

VALOREM PRINCIPIA

The Principles of Value

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THE LAW OF GRAVITY:

What Goes Up Must Come Down

by: Mary K. Lee-Wlodek



If the economy progressed at a steady pace and the Federal Reserve did not need to monitor and project the future, what career path would Alan Greenspan have chosen? Perhaps to fulfill his desire to "predict", he would have been a weatherman, although he could not control the weather as he controls the money supply. Maybe he would have been the president of a Fortune 500 company, where his employees would revere him in the way he is revered as the Chairman of the Federal Reserve; but, he still would have to answer to shareholders.

The reality is that the economy has its ups and downs and goes through its cycles over and over again, albeit for varying durations. So, rest assured, Mr. Greenspan, it is doubtful that your position will be eliminated by government downsizing.

It is no secret that after a prolonged "up cycle", the worldwide, national and many regional economies are not as strong as they were a year ago, and the Fed has been working hard to avoid an economic recession.

However, despite the 2.00% reduction in the Federal Funds Rate since January, both the public and private capital markets remain constricted. Consumer confidence is down and unsurety about what constitutes a quality investment has veiled the market.

The "flight to quality" in the public markets is evidenced by the changes in stock indices from May 1, 2000 to May 1, 2001: the NASDAQ is down by 45%; the S&P 500 is down by only 13.74% and the Dow Jones is even. As a result, many growth companies are not able to access the capital that they need to continue operations and make their business plans a reality. Some are breaking up - think eToys and Kozmo.com. Others are being acquired. Those that have viable business models may be undergoing financial reorganizations, including seeking protection under Chapter 11 of the Bankruptcy Code.

Continues on Page 4

Settling Goodwill Claims Before Trial:

Prevent Costly Litigation & Uncertain Outcomes

by: Forrest A. Vickery

This article presents examples to illustrate how redevelopment agencies and business owners may avoid costly litigation by settling goodwill issues before trial. However, applicability and results may vary by situation.

In the previous issue of *Valorem Principia*, two examples were presented to demonstrate how a redevelopment agency ("Agency") may save time and money by hiring a qualified, experienced goodwill appraiser early in the process to advise on its potential risk and exposure to goodwill loss claims. The article illustrated attempts to reach efficient resolutions and settlements of goodwill loss issues before litigation arises. However, the condemnation process is not immune to Murphy's Law, so things don't always proceed as planned. Therefore, Agencies and business owners must be prepared to cope with potentially protracted litigation. But, don't despair - a settlement still may be reached before bringing the experts in for costly court testimony.

The Right Experts

Since there are no guarantees, and any condemnation action bears the risk of protracted litigation, it is important to hire the right expert for the job - someone who can carry the ball from the beginning to the end, including court testimony, if necessary. Both Agencies and business owners should consider the following qualities when interviewing and retaining experts:

- ◆ An expert with the appropriate credentials and experience to qualify for court testimony.
- ◆ An expert with experience and knowledge of the eminent domain code and case law in California.
- ◆ A firm with the resources to handle multiple projects concurrently.
- ◆ A firm that can devote resources to your case subject to the gyrations of a litigation time schedule.

Continues on Page 2

INSIDE THIS ISSUE

- 1,4.....The Law of Gravity: What Goes Up Must Come Down
- 1-3.....Settling Goodwill Claims Before Trial: Prevent Costly Litigation and Uncertain Outcomes
- 3.....SEC WARNING! Is your CPA Independent?
- 3.....SP&H Offers MCLE Courses
- 4.....SP&H Calendar: Recent & Upcoming Events

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Agencies and business owners alike benefit from retaining experts whose professional experience gained from past cases, depositions, and trials equips them with the ability to help guide the case down the least acrimonious path. Ultimately, experts may be able to provide advice about strategies to reach settlement at any point in time.

Example 1: Critical Issues Analysis

Even after litigation commences and experts for both the Agency and the business have been retained, settlement can be reached before the experts finalize their reports, which otherwise would be "exchanged" in a court setting. For example, consider a pest-extermination business that conducts almost all of its operations off-site at customer locations. The business' headquarters relocated as a result of an eminent domain project. According to the owner's deposition testimony, operations at the relocation site, which is of comparable size and layout, are essentially unchanged and the relocation site is not far from the original location. The principal issue at hand is that occupancy costs (especially rent) are much higher at the new location.

Recognizing that any disagreement of lost goodwill value is going to revolve primarily around the impact of the increased occupancy costs, the attorneys representing either party can request their respective experts to analyze the effects on goodwill of the higher occupancy costs. The results of this preliminary analysis can then be used in settlement negotiations. If a settlement can be reached, this pre-emptive analysis could save significant costs (including attorneys' and experts' fees) to both the business owner and the Agency.

Example 2: Report Review and Critique

The business being relocated and the Agency taking the property each have hired their own goodwill appraisers. Each appraiser performs his or her analysis, and opinions of lost goodwill are exchanged:

- ◆ Agency's Appraiser \$75,000
- ◆ Business' Appraiser \$180,000

In this case, the Business Appraiser's opinion of loss is more than double that of the Agency Appraiser. However, the magnitude of loss being claimed by the business owner is not substantial compared to the costs of experts' and attorneys' fees that may be incurred in trial.

In this situation, either the Agency's or business owner's attorney can request their respective goodwill appraiser to review the opposing side's appraisal to identify strengths and weaknesses of the other side's case. Such an analysis may reveal:

- ◆ Mathematical errors;
- ◆ Fallacious reasoning;
- ◆ Non-compliance with California eminent domain law;
- ◆ Lack of independent research into industry, economic, or market conditions; and/or
- ◆ That material information was unknown to one side's appraiser, requiring that appraiser to amend his or her opinion.

Outlining these factors and assessing their respective impact on the opposing appraiser's opinion may result in a negotiated settlement before incurring further costs for deposition, trial preparation, etc. This avails an opportunity to devote limited funds to a settlement as opposed to inevitably expensive litigation costs with an uncertain outcome.

Example 3: Deposition Testimony s

The business being relocated and the Agency taking the property each have hired their own goodwill appraisers. Each appraiser performs his/her analysis, and opinions of lost goodwill are exchanged:

- ◆ Agency's Appraiser \$250,000
- ◆ Business' Appraiser \$1,400,000

In this case, the difference in the conclusions and the amounts at stake are substantial. Hence, in all likelihood, depositions of each expert will go forward. Again, the Agency or business owner attorney can request his/her respective goodwill appraiser or staff members to review the opposing appraisal to identify strengths and weaknesses of the other side's case. A qualified, experienced expert will be able to:

- ◆ Provide a detailed, thorough review of the opposing appraisal before deposition to identify critical areas;
- ◆ Assist the attorney with the deposition by participating in preparatory meetings and scripting or outlining deposition questions; and
- ◆ Attend the actual deposition to provide assistance to the attorney.



Don't tell people how to do things. Tell them what to do and let them surprise you with their results.

--George Patton

The results of an effective deposition can be critical in settling a case. The expert's support work can save time in the deposition process and make the deposition of the opposing expert more effective by facilitating the attorney's efforts to reveal weaknesses in the opposing appraiser's work and research.

For example, in this illustration consider that the business' expert testified that the business suffered significant damages to its sales from "activities of the Agency" during the two years prior to condemnation. According to this expert, these activities caused the business' sales to level off over the last two years, as compared to sales growth of 10% annually for each of the prior three years. The business' expert argued that, but for the agency's pre-condemnation activities, sales would have continued to grow by 10% each year. An appraiser must value a business' goodwill as if unimpacted by the project. Therefore, to remove any perceived effects of the Agency's activities, the business' expert increased sales by 10% for each of the two affected years. This resulted in significantly higher sales and profits during those two years and a substantially higher goodwill value.



Continued from Page 2

The Agency's expert also recognized the stagnant sales for two years and performed some additional research. Her analysis revealed two facts:

- ◆ Two new competitors moved into the business' trade area the year before sales leveled off; and
- ◆ The business owner testified in deposition that the business was reaching its capacity near the time its growth slowed, and had no plans to increase capacity.

During deposition, the business' expert revealed that he had not read the business owner's deposition, and he had not researched whether any new competitors had moved into the business' area. The business' expert previously had testified in deposition that increased competition generally could have a negative effect on a business' sales, and that capacity constraints would limit the ability of the subject business to grow over the long term.

As the above example illustrates, unearthing clear, indefensible variables in the opposing expert's testimony can weaken his/her opinion of total goodwill substantially, and therefore potential lost goodwill. This can both encourage settlement and promote flexibility in settlement negotiations.

Conclusion

As stated in the preceding article in the last issue of *Valorem Principia*, litigation involving business goodwill has at least two guarantees - it takes a significant amount of time and energy, and it always risks being very expensive. An experienced, qualified goodwill appraisal firm can offer practical recommendations and "war-story" knowledge to provide advice about the potential risks of and exposure to trial. As a result, both parties may benefit by reaching a reasonable settlement without protracted litigation.

Forrest A. Vickery, Manager of SP&H's Sacramento office, has six years of experience in business valuation. He has been involved in over 150 goodwill loss valuations for condemnation and is an official trainer of SP&H's Goodwill Loss Seminar Series. Mr. Vickery can be reached at (916) 614-0530 or fvickery@sphvalue.com.



**SEC
WARNING!**

Is your CPA "Independent"?

It is important to be aware of the rules under which your vendors operate. With respect to business valuations, it is caveat emptor when you have your CPA prepare a valuation. Pursuant to the Securities and Exchange Commission's (SEC) recently issued amendments to Rule 2-01 regarding auditor independence under the Securities Exchange Act of 1934:

"...an [auditor] is not independent [of its audit client] if the accountant provides appraisal or valuation services or any service involving a fairness opinion."

The SEC's logic is as follows:

"[I]f an audit firm provides these services to an audit client, when it is time to audit the financial statements the accountant could well end up reviewing his or her own work, including key assumptions or variables suggested by his or her own firm that underlie an entry in the financial statements."

Ultimately, the risk to your company can be expensive and time consuming, as the SEC, Department of Labor and/or the IRS may require you to retain an independent firm to prepare a new valuation after you already have paid for it once. Additionally, damages may be incurred as a result of the original valuation.

For more information, please contact Thomas E. Pastore, CEO of SP&H, at (310) 571-3400 or tpastore@sphvalue.com.

Take Note

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SP&H is an APPROVED PROVIDER
of the California State Bar
for Minimum Continuing
Legal Education (MCLE) Credits

COURSES CURRENTLY OFFERED INCLUDE:

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- ◆ Valuing Stock Option Plans
- ◆ Valuing Growth Companies in a Dynamic World
- ◆ Current Trends in Business Valuation
- ◆ Goodwill Loss for Eminent Domain

For more information about these or a custom program, please contact us at (310) 571-3400 or bizval@sphvalue.com.



Continued from Page 1

It is highly likely that you are involved at some capacity with an operationally and/or financially troubled company as a creditor, investor, trustee, advisor or debtor. Regardless of your position, you may need to address such questions as:

- ◆ Am I fulfilling my fiduciary responsibilities to protect creditor and shareholder value?
- ◆ Are there hidden assets in the company?
- ◆ Can the company continue as a going-concern?
- ◆ Is the Plan of Reorganization feasible?

Specializing in highly scrutinized situations and dispute resolution, SP&H can:

- ◆ Assess the feasibility of competing restructuring plans
- ◆ Determine the viability of the company as a going-concern
- ◆ Identify hidden asset values
- ◆ Value intangible assets
- ◆ Perform low-cost initial valuation assessments
- ◆ Opine on actions of Trustees/Debtors-in-Possession as fiduciaries for creditors and investors
- ◆ Provide Solvency Opinions
- ◆ Provide Expert Witness Testimony

SP&H's services are provided under competitively priced budget estimates based on the scope of work to be performed. If you are interested in learning more about how SP&H can help your troubled company or client, please do not hesitate to contact us.

Mary K. Lee-Wlodek handled workouts and restructurings for Chase Manhattan Bank during the last bear market of the early 1990's. She earned her MBA in Entrepreneurial Finance from The Anderson School at UCLA and a B.A. in Economics from Stanford University. She can be reached at (310) 571-3400 and marylee@sphvalue.com◆

SP&H Calendar: Recent & Upcoming Events

May 12th - Universal City

33rd Annual Family Law Symposium

SP&H was an Exhibitor.

May 14th - Orange County

Harvard Business School Association - Entrepreneurs Conference

SP&H was a sponsor and Nevin Sanli was a panelist on "Buy, Build & Sell: Lessons From the Field".

May 17th - Los Angeles

2001 Entrepreneurship Capital Conference

SP&H sponsored this event and Nevin Sanli presented "Unlocking Corporate Value".

May 17th - 18th Anaheim

California Redevelopment Institute

Nevin Sanli presented "Property Acquisition and Relocation".

May 22nd - San Fernando Valley

San Fernando Valley CPA Discussion Group

Thomas Pastore presented "Business Valuations for 706 Purposes".

June 7th - Los Angeles

Software Council of Southern California

Nevin Sanli will be presenting "Valuing your Venture".

June 7th - Los Angeles/June 21st - Sacramento

Goodwill Loss Seminar, Level III

"Business Valuation Methodology and Complex Issues".

June 20th - Huntington Beach

ESOP Association Western States Chapter

Nevin Sanli will be presenting "Valuing ESOPs".

June 21st - 22nd - Los Angeles

CLE International - Eminent Domain Conference

Thomas Pastore will be presenting "Loss of Goodwill".

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1990 S. Bundy Drive, Suite 800, Los Angeles, CA 90025

Telephone:	Los Angeles	310/571-3400	Fax: 310/571-3420
	San Francisco	415/955-2699	
	San Diego	858/597-7505	
	Sacramento	916/614-0530	

E-mail: bizval@sphvalue.com

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Articles, letters, comments and suggestions are welcome. Please contact Christine Albino at 310/571-3400 or calbino@sphvalue.com◆