

# Viewpoint on Value



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# Electronic discovery: Federal Rules meet the 21st century

Most businesses create and retain information in some type of electronic format, which may include e-mails, spreadsheets, voice mails, text messages, blogs, accounting records and text files. Increasingly, companies are replacing their file cabinets with laptops, backup tapes, servers, flash drives, cell phones and MP3 players. And all of this electronically stored information (ESI) could be relevant in a lawsuit.

After five years of research, debate, compilation and public comment, the federal judiciary's Civil Rules Advisory Committee finally unveiled its amendments to the Federal Rules of Civil Procedure (FRCP), which govern ESI.

The amended rules strive to provide litigants with a cost-effective, timely way to share electronic data. As attorneys and valuers gain experience with the new-and-improved FRCP, which took effect in December 2006, they're learning that ESI brings to the table many information storage challenges and space-saving opportunities.

## Making discovery proactive

It's never too soon to bring in a valuation expert, especially when a case involves electronic information. The amended rules require the parties to discuss e-discovery issues no later than 100 days after a lawsuit's filing.

A valuation expert can help attorneys prepare for meet-and-confer conferences by addressing such issues as potential sources of electronic data, control concerns, preferred formats for electronic documents, and ESI preservation and authentication.

Requesting ESI requires a delicate balance. On the one hand, electronic data is prolific compared with conventional paper discovery, and "fishing expeditions" can be costly. In fact, amended FRCP Rule 26(b) protects litigants from the necessity to produce ESI from sources that are not reasonably accessible because of undue burden or cost. The amended rule also provides for a "safe harbor" limit on sanctions under Rule 37 for the loss of electronically stored information resulting from routinely operating computer systems.

Conversely, if the parties request too little information at meet-and-confer conferences, the court might deny later



ESI requests. Even if the court grants access, late e-discovery limits the time available for analysis, authentication and integration of the findings into a valuator's report.

## Seeking authentication

One characteristic that differentiates electronic data from tangible evidence is the ease with which it can be changed. In a keystroke or in the normal course of business operations, electronic data can be altered or deleted — sometimes without the creator's knowledge. This risk of alteration is compounded because multiple users at remote locations sometimes have access to ESI.

A valuation is only as reliable as the information upon which it is based. Like any type of evidence, ESI cannot be taken at face value. All parties must take steps to verify the sources and protect the accuracy of electronic data. (See "Authentication checklist" on page 3.)

Most important, management should institute a "litigation hold" when it decides to file a lawsuit or reasonably anticipates that the company will be sued. If not, ESI may be compromised. A litigation hold suspends all routine document destruction and retention policies. Furthermore, employees are instructed to collect and preserve all relevant ESI.

## Factoring in forensics

Forensic specialists often can recover electronic data that appears to have been changed or deleted. For example, when an e-mail is drafted, sent, forwarded or deleted, the computer stores related metadata that doesn't appear on the face of the e-mail. Although the person might think e-mail has been deleted from the system, forensic specialists can track the metadata to reveal who created the original draft, who received and read the file, and who deleted it (and when). Likewise, information erased from a computer hard drive is often recoverable.

If you suspect spoliation of relevant evidence, forensic retrieval can locate, restore and search lost information. Larger valuation firms typically employ forensic specialists. Smaller boutique firms can refer you to a competent forensic professional in your area.

## Using search functions

Manually searching ESI for relevant information can be costly and time consuming. Fortunately, experts can cull

and vet large datasets using search software. For example, the software can narrow down the volume of electronic data using search parameters, such as keywords, file types, custodians and dates. Alternatively, hashing and near-duplication tools can determine whether two documents are exact duplicates — or where they differ.

Many valuers have access to and experience in using these software tools in cases involving ESI. Thus equipped, an expert is more efficient and less likely to overlook relevant information.

## Recognizing expertise as key

Electronic data is a fact of life in the digital world. When interviewing potential experts, inquire about their working knowledge of the amended FRCP, including e-discovery requests, authentication, forensics and searchability techniques.

For more information on e-discovery, visit the U.S. Court's "Federal Rulemaking" Web site at: [www.uscourts.gov/rules/congress0406.html](http://www.uscourts.gov/rules/congress0406.html). ●

## Authentication checklist

A recent federal court case, *Lorraine v. Markel American Insurance Co.*, outlines an 11-step checklist for authenticating electronic records:

1. Does the business use a computer?
2. Is the computer reliable?
3. Has the business developed a procedure for inserting data into the computer?
4. Does the procedure have built-in safeguards to ensure accuracy and identify errors?
5. Does the business keep the computer in a good state of repair?
6. Did the witness have the computer read out certain data?
7. Did the witness use the proper procedures to obtain the readout?
8. Was the computer in working order at the time the witness obtained the readout?
9. Did the witness recognize the exhibit as the readout?
10. Did the witness explain how he or she recognizes the readout?
11. If the readout has strange symbols or terms, did the witness explain the meaning of the symbols or terms for the trier of fact?

Unless the attorney and valuator establish this foundation, ESI may be excluded from evidence or rejected from consideration during summary judgment. To the extent that an appraiser relies on inadmissible evidence, the court may disregard his or her opinion as well.



# For what it's worth

## The issue of owners' compensation

One of the biggest expenses for private businesses is owners' compensation. The amount employee-owners take home varies significantly from one business to the next. For example, some owners work excessive hours but forgo a paycheck. Others insist on receiving hefty salaries and treat the company checkbook as their personal slush fund.

Value often is based on comparisons between a subject company and guideline companies. If owners are over-compensated compared with similar businesses, the subject company will be undervalued on a controlling basis — and vice versa — unless the valuator adjusts the company's income stream for above (or below) market owners' compensation.

### Beyond business value

Executive compensation also comes into play in divorce cases. In many jurisdictions, maintenance and child support payments are based on a statutory percentage of the monied spouse's salary. Some unscrupulous business owners intentionally lower their salaries in anticipation of divorce — or siphon cash under the table in lieu of receiving salaries.

A valuator may be called in to estimate how much other people get paid for performing the same duties and services in arm's-length transactions.

## Some unscrupulous business owners intentionally lower their salaries in anticipation of divorce.

### Tax issues

Similarly, the IRS is interested in how much employee-owners get paid. The Internal Revenue Code allows owners' compensation deductions only when the deductions are reasonable for the personal services rendered.

For C corporations, the IRS checks to make sure owners aren't paid too much. That's because C corporations can avoid double taxation — once on corporate income and

again on personal dividends — if they disguise dividends (a return on investment) as salary expense.

The opposite is true for S corporations, partnerships and other flow-through entities. These businesses can avoid paying payroll taxes on employee-owners' salaries by classifying payments as income distributions rather than salary expense.

### Factors to consider

When quantifying how much an employee-owner should receive for his or her contribution to the business, valutors look at many factors, including the person's unique characteristics, the job itself, the company, the industry and the general economy. Among other things, they look at:

- The person's education level, training, licensing requirements and other qualifications,
- His or her years of experience and previous salary history,
- His or her age and health,
- Personal attributes, including strategic vision, energy and mentoring abilities,
- Average hours the person worked each week,
- The extent of his or her personal guarantees on company debt,
- The job description(s), including primary and ancillary services rendered,
- The subject company's employee turnover rate,
- Prevailing compensation policies and rates for other workers at the same or similar companies,
- The company's size and financial condition,
- The company's geographic location,
- Industry trends and norms, and
- The strength of the local and national economy, including unemployment rates.

## Choose your words wisely

Some people use the terms “replacement compensation” and “reasonable compensation” interchangeably. But subtle differences may exist from a valuator’s point of view.

*Replacement compensation* refers to how much money (including the value of noncash perks) another person would expect to receive for performing the same duties for the subject company. In other words, it is the fair market value of the person’s contribution to the business.

On the other hand, *reasonable compensation* connotes an element of fairness. Reasonable compensation is more likely a range of values. It may differ from replacement compensation — for example, if the person possesses unique qualifications atypical of hypothetical job applicants or personally guarantees the company’s debt.

Beware, too, that a red flag potentially could be raised when a valuator uses the term “reasonable compensation” in a divorce case or when normalizing a company’s income stream for valuation purposes. IRS agents have their eyes peeled for companies that over- or undercompensate owner-employees. Business owners (or disgruntled spouses) who admit to unreasonable compensation expense — or hire an expert to testify to the same — risk IRS scrutiny. And that could result in back taxes, penalties and interest charges.

The IRS also has created the Independent Investor Standard to indirectly determine whether owner compensation appears reasonable. This bottom-up approach estimates how a hypothetical third-party buyer would compensate an employee if the business were sold. As long as equity investors receive a reasonable return on their investments, the IRS presumes owners’ compensation is reasonable.

## Finding comparable data

*Annual Statement Studies* published by Risk Management Association (RMA) provides a classic and useful starting point for estimating owners’ compensation. But valuers have many other resources at their disposal, such as *Statistics of Income: Final Corporation Income Tax Returns* published by Bernan (a distributor of U.S. government publications), *Executive Compensation* published by the National Institute of Business Management, and *Salary Guide* published by Robert Half International.

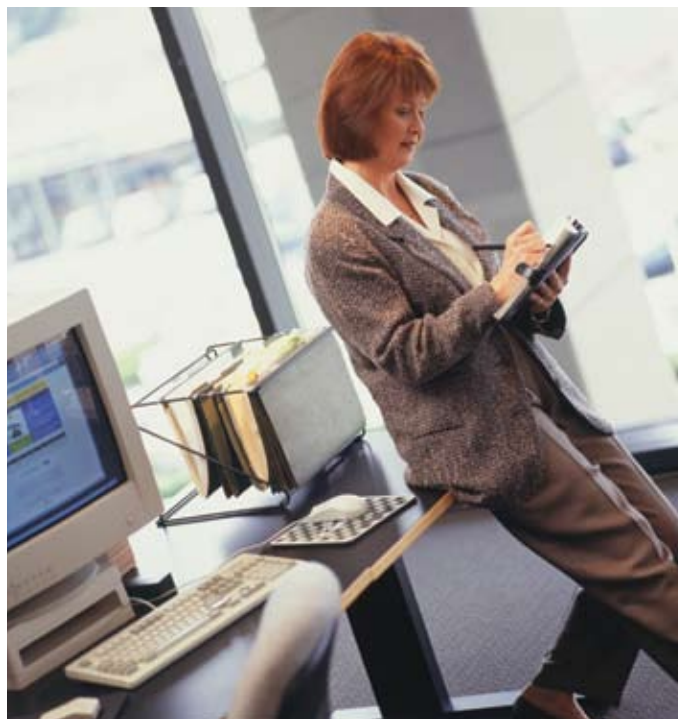
Industry trade associations and executive headhunters are other resources valuers might consider. Although more time-consuming to research, these sources can provide insight on local pay rates based on the industry and the individual’s experience, education and skills. In addition, many industry-specific databases break down information by, say, company size, years of experience, specialty or geographic location.

When comparing multiple sources of compensation data, appraisers need to understand the terminology and nuances of each database. For example, some sources just report owners’ salaries and bonuses. Others may include such items as payroll taxes, retirement benefits, quasi-business expenses and other perks. Appraisers who fail to adequately define “owners’ compensation” will be comparing apples to oranges.

## Defensible estimates

Little consensus exists on how to estimate replacement or reasonable compensation. (See “Choose your words wisely” to the left.) These estimates are among the most subjective and contested issues in valuation, especially if the owner performs multiple roles or is compensated with noncash benefits, such as employee stock options.

Owners’ compensation also has a significant impact on a business’s value. Experienced appraisers are careful to support estimates with sound empirical data and in-depth research. ●



# Identify a qualified appraiser with these questions

Working with an appraiser can be daunting, especially if you have limited experience with technical experts. It's important to remember that not all experts were created equal. Here is some advice to help you identify qualified valuation experts and facilitate questioning in deposition and at trial.

## Use selection criteria

When choosing a business valuator, you want the best. The following questions can help you assess an expert's qualifications. Ask this professional:

- Do you belong to any business valuation professional organizations? If so, do you possess business valuation credentials?
- Are you up-to-date on your membership dues and continuing professional education (CPE) requirements?
- What percentage of your time is spent valuing businesses?
- How many years of experience do you possess?
- Have you had experience valuing companies in the same industry as the subject company?
- How many valuation reports have you performed in your career? Over the last year?
- Have you ever testified in court? If so, what is your track record?

Valid valuation credentials should be a top consideration when hiring an expert. Also look for those who make valuation their top priority — part-timers might not be current with the latest trends, research and case law.

In addition, ask whether your potential appraiser specializes in a particular valuation niche. For example, someone who works primarily for nonmonied spouses in divorce cases might be perceived as a hired gun.

## Delve into valuation basics

Every valuation assignment is unique, but attorneys can frame deposition and trial questions around certain common denominators. After asking about the opposing expert's qualifications, delve into more detailed inquiries, such as:

**Basic business valuation.** Consider giving the opposing expert a pop quiz on valuation basics. Obviously, he or she should be able to define fair market value and know the three approaches (cost, market and income) to valuing a business.

The opposing expert also should be well aware of the eight factors to consider when valuing a business under Revenue Ruling 59-60, including the:

1. Nature and history of the business,
2. Economic and industry outlook,
3. Book value and financial condition,
4. Earnings capacity,
5. Dividend-paying capacity,
6. Goodwill and intangible value,
7. Previous sales and size of the block, and
8. Comparable transactions.

Experienced valuers should have no trouble answering these questions. Hesitation and mistakes suggest that the expert is unprepared or unqualified. If the mistakes are significant enough, a *Daubert* challenge may be a viable option.

**Valuation process.** Determining whether an expert followed all the routine steps required to value the business is key. For example, ask whether he or she conducted a site visit and interviewed management. If not, ask why. Some experts may sidestep these procedures to reduce expenses. In adversarial situations, experts sometimes simply assume controlling owners will deny access to the company's facilities or personnel — and fail to ask for it.

Also inquire about who worked on the valuation and whether it was subject to peer review. Some large firms use inexperienced staff to “crunch the numbers” and then experienced valuers sign off and testify. If subordinates are doing most of the work, a detailed review is especially important in avoiding errors and omissions.

**Assumptions and limiting conditions.** Most appraisal reports contain an appendix that lists all of the valuator's



major assumptions and limitations. Scour this statement for any red flags, such as a scope limitation, overreliance on management-prepared spreadsheets, or the valuator's (or the valuation firm's) ongoing financial interest in the client's business. These elements may introduce an element of uncertainty in the expert's case or expose potential conflicts of interest.

### Get a second opinion

For more help, consider hiring a second valuation expert to act as a consultant. Your primary valuation expert cannot act as an advocate for a client's financial interests. To do so would compromise his or her perceived objectivity.

But a disinterested consultant can review both experts' reports and help draft targeted deposition and trial questions. In addition, the second valuator can highlight the strengths and weaknesses in both reports. But the best part is that a consultant's work product is protected by attorney-client privilege, which means you're free to discuss and promote case strategy.

These issues merely scratch the surface of what's relevant in a valuation case. Obtaining clarification up front can help you get the most from your valuator's expertise and avoid costly mistakes. ●

## What's the valuation Rx for unhealthy companies?

The recession has taken its toll on many companies. Among those hardest hit have been homebuilders and retailers, including restaurants and auto dealers. Factors driving companies to the brink of bankruptcy include weak demand, scaled-back corporate budgets, rising commodity prices, tighter credit and increasing government regulation.

### What are the symptoms?

In every assignment, appraisers assess and benchmark financial health against industry norms. Financial statement trends — such as recurring net losses, declining or erratic sales growth and deteriorating liquidity — are telltale signs that a company is in trouble. But other warning signs include:

- Late or missing financial records,
- Fully extended lines of credit and denials for credit extensions,
- Deferred maintenance, repair and equipment updates,
- Negative operating cash flows,
- Sales of fixed assets to generate cash, and
- High employee turnover, loss of a key person, and low employee morale.

When valuers recognize these warning signs, they can modify their appraisal approach to avoid over- (or under-) valuing a distressed business.

### What are the treatment options?

Financial distress creates specific valuation challenges. First, it's unlikely that a distressed business's historic financial performance will provide insight into its future performance. Future cash flow is important, because it determines business value under the income and market approaches.

If turnaround plans exist and appear reasonable, valuers may use these estimates to forecast future cash flow. If not, valuers might work with management to project future cash flow based on expected demand, not past performance.

Financial distress adds an element of risk, which lowers value. So, compared with healthy companies, distressed businesses have higher discount rates (income approach) and receive downward adjustments to pricing multiples (market approach). Or, valuers might select guideline companies based on similar financial performance or a proximate transaction date to avoid using deals that occurred during better economic times.

Finally, liquidation value plays an increasingly important role in valuing distressed companies. Here, valuers consider what the company would receive at an auction — and then subtract outstanding debt obligations. If the company is worth more in liquidation than as a going-concern business, it's probably time to close shop. ●