VALUE MANAGEMENT INC.

Investment Banking + Advisory Services

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The Secrets to Expert Testimony That Engage and Persuade a Court

The shareholder dispute case should have been a slam dunk. The determination of the economic value of plaintiff's interest was clear. There was no question of what a willing buyer would pay. At trial, the industry expert had sterling credentials, decades of experience inside of the industry, and deep knowledge of the financial marketplace. He provided an air-tight analysis and report. A multi-million-dollar finding for the plaintiff was a given.

Then, during fierce cross-examination by defense counsel, the expert imploded. He stumbled over simple answers. He looked confused. His shoulders slumped. His voice got quieter. Every piece of his report was rock-solid; every word of his testimony was true. But, suddenly, the expert's behavior made his once-credible testimony suspect in the minds of the triers of fact. The cost: millions of dollars.

Pre-empting catastrophe

It happens more than you think. Smart experts who know what to say sometimes falter in how they say it. How can you ensure this doesn't happen to your expert? A recent article covered the secrets to expert testimony that engage and persuade the court including what jurors want, a polished preparation, hard skills vs. soft skills, and more.

Hard skills vs. soft skills

The expert may have stunning credentials, specialized knowledge and experience, be able to prepare pristine analyses, and speak astutely about the analysis. However, that alone will not get you the results you need when it comes to engaging and persuading the court. The hard skills—what you know—are only the first step.

To be successful in court, your expert needs finely tuned soft skills. Soft skills are the ability to engage with the judge or jurors, to relate to them, to communicate complex ideas in an easy-to-absorb manner, to handle the most challenging questions with aplomb, and to

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In This Issue:

VMI Highlights:

VMI will be sponsoring the Philadelphia Estate Planning Council's luncheon meeting on March 17, 2020. The topic will be "Current Issues in Estate and Gift Tax Audits and Litigation." The speaker will be John Porter of Baker Botts, LLP. If you are interested in attending as our guest or would like more information, please contact Susan Wilusz at smw@valuemanagementinc.com.

Ed Wilusz will be participating on a panel at the Angel Venture Fair 8th Annual Snake Pit in December. The program teaches entrepreneurs about what investors are looking for when presenting to raise capital.

VMI would like to wish everyone a happy and healthy holiday season!

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defend a position without being defensive. Mastery of these soft skills moves a person from being an expert on paper to being an expert in the courtroom who can help win cases.

What jurors want

Time and again, in juror debriefs, they talk about which witnesses they liked, which they trusted, and which they believed. If the jurors talk about data or facts at all, it's most likely through the filter of how they felt about the expert. Often, jurors express their feelings toward experts in the following way: "I didn't believe a thing that expert said; he was too pompous" or "I didn't trust that accountant, so I don't believe her numbers."

Jurors are naively admitting what neuropsychology proves: Emotions are powerful determinants in decision-making. In the consumer world, experts know that we buy on emotion and only then justify with facts. In the courtroom, the same is true. Jurors will buy—or not buy—testimony based on how they feel about the expert. It's never the other way around.

Developing soft skills

How do you help the triers of fact have positive feelings toward your expert? Here are the three most important ways:

1. *Body language.* Research shows that more than 90% of communication is nonverbal. That means everything from the top of your head to the tip of your toes is "communicating." The judge or jury is watching your expert like a hawk. Is their body language telling them they can believe them because they are confident and comfortable? Is their posture open and welcoming? Are they making eye contact with opposing counsel even when they challenge their expertise?

2. *Language.* Think of the testimony as a conversation with the judge or jury. So, is the expert actively inviting them into the conversation? Is their tone warm and friendly? Do they use comfortable, colloquial terms? Are their sentences short and clear? Remember, how they speak to them determines how they feel about your expert.

3. *Attitude.* This may seem a little obtuse. But people pick up all unconscious signals. If the expert shows them respect, if they help them understand complex issues, and if they engage them, the expert now cleared the way to persuade them.

A polished preparation

It's clear from both research and real life that it's not only what you say, but how you say it. It takes time and dedication to be able to deliver calm, clear, concise answers with unflappable confidence.

When working with experts, the focus is on mastering their soft skills. Practice helps accomplish this. Cross-examination is where experts can falter in court. Practicing the toughest challenges builds confidence. You might not know exactly what opposing counsel will ask, but by working on potential questions, you can work through any potential ambushes. What will be the biggest challenges to the expert's expertise and findings? An insurance expert knew opposing counsel would hammer him on his use of the term "industry standard" in his report. Where was it written down? What authority set it up? His initial wishy-washy answer of "that's how it's always been" would only invite a further assault. To give him ammunition and confidence, the expert conservatively estimated how many files he had handled in his years in the industry. There were over 15,700. Now he could confidently face the challenges with "I've handled more than 15,700 files, and this is the industry standard." The court had no doubt that he was an expert on the matter.

Hypotheticals can be quicksand. If you pause too long, break eye contact, or duck your head, you may appear to be evasive. But a firm, clear "I don't speculate" or "That's outside of the scope of the work I was hired for" tells the court there's nothing to hide.

Conclusion

Much as you might want to think that the facts speak for themselves, it's really how your expert speaks about those facts that influences judges and jurors. Take the time to assess your expert's soft skills and then diligently hone them so that they can easily engage and persuade the court.

Survey Finds Market for Small Businesses May Have Peaked

Seller's market sentiment is down in all market segments except for businesses with $5 million to $50 million in enterprise value. Looking back a year, seller's market sentiment has decreased notably for businesses valued between $1 million and $2 million, dropping six percentage points from Q1 2018 (72%) to Q1 2019 (66%). According to the "Q1 2019 Market Pulse Report," published by the International Business Brokers Association (IBBA), M&A Source, and the Pepperdine Private Capital

Market Project, seller's market sentiment increased for businesses valued from $5 million to $50 million, rising from 77% in Q1 2018 to 81% in Q1 2019. "This is the first time in years that we've seen four out of five sectors report a dip in seller market sentiment. This is a sign the market may have peaked and more people are expecting a correction in the year or two ahead," said Craig Everett, Ph.D., director of the Pepperdine Private Capital Markets Project at the Pepperdine Graziadio Business School. "Sellers should consider selling now or waiting another few years until the market cycles back up to current conditions. To be clear, this doesn't mean you won't be able to sell your business over the next few years, but you probably won't get the multiples you can get today. Any market pessimism or uncertainty will drive down value across the board."

Delaware Chancery Relies on Deal Proposal Valuation in Adjudicating Buyout Dispute

Smith v. Promontory Financial Group, LLC, 2019 Del. Ch. LEXIS 148 (April 30, 2019)

In a buyout dispute centering on a company, Promontory Growth and Innovation LLC (PGI), with an unusual business model and an "improvised operating agreement" (court's words), one of the two equal partners withdrew and sued in the Delaware Court of Chancery for the value of his interest. In determining the company's going concern value, the parties' experts used the discounted cash flow method (plaintiff) and asset accumulation method (defendants). The court found both approaches were entirely unsuited for the circumstances. Instead, the court looked to a deal proposal that the parties negotiated just prior to the plaintiff's departure.

The court said that a debt/equity deal proposal was the best indicator of the company's value with the plaintiff in place. Both the plaintiff and the defendant, agreed with the plaintiff's written statement in the proposal that PGI, with the plaintiff there, was worth $16.25 million. Also, this proposal was nearly contemporaneous with the plaintiff's withdrawal, the court pointed out.

Based on the formula in the LOI, the court decided that the value of the company without the plaintiff was $8.125 million. The plaintiff was entitled to 50% of that amount, the court decided.

The court dismissed defense arguments that the plaintiff in effect was more important to the success of the business than the defendant and that his departure would drive the value for the company without the plaintiff below 50%. The court observed that the company had continued following the plaintiff's departure and obtained some engagements. Therefore, the company retained half of its value after the plaintiff's departure, the court concluded.

Based on the withdrawal provision in the LOI and the value stated in the plaintiff's debt/equity deal proposal, the court awarded the plaintiff about $4 million, noting that this amount would be reduced by the plaintiff's obligation to pay half of PGI's debt to the defendant's LLC.

AICPA Final PE/VC Guide Issued Soon

The final version of the AICPA's new Accounting and Valuation Guide "Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies" is expected shortly. The guide provides "non-authoritative guidance" and addresses many accounting and valuation issues regarding portfolio company investments held by investment companies within the scope of FASB ASC 946. The guide is also useful for other entities, such as corporate venture capital groups or pension funds.

Court of Chancery Rules Unaffected Market Price Is Best Evidence of Fair Value

In re Appraisal of Jarden Corp., 2019 Del. Ch. LEXIS 271 (July 19, 2019)

In a major statutory appraisal action, the Delaware Court of Chancery recently ruled, in an "unfortunately long opinion" (court's words), that the unaffected market price was the most reliable indicator of fair value. The opinion came close on the heels of the Delaware Supreme Court's *Aruba Networks* decision, in which the high court rebuked the trial court for relying on the unaffected market price. The instant opinion includes important analysis of the principles guiding the Court of Chancery's fair value determination after the high court's *DFC Global, Dell,* and *Aruba* decisions. The opinion also features an in-depth analysis of the "traditional" valuation methods the parties' experts used, resulting in strikingly disparate value conclusions. The court did its own DCF analysis, which it found supported reliance on the market price.

Jarden argued the unaffected stock trading price was a strong indicator of the fair value, as it "impounded the collective judgments of thousands of stockholders, as well as the more than 20 professional analysts that followed Jarden." Jarden's expert prepared an analysis that included a "helpful chart" (court's words) that proved Jarden's stock traded in a semi-strong, efficient market. An efficient market means the company's stock price quickly reflects publicly available information about the company. "When the market is efficient, the trading price of a company's stock can be a proxy for fair value," the court noted.

Jarden's expert explained Jarden's stock traded on NYSE, at a high volume, and had high market capitalization, leading to greater "interest in the security being analyzed." The company had no controlling shareholder but had a high public float, meaning many stockholders were not insiders with access to nonpublic information. There was a greater likelihood the market would require information be released for public consumption. Also, there was a narrow "bid-ask" spread, which indicated that there was little asymmetry as to the information insiders and the public markets had. This also meant higher market efficiency.

Moreover, Jarden's expert prepared an event study that showed how the company's stock in the two years before the merger had responded "quickly and appropriately" to earnings and other performance-related announcements. The court found the petitioners' expert did not "persuasively rebut" Jarden's market evidence. Accordingly, the court decided to give "substantial weight" to the unaffected market price in determining fair value.

Court's value conclusion. The court achieved a DCF value of $48.13. In contrast, the unaffected market price was $48.31. The court found the unaffected market price was the best evidence of fair value, but the court's DCF value served to corroborate the unaffected market price. The court said it was "satisfied" that the slight difference between the two values reflected "the subjective imperfections of the DCF methodology."

"What stands out here, of course, is that petitioners' proffered estimate of fair value for Jarden of $71.35, is to put it mildly, an outlier," the court noted at the end of its analysis.

Tax Affecting of S Corporations

In the recent *Kress* decision, Kress v. United States, 2019 U.S. Dist. LEXIS 49850, 2019 WL 1352944, the federal district court ruled in favor of the taxpayers. The case is important because, in valuing the minority shares of a family-owned S corporation, experts for both the taxpayers and the government applied a C corp tax rate to the company's earnings. In addition, the government's expert applied an S corp premium to account for the tax advantages related to S corp status. The taxpayers' expert did not make a specific S corp adjustment. The court, with a minor modification, adopted the latter's value determinations.

Valuators welcome the collective recognition, by the experts and the court, that the tax consequences for pass-through entities must be accounted for in some measure. Accordingly, the *Kress* case may be used to push back against the Internal Revenue Service's longtime rejection of S corp tax affecting.

M&A Holdback Escrow

When selling a business, why doesn't the seller get the full purchase price at closing?

The simple answer can often be found in the difference between the price (or total consideration to be paid for the business) and terms (how and when the price will be paid) of the deal. For this article, our focus is on the common use of holdback escrow in M&A transactions and how it impacts what the seller will receive at and after the closing.

What is M&A holdback escrow?

M&A holdback escrow (also called holdback, escrow, indemnity holdback, indemnity escrow, or working capital holdback) is where a percent of the acquisition purchase price in a transaction is placed in a third-party escrow account or withheld from the seller for a defined period to serve as security for the buyer. Holdback escrow is used to mitigate transaction risk. Most M&A transactions involving privately held businesses have escrows or other forms of holdback to protect against issues that are not known or could not be known at closing. The scope of these issues and the buyer's recourse is detailed in the written transaction agreement, specifically in the representations and warranties made by the seller, as well as in the definitions and terms for working capital and other key deal elements.

Representations & Warranties, also known as "Reps & Warranties"

Seller Reps & Warranties are important components of an acquisition agreement. A representation is an assertion as to a fact, true on the date the representation is made,

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that is given to induce the buyer to enter into a contract or take some other action. A warranty is a promise of indemnity if the assertion is false. The indemnity carries a promise to compensate the buyer for incurred hurt, loss, or damage related to the transaction. In typical M&A transactions, the seller (or its owners) agree to indemnify the buyer (subject to caps, exclusions, and time limits) for breaches of the seller's representations and warranties. The indemnity is backed by an escrow or holdback of a portion of the transaction proceeds, which would be otherwise payable at the closing (or per the other terms of the deal).

In addition to a general indemnity escrow fund, if there are identified issues, contingencies, or litigation prior to closing, the parties could set up a separate holdback specific to that known issue. Working capital often has its own holdback, separate from the indemnity escrow. (See article on The Significance of Working Capital.)

According to the J.P. Morgan 2019 M&A Holdback Escrow Study[1] (the "J.P. Morgan Study"), holdback escrow claims[2] made by buyers normally fall into three categories: indemnity claims, purchase price adjustments, and expenses. Common types of indemnity claims are for contracts, accounts receivable, employee issues, financial statement adjustments, litigation, taxes, and environmental matters.

Purchase price adjustments could stem from the final determination of various financial measurements of the acquired company after the deal has closed. The most common is some variation of a net working capital formula, making these net working capital claims. A net working capital adjustment can favor the buyer or the seller.

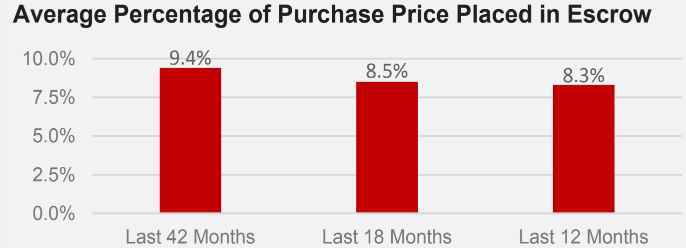
Expense claims can be either a direct claim made by the buyer or a third-party claim. Expense claims may be based on terms such as seller's obligation to pay outstanding transaction costs, or third-party professional services disclosed prior to closing.

The J.P. Morgan Study shows:

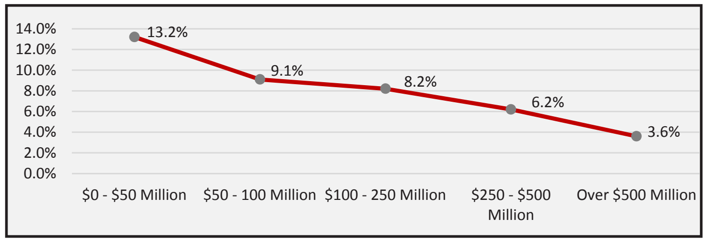
Escrow Size

Results from the J.P. Morgan Study indicate that the average percentage of purchase price placed in escrow is 9.4%; it has decreased over the 3.5 years examined.

Average Percentage of Purchase Price Placed in Escrow

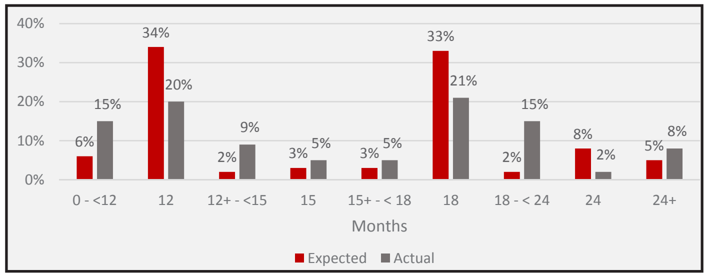


There exists a negative correlation between transaction size and the percentage of the purchase price placed in escrow; a larger deal size translates to a smaller escrow holdback percentage.



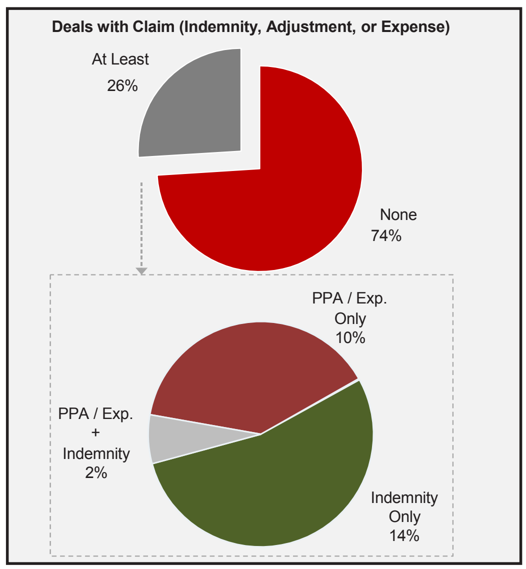
Escrow Duration

The average expected escrow duration is 16.6 months. The general range of 12 months - 18 months makes up most of total deal population.



Claims

At least 26% of transactions had an indemnity, adjustment, or expense claim.



The average indemnity claim request was 52% of the value of the escrow; 28% of the escrow was eventually paid to buyer.

[1]Based on 2,400 separate M&A holdback escrows for deals closed between 2016 and the first half of 2019, ranging in deal size from below $1 million to over $7.5 billion, with the $50 million or less deal size consistently being the largest category, approximating 36 percent of deals over the 3.5 years used for the Study.

[2]For this article, a claim relates to a disbursement of funds to the buyer that was not delineated in the escrow agreement. Claims may be made but not all claims are paid.

The Significance of Working Capital

Working capital is critical to running a business and is important to buyers and sellers of businesses. For running a business, the term "capital" generally refers to financial resources that are available for use. To an operating company, capital is more than just money. Capital is part of that which is used to help generate income. The term "working capital" refers to the financial resources of a business that are used in its day-to-day operations and its base calculation is reflected by the amount of current assets minus the amount of current liabilities.

Operationally, working capital is crucial because it reflects a company's ability to pay its creditors in the short term and to keep the business running. Each business determines its optimal level of working capital. Working capital can fluctuate throughout the year, and it may change with time and circumstances. In the sale of a business, it's not uncommon for working capital to initially be defined as: "sufficient working capital at closing." As the potential transaction progresses, a specific target dollar amount for working capital is agreed upon. A price adjustment will then occur for amounts above or below the target. Additionally, an escrow account is often established where some of the proceeds to the seller are held until a final accounting of working capital is completed.

Buyers typically purchase companies on a debt-free basis and the formulas used to determine working capital are often on a cash-free and debt-free basis. Current assets which are commonly transferred as part of working capital include: a normal level of cash (while cash is usually not part of the working capital formula, cash is still considered when verifying the amount of working capital left behind by the seller), accounts receivable from clients/customers, inventories, and prepaid expenses. Current liabilities transferred include current obligations to vendors, other payables, and accruals (tax, bonus, vacation, etc.) There is no commonly accepted level of working capital that is applicable to all businesses. Even in the same industry, levels of working capital can vary from business to business. For some companies, working capital is seasonal and can vary significantly throughout the year. The nature of business can also cause volatility and lead to erratic levels. Additionally, growing companies will need increasing amounts of working capital as the business expands. Given the above, there may be difficulty in establishing a level of working capital acceptable to both the buyer and the seller. To avoid unwelcome surprises, it's better to address the issue early. Doing so can avoid misunderstandings and give the seller a better idea of the net proceeds that will be available to them.

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