



Defense Strategies against Expert Business Valuation Tactics - Episode #136

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John Czuba: Welcome to the *Insurance Law Podcast*, the broadcast about timely and important legal issues affecting the insurance industry. I'm John Czuba, Managing Editor of *Best's Recommended Insurance Attorneys, including Expert Service Providers*.

We're pleased to have with us this morning, Derek Royster and Matthew Curtis from RGL Forensics, a leading financial investigations company with worldwide offices and coverage, specializing in the economic analysis of major claims for the insurance industry.

Derek Royster is a partner and CPA who works extensively with insurance companies and law firms, to quantify economic damages and provide litigation support in high value and high profile claims and cases.

His engagements have taken him on assignment throughout North America, Central America, Europe, Africa, and the Caribbean.

Matthew Curtis is a senior manager who is both a CFA Charterholder and a CPA licensed in the state of Texas. He specializes in the practical application of financial, economic, and valuation principles to solve a variety of client challenges.

The scope of Matthew's work includes providing analysis for mergers and acquisitions, corporate strategy, and commercial disputes. We're very pleased to have you both with us this morning.

Today, we'll be discussing business valuation and the impact in the courtroom. For our first question this morning, Derek, from a defense perspective, what are some of the ways an attorney can defend and attack expert valuation testimony?

Derek Royster: There are a number of ways. First and foremost, would be to attack the expert's qualifications. Since we're talking about from a business valuation context, an expert attempting to

calculate a business's value will normally have a business valuation certification. There are a number of them out there.

The American Society of Appraisers has the AM and the ASA. The AICPA has the ABV. The National Association of Certified Valuation Analysts has the CVA and the AVA. The Institute of Business Appraisers has the AIBA, the CBA, and the MCBA.

Each of those certifications has a different requirement, but each requires the applicant to pass a written exam. Further, an expert's qualifications can be evidenced by their training, experience, prior testimony, author publications, positions held in industry associations, and so forth.

Generally, the attack of credentials is difficult, and usually occurs when the other side uses an in house expert, such as their controller, or CFO, that may not have a certification or the training in business evaluation. Qualifications are one.

Another one is what is the expert trying to calculate, and did they use an appropriate methodology? From an insurance context, on a first party property insurance claim, did the expert calculate in accordance with the conditions of the policy or the contract?

If you're looking at from a commercial litigation perspective, for example lost profits, has the expert established that there's a reasonable link between the allegations and the measured damages? What is the damage period being used? Is the length of time appropriate?

If the expert is calculating future damages, have they been discounted to present value? The failure to do so will overstate the damages. Another issue with methodology that we see is, did the expert calculate lost profits versus lost business value, or did they calculate both? If they calculated both, is there a duplication?

In regards to business valuation, did they use an appropriate business valuation methodology? Matthew is going to get into some of those later in the podcast.

Another way is, did the experts base their analysis on a number of assumptions, rather than facts? From an attack perspective, the attorney should have the expert explain, whether in deposition, or cross examination at trial, the assumptions that were used, and then attack those assumptions. If for example, how would the calculation have changed had they used a different assumption?

Another way is to identify the information the expert considered and relied upon. Were their certain facts and/or documentation that was presented in discovery that was not considered. If not considered, why not, and how would the analysis and the calculation change if the information was considered.

Another way is, have the appropriate professional standards been adhered to? Review the standards for the organizations and the governing bodies for which the expert holds credentials. For example, the ASA and the AICPA, as I mentioned before, and others. Did the expert prepare the analysis in accordance with those standards?

Another way is to attack the lack of consistency with prior testimony, or publications, and writings, and so forth. Recognize that each case is different, but the application of methodology and theory should be applied consistently.

A review of the expert's authored publications, articles, presentations, prior transcripts, will provide insight into their position, and either support or question the credibility, and then attack any errors that are found.

Some of the major areas that we see are from an opposing expert's failure to consider causation. Were there other factors, such as new competition, industry or economic downturns that may have impacted sales that were not considered?

Failure to consider all relevant data. If there is information that was provided in discovery, as I mentioned previously, that is important and relevant that wasn't considered, that may impact the valuation.

Failure to consider mitigation is a big one. Were the damages mitigated? There's a number of ways that a business may look at mitigation to mitigate their overall exposure. Then the typical, the mathematical errors, or the inconsistent applications of growth rates, discount rates, premiums, capitalization rates, and so forth.

A lot of times, we'll see things being double counted. There are, obviously, others, but those are a number of ways that, from a defense perspective, counsel can attack expert valuation testimony.

John: Matthew, can you briefly define the Daubert standard, and some challenges there?

Matthew Curtis: Sure. It's helpful to have a little bit of background when talking about Daubert, just so people have a framework for understanding why it came about the way it did.

Prior to Daubert, we had what was called the Frye standard, which came out of a case in the '20s. What was basically ruled in that case was, for scientific evidence to be presented, it had to be generally accepted for it to be admissible into a trial setting.

That presented some problems as advancements in technologies and processes occurred, that the rate of acceptance wasn't always as fast as your ability to get that evidence into a courtroom. You also had the interpretation of different judges trying to determine what was generally accepted and what wasn't.

To address this, we had a Chief Justice, Earl Warren, who came up with a panel to determine what is now referred to as the Federal Rules of Evidence, that got enacted into law in the '70s. Based on these, there was a court case. It was a pharmaceuticals case. Daubert was the plaintiff in that case.

What ended up coming out of that case was a more general framework based on the Federal Rules of Evidence, that was more lenient in what could be admissible into a courtroom, in terms of scientific evidence or what you would refer to as expert testimony.

In general, what you're looking at there is a lot of what Derek just covered, in terms of how you can attack an expert valuation. You can frame it into three different buckets, the first one being qualification.

Does the expert have the qualification, the knowledge, the experience to answer the questions that they're being asked? That's the credentials and the knowledge part of it that he spoke about at the beginning there.

The second question is, is the evidence that is being proposed, is it relevant to the question at hand? Is it probative? Does it answer the questions that are being asked? The third part is, is it reliable?

It's interesting, the way that it seems to be interpreted right now. You don't have as many challenges based on qualification and relevance as you do on the reliability, probably because those questions are more easily answered. There's a little more ambiguity around what is considered reliable and what isn't.

It's left up to the judge or the trier of fact to parse out what is reliable, has it been sufficiently demonstrated that it can be put in front of either them for consideration, or the jury for consideration?

Have questions about whether that's the appropriate methodology or not to use to be parsed out through the competing testimony of the experts, or whether it's sufficiently unreliable enough that it should be excluded, and not even presented for consideration.

That's where we are with Daubert right now, and how that works, and generally provides a framework for considering those aspects of expert testimony as it comes into play in these cases.

John: Derek, can you tell us how insurance claims value standards affect or impact value results?

Derek: We often see claims being submitted against a first party property insurance policy, in which covered property has suffered damage due to some covered peril. These same claims also may end up in subrogation against the third party, with the first party property carrier seeking recovery from the party alleged to have caused the loss.

These claims can also be filed in lawsuits filed directly against the third party, and in turn as a claim against the third party's commercial general liability policy.

While the general economic theory and concepts are the same in each setting, the loss recovery will certainly be different in the property setting, as the insurance contract is the differentiating factor. For example, these claims are subject to the conditions set forth within the insurance policy.

Some of these limitations and conditions include policy language regarding the covered peril, actual loss sustained wording, applicable waiting periods and deductibles, co insurance requirements, monetary limits and time limits for ordinary payroll, actual loss sustained requirements – as I mentioned – and then the time limits for loss recovery.

It's basically the same theory. However, there are going to be differences, because in a commercial litigation or third party setting, the loss is really the true damages, whereas you've got the insurance contract in the first party property claim.

For example, on the property damage, a lot of times, you'll see replacement costs or actual cash value. Actual cash value, this is more of a general definition, because it may differ from policy to policy, but generally, it's the amount it would cost to repair or replace insured property on the date of the loss, with material of like kind and quality, with proper deductions for obsolescence and physical depreciation.

Whereas in a commercial damages perspective, fair market value in the valuation world may differ from actual cash value. Matthew may get into that a little more.

Really, the primary difference would be the limitations within the contract, versus when you look at it from a third party perspective or from commercial litigation, with the policy language being the differentiating factor.

John: Thank you, Derek. Matthew, can you comment on the nuances of the three business valuation approaches?

Matthew: Sure. There are typically three approaches that are most commonly used among business valuation professionals. You have what's often referred to as a comparable companies approach. You have a comparable transactions approach, and then some kind of income approach, often as something like a discounted cash flow analysis.

The first two are lumped together in what are referred to as market analyses. They're referred to as market analyses because they're based on observing transactions that occur in a marketplace.

For instance, in the comparable companies analysis, you would select a universe of companies that are similar to the subject company, and observe the prices at which shares in those companies are priced as investors and shareholders trade those shares back and forth.

For a comparable transactions, rather than individual shares being bought or sold, it's the entire company being bought or sold. It's a different marketplace, and different types of transactions, but it's still, at the end of the day, a market transaction that happens there.

Then you have the income approaches. As I said, it's often a discounted cash flow, or a capitalized earnings model, something along those lines, where the business valuation is dictated by the amount of income or cash flow that it generates. It's based on an expectation of what that cash flow generation ability or earnings power is, going forward into the future.

Those approaches tend to be the most commonly encountered. There are some others that people have started using, that tend to be hybrids of those types of approaches. At the end of the day, those three provide a pretty good framework for understanding the basis for the valuations and the resulting value conclusions that come out of those.

John: Derek, what approach would typically work best for insurance defense claims in particular?

Derek: Back to my previous comments, in the first party property perspective, generally, you wouldn't see a valuation approach in terms of trying to quantify a diminution in value of a business, because under the time element provisions, it's generally limited to a time period, or a dollar amount.

If you look at it from a commercial damages or a third party liability, if you go back to what Matthew mentioned, there are three approaches. One particular approach is not necessarily better than any of the other two. More times than not, you'll see the income approach, but I've seen the other approaches as well.

John: When is the best time to get an economic damages expert involved in a particular case?

Derek: From our opinion, timing is critical. We feel the earlier you can get your accountant or economic damages expert involved, the better, especially because that expert can help identify the accounting and financial considerations of the case, and can identify potential problems early before they snowball.

The expert can assist with the preparation of document requests, and help with questions for interrogatories, prepare questions for deposition or cross examination.

It's always difficult if we, as experts, get involved late in the discovery phase, or even after discovery is over, because at that point, the amount of documentation that you can get could be limited, or there may not be any additional information to get if discovery is closed. In our opinion, the earlier, the better, certainly.

John: Derek and Matt, thank you both very much for joining us today.

Derek: Certainly, our pleasure.

Matthew: Thank you very much.

John: That was Derek Royster and Matthew Curtis from RGL Forensics, with offices and services providers worldwide. Special thanks to today's producer, Frank Vowinkel.

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