would "lead to an inequitable result" or "deny plaintiff the benefit of the bargain." □

Playing the goodwill game

Consult state law for a winning valuation

While valuation principles, for the most part, exist apart from the law, the context in which a valuation is performed can have a dramatic impact on the result. Nowhere is this more true than in the treatment of goodwill for marital dissolution purposes.

Is it business or personal?

A significant portion of most companies' value consists of goodwill. According to the *International Glossary of Business Valuation Terms*, goodwill is "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified."

Goodwill can be divided into two components:

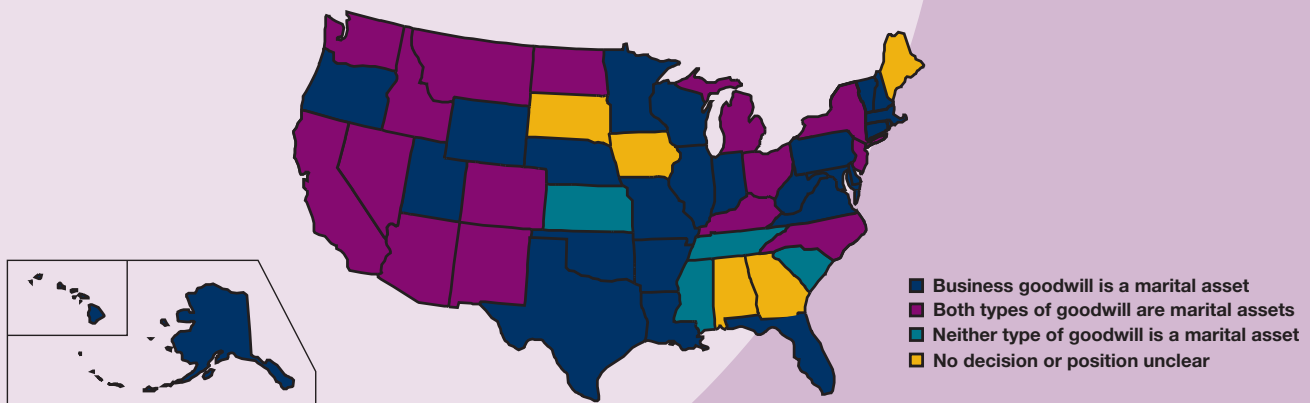
1. Business, or "enterprise," goodwill, which is associated with the business itself apart from any specific owners or employees, and
2. Personal goodwill, which reflects an individual owner's reputation, skills, education and experience.

In most valuations, there's no need to treat the two components separately. But goodwill classification can be critical when a business or professional practice is being valued for purposes of divorce.

How do states treat it?

About half the states treat business goodwill — but not personal goodwill — as a marital asset subject to division. The rationale is that personal goodwill is related to a spouse's personal earning capacity rather than to the ownership of a business. So it should be treated as his or her separate property.

Some states treat all goodwill as marital property, while a few exclude all goodwill from the marital estate. At press time, here's a brief look at how the different states treat goodwill:



State your case

If business and personal goodwill are treated differently, the appraiser will need to perform additional analysis to identify the portion of the business's earning capacity that is derived from the owner's personal attributes.