Positively Neutral

Arbitration and Mediation for Attorneys and Their Business Clients

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For this quarter's newsletter, I want to share an insight that I took away from a business divorce where I served as arbitrator a couple of years ago.

In many business divorces, the dominant issue is the valuation of the company (and, derivatively, the respective owners' interests). The other issues—claims of self-dealing, inequitable compensation, usurpation of business opportunities—while meaningful, often are substantially less important economically compared to the question of how much the business is worth. Whether the business is being sold, or one of its owners is departing, a business divorce requires venturing into the world of valuation.

The arbitration I reference followed standard operating procedure. Each party engaged a business valuation expert. The experts independently plowed through the company's financial records and then delivered reports that set forth their respective valuation opinions. The reports were exchanged and submitted as exhibits in the arbitration. Both experts were present at the arbitration, prepared to testify.

No surprise, the two expert reports reached meaningfully different bottom line conclusions. And another no surprise, the higher valuation came from the expert engaged by the departing owner seeking liquidation of his ownership interest.

Drilling down, however, more striking than the different bottom line valuations were the reports' similarities. Each expert had used the valuation methodology, frequently followed in these kinds of matters, that seeks to determine the anticipated future cash flows of the business, which are then discounted to present value. In other words, they were opining on what a dispassionate investor currently would pay for the stream of income he would expect to receive from the business in the years ahead.

This methodology requires valuation experts to make assumptions about a host of underlying factors. What are the anticipated revenue growth rates, margins, and capital expenditure requirements of the business? What are the expected impacts of the future competitive, regulatory, interest and tax environments? What rate of return would a hypothetical investor require to invest in the business? What reductions are appropriate to reflect the absence of control that a minority shareholder would have?

Since business valuation is not an exact science, there is always a degree of subjectivity involved, and business valuation experts can have different opinions regarding the underlying assumptions. And because they are interdependent, even minor differences in the underlying assumptions will impact the bottom-line valuation, sometimes significantly.

When an expert games the system, he will make assumptions that are shown during cross-examination to be unrealistic and unreasonable. In those instances, it usually reflects poorly on the position of the party who proffered the expert.

But that’s not what happened in the arbitration before me. Even though the experts reached substantially different valuation figures, their underlying assumptions were very much within shouting distance of one another. So close, in fact, that it was apparent that each of their reports would survive scrutiny.

After Expert #1 concluded his direct testimony, he was asked questions along the following line:

> Q: Have you read Expert #2’s report?
> A: Yes
>
> Q: While Expert #2’s assumed growth rate differs from yours, do you believe the rate he used is reasonable? A: Yes
>
> Q: While Expert #2’s assumed discount rate differs from yours, do you believe the rate he used is reasonable? A: Yes

Etc., etc.

Hearing this testimony, it was apparent to me that, as arbitrator, I would be required to decide the valuation issue based on competing experts' opinions, each of which was both defensible and reasonable.

I told counsel that I wanted their post-hearing briefs to provide guidance as to how I was to determine valuation. Assuming I found, as the evidence compellingly suggested, that each expert used (and thought the other used) reasonable foundational assumptions in arriving at their respective valuations, was I to inject my personal, non-expert views about the economic underpinnings of their analyses? Was I to apply whatever conclusions I reached about the parties' respective behaviors in other aspects of the case to the valuation determination? Was I to split the numbers in half? None of these struck me as satisfyingly consistent with my obligations as an arbitrator.

Of course, it never came to that. The parties and their counsel, after seeing the expert presentations unfold, and before the presentation of evidence concluded, successfully negotiated a resolution of the dispute.

And the takeaway that I referenced at the outset? When representing a party in a business divorce, attorneys should:

1. Assess the economic importance of the valuation of the business and ownership interests to the overall dispute.

2. If valuation is a dominant issue, the attorneys are well served to engage at the earliest opportunity, capable and credible business valuation experts (not charlatans whose reports and testimony will be disregarded as unreasonable and incredible).

3. Utilize the resulting valuations to explore resolution, either independently or with the help of a mediator, at a sufficiently early juncture to avoid the costs and uncertainties of litigation or arbitration.