

Best Practices

The Relationship between the Attorney and the Valuation Analyst

Robert P. Schweih

Too often in litigated matters the attorneys are surprised and the valuation analysts are disqualified. Standards of conduct between the attorney and the valuation analyst have been established to avoid the risk of losing a decision or of delaying the proceedings because information has been inadequately disclosed.

INTRODUCTION

The role of the independent valuation analyst is most important when there is an existing dispute or an anticipated dispute over the value of a business or business interest.¹

A potential dispute over the value of a business interest requires at least two parties. One party believes the value of the business interest is greater than the amount believed by the other party. When money will change hands depending on the outcome of the dispute, attorneys are usually involved.

Independent valuation analysts need to be able to work effectively with attorneys.

This discussion explores some of the practical aspects of the relationship between the attorney and the valuation analyst.

THE ENGAGEMENT AGREEMENT

Before the engagement begins, the independent valuation analyst needs to understand (1) the scope of the services to be provided and (2) for whom the services are to be provided. The most obvious reason for clearly defining who is the analyst and who is the client is to know who is responsible for providing the services and who is responsible for paying for the services.

Another reason is that the valuation analyst has a responsibility to release confidential information

about the assignment only to the client. Other parties may receive confidential information about the assignment only with the client's permission, or if required by law.

If the case involves pending or potential litigation, the attorney may prefer to have his or her law firm retain the valuation analyst, rather than have the client retain the valuation analyst directly. When the attorney's firm retains the valuation analyst, the analyst's work and files may be protected from subpoena by the opposing attorney. However, the effectiveness of such protection varies greatly from one situation to another.

Even when a business transaction (instead of litigation) is likely to be the ultimate outcome, it is important to specify who has engaged the valuation analyst. Instead of by the attorney who represents the client, the valuation analyst may be engaged directly by a party to the transaction, such as the board of directors of the buying or selling company, the employee stock ownership plan trustee, or one or more individual shareholders of the buying or selling company.

The party to the transaction and the valuation analyst may agree on how they intend to communicate and to protect the confidentiality of the data and work product of the assignment.

Unless the party who is engaging the valuation analyst is an attorney representing a client, it is unlikely that the work product would be protected by the attorney-client privilege.

The valuation analyst's relationship to the parties involved should be clear.

When the valuation analyst is directly engaged by the client as a consultant rather than by the attorney who is representing the client, the work product of the consultant may be subject to discovery by the adversary in a litigation proceeding. In this situation, the valuation analyst may become a fact witness in the litigation. As a fact witness, all of the valuation analyst's thoughts, working files, and communication with the client might be subject to discovery.

WHEN THE CONSULTING EXPERT BECOMES A TESTIFYING EXPERT

When the valuation analyst is engaged by an attorney, often he or she is initially engaged as a consultant to provide advice to the attorney so that the attorney can properly represent his or her client.

The attorney may decide that the consultant's work is not going to be used in litigation. In this situation, the consultant's work is protected by the attorney-client privilege and is not subject to discovery by the adversary.

When the determination is made by the attorney who has engaged the consultant that the work product of the consultant is going to be used in litigation, then the consulting expert becomes a testifying expert.²

Communications between the attorney and the testifying expert are discoverable when the communications are related to:

1. compensation,
2. facts or data provided by the attorney and used by the expert to form the expert's opinions, and
3. assumptions provided by the attorney and used by the expert to form the expert's opinions.

Often, the testifying expert's drafts of the expert report and most attorney-expert communications (unless undue hardship can be shown) are not subject to discovery.³

While this discovery protection gives the attorney some flexibility in representing the client, it is still complicated. This is because the process of educating the expert about the facts of the case took place while the expert was a consultant.

PROFESSIONAL STANDARDS

Many experts already operate within ethical codes that are applicable to their chosen professions.

Until recently, there were no uniform standards that applied to the retention and employment of experts by attorneys. The lack of uniform standards led to (1) inconsistent expectations of conduct required by experts, (2) unnecessary surprises, and (3) motions by adversaries to disqualify an expert.

Attorneys and experts should be focused on the matters for which the experts were retained and avoid the risk of delayed proceedings and the added expense associated with clearing the way for the expert's opinion.

In August 2011, the American Bar Association adopted Standards of Conduct for Experts Retained by Lawyers (the "Standards").

The Standards set forth five basic standards that govern the attorney-expert relationship. They require: (1) integrity/professionalism, (2) competence, (3) confidentiality, (4) avoiding conflicts of interest, and (5) avoiding contingent compensation of experts in litigated matters.

The Standards apply to all litigated matters (but not only to litigated matters), whether civil or criminal, whether the expert is proposed as a testifying expert or simply retained as a consulting expert. They apply to matters to be resolved in court, by arbitration, mediation or through any other recognized ADR procedure.

These Standards supplement and are in addition to ethical requirements governing the expert's selected profession or field of expertise. The Standards are not intended to create any lesser standard of conduct that otherwise govern the expert's profession.

Confidentiality

All information received and work product produced during an engagement is to be treated as confidential except as required by law or with the consent of the client.

Because confidentiality is so important to a attorney's relationship with his or her client, as well as to the integrity of the judicial process as a whole, information regarding the engagement should only be disclosed to third parties when explicit consent is provided by the client or when disclosure is otherwise required by law.

If a testifying expert receives a request from a third party for confidential information, either informally or by legal process, the testifying expert should refer the request to whoever retained him or



her (i.e., counsel or the client) so that confidentiality may be protected.

Valuation analysts may be retained to conduct an assignment that may never be finalized or may be finalized but never becomes publicly available. The valuation analyst should not be placed in the position of making determinations regarding what documents or information should be deemed confidential.

Disclosure to the Retaining Attorney of Prior Relationships

The Federal Rules of Civil Procedure require the disclosure of (1) all matters in which the expert testified in the past four years and (2) a list of all publications authored in the past ten years.

To the retaining attorney, the expert should disclose this much information and more. Based on a review of the additional information, the retaining attorney may decide not to retain the expert or, if the expert is retained, the extent to which additional information is required to be disclosed to other parties during the course of the litigation.

Prior to retention by the attorney, the expert should disclose any of the expert's relationships that could jeopardize the soundness or the credibility of the expert's opinion.

The expert should be prepared to respond to inquiries such as these:

- The expert depends for his livelihood on securing engagements in lawsuits.
- The expert's ability to attract repeat business depends on making his clients—i.e., the attorneys—happy.
- Given the attorney's status as a loyal customer, the expert has ample incentive to

come up with the opinions the attorney needs, regardless of what a dispassionate analysis may conclude.

Financial interests and personal or business relationships have the potential for creating the appearance of a conflict of interest. Relationships with the client or other parties and with attorneys representing the adversary should be disclosed to the retaining attorney.

To the extent that a prior or existing relationship is subject to a confidentiality agreement, that fact should be disclosed to the retaining attorney along with enough information that may properly be disclosed to allow the retaining attorney to make an informed judgment.

This disclosure routine not only pertains to relationships with the existing parties but also relates to relationships with other parties who are reasonably likely to become involved or may be affected in some way by the outcome of the dispute. The retaining attorney does not want to be surprised, especially after it's too late to make a correction.

If the expert has provided any other services to one of the existing parties (such as accounting services), then the expert should disclose that relationship to the retaining attorney.

In most cases, it is appropriate for the expert to disclose to the retaining attorney any services regarding the subject property that have been provided by his employer within three years of accepting the assignment unless it violates some confidentiality concerns.

Even if the expert has an ongoing relationship with a manufacturer of a given product, for example, and the dispute relates to alleged misbehavior by a competing manufacturer of the same type of product, then the expert should disclose to the retaining attorney the relationship with the first manufacturer (even though the first manufacturer is not involved in the dispute).

Disclosure to the Retaining Attorney of Prior Positions

An expert is not necessarily bound forever to any statement made in a prior case or publication. However, if what the expert intends to say is in conflict with the expert's prior testimony, the attorney should be aware of it and there should be a reasonable explanation.

The retaining attorney should be made aware of prior testimony, writings or positions taken by an expert, at least in the last ten years, which bear on the subject matter of the engagement. Inconsistent

positions, whether in testimony, writings, speeches, or otherwise, to the extent discovered by the adverse party, will likely be the subject of cross-examination by the adverse party.

To the extent positions taken in the past are different, even if they are not necessarily inconsistent but bear on the subject matter of the engagement, those differences may have an impact on the perception of the expert's credibility. Accordingly, these positions also should be disclosed to the retaining attorney.

Prior conflicting testimony that should be disclosed to the retaining attorney may not be limited to that provided by the individual expert. Prior testimony or articles by anyone in the expert's firm may cause controversy.

Retaining attorneys should also be advised of prior rulings in which all or part of an expert's opinion was excluded on substantive grounds.

Adverse court determinations may not be insurmountable obstacles. However, the retaining attorney should be informed of such facts from the outset so that the retaining attorney can make the required evaluation.

If an expert witness was excluded for reasons that do not challenge the underlying soundness of the expert's opinion or expertise (e.g., because the testimony was cumulative or not a proper subject for expert testimony), then there may be no reason for the expert to be disqualified in the instant case.

Valuation Standards

When it comes to providing an opinion regarding the value of a business or business interest, many professional appraisers recognize the Uniform Standards of Professional Appraisal Practice (USPAP).⁴

Among other disclosure requirements, the Ethics Rule of the 2012-2013 edition of USPAP requires the appraiser to disclose whether the appraiser (but not necessarily the appraiser's employer, unless the appraiser believes that information may be relevant) has provided any services regarding the subject property within three years of accepting the assignment unless it violates some confidentiality concerns:

If known prior to accepting an assignment, and/or if discovered at any time during the assignment, an appraiser must disclose to the client, and in the subsequent report certification:

- Any current or prospective interest in the subject property or parties involved; and

- Any services regarding the subject property performed by the appraiser within the three year period immediately preceding acceptance of the assignment, as an appraiser or in any other capacity.

Comment: Disclosing the fact that the appraiser has previously appraised the property is permitted except in the case when an appraiser has agreed with the client to keep the mere occurrence of a prior assignment confidential. If an appraiser has agreed with a client not to disclose that he or she has appraised a property, the appraiser must decline all subsequent assignments that fall within the three year period.

Accordingly, the opinion report of a valuation analyst who is complying with USPAP may state:

I have no current or prospective interest in the business interest that is the subject of this report. I have (or have not) previously appraised this property during the three years prior to this assignment. I have no personal interest or bias with respect to the subject matter of this report or the parties involved.

The above disclosure routine continues throughout the engagement. In other words, if during the course of an engagement the expert is contacted by an adverse party regarding a new potential matter, this should be disclosed to the retaining attorney.

COMMUNICATION BETWEEN THE ATTORNEY AND THE EXPERT

In a litigation context, all communications between the attorney and the expert since the expert began work as a consultant are (arguably) discoverable unless there is an agreement to the contrary with the other side.

This means that every step of the assignment may become an open book. An expert's report will usually specify all information the expert considered in forming the expert's opinions.

In deposition, expect opposing counsel to ask the expert what information and documents the expert received from the attorney, what the expert asked for and didn't get, what the expert obtained

independently, and what the expert discussed with the attorney about the subject matter.

From the outset of the engagement, even if initially engaged as a consultant, the expert should expect that this line of inquiry is coming.

Needless to say, the attorney and the expert should be extremely careful when communicating, especially in writing.

The need to educate the expert outweighs the risks of disclosure. However, written communications such as e-mails are not the place for reflections about litigation strategy or the strengths or weaknesses of the opponent's case. Generally, the expert should not send anything in writing unless requested and should exercise care in taking notes.

Educating the Expert

In educating the expert about the facts of the case, the attorney has two related goals.

The first goal is to provide the expert with the information needed to form an opinion. The expert will submit an expert report feeling comfortable that there is a solid technical basis for the opinions expressed in the report.

In most Tax Court cases, the expert report will typically serve as the expert's direct testimony. Unless permitted by the Tax Court, no oral direct testimony from the expert will be admitted regarding the expert's valuation opinion. Therefore, the expert report submitted in anticipation of a Tax Court dispute should contain the source for all facts, data, and reasoning on which the expert bases the valuation conclusion.

By comparison, tax cases involving valuation tried in other forums—either a U.S. district court or the Court of Federal Claims—follow the more traditional format where an expert renders an opinion on direct examination, which is then subject to cross-examination.⁵

Regardless of the litigating forum, the methodology must be rational and understandable. If a part of the valuation opinion is based on facts provided by third parties, those sources should be identified. For example, the source of the transaction prices and empirical data should be identified and included in the report if a part of the valuation opinion is based on:

1. transaction prices derived from transactions involving guideline companies or
2. other empirical data.

While the inclusion of this material may make the report more cumbersome, it will allow the read-

er to fully understand the reasons for the appraiser's valuation conclusion.

The second goal is to establish a record that will survive cross-examination at trial or the scrutiny of a future *Daubert*⁶ challenge.

A *Daubert* motion challenges the admissibility of expert witness testimony before the testimony is given. It requires the trial judge to ensure that the expert's testimony is relevant to the task at hand and that it rests on a reliable foundation.⁷

After the expert report has been submitted, it will be subject to an adversarial review.

If the expert has been educated properly, the court and/or the jury⁸ will conclude that the expert conducted a reasonable investigation, counsel was forthright in providing the expert with information, and the expert's opinions have a reliable basis in fact.

Providing Information to the Expert

Generally, it is best for the attorney to provide information to the expert incrementally.

Attorneys usually begin providing information to the expert by sending the core materials that provide an overview of the facts and case-specific issues: the complaint, any relevant motions, the opposing party's deposition, and the opposing expert's report (if available).

Without asking for a final opinion, the attorney will usually communicate regularly with the expert, even before the expert has seen all of the relevant information. The attorney and the expert will discuss preliminary indications of progress.

Based on the first wave of material, the expert may see a weakness in the client's preferred position—a piece of news that is better for the attorney to receive sooner rather than later.

Assuming the expert is supportive of the client's preferred position, successive waves of material containing more facts may be communicated. The expert will request information needed to form an opinion.

The expert should have access to anything in the discovery record. This preempts a charge that the expert based his opinion solely on the information that counsel spoon-fed him. Information that an expert requests that is available and not privileged should be provided unless there is a compelling reason not to do so. It will not be helpful if the expert later testifies that the attorney failed to supply information that the expert asked for and believed was relevant to the expert's opinion.

The universe of available documents may be far more than can be assimilated within the time frame of litigation. Compromises may be necessary along

the way. In that situation, the expert should try to identify reliable summary documents or representative subsets of a larger universe of documents that eliminate the need for the expert to review the entire universe of available documents.

The expert should be able to articulate the rationale, other than “counsel told me not to,” for not looking at the omitted materials. Also, fact discovery may have clarified which relevant documents the other side is focusing on, and the expert should pay special attention to those.

Of course, if the universe of relevant documents is huge, the opposing expert may face the same problem, so it may be that neither side emphasizes the other’s investigative shortcuts.

Valuation analysts need to be provided with fact information that is reliable. The source of that information is often an attorney, an accountant, another expert, and the client.

Working with Attorneys

In many valuation assignments, basic legal issues are in dispute. Examples of such issues include the effectiveness of a contract, such as a buy-sell agreement or the right to buy or sell a product, and the rights of an owner of a partial interest in a property.

Examples of partial interests include undivided interests in real estate, limited partnership interests, and ownership of less than all of the shares of a corporation. Each of these ownership interests carries with it a different bundle of rights and obligations under applicable state law.

Understanding the rights that a hypothetical seller can transfer and the rights that a hypothetical buyer can receive is critical to the valuation analysis. The valuation analyst’s role is to apply the appropriate standard of value, such as fair market value (the price at which the subject property interest would change hands between a hypothetical willing buyer and a hypothetical willing seller, both having reasonable knowledge of relevant facts).

Relevant facts include all of the attributes attached to the property (hypothetically) being transferred, including any legal rights or obligations attached to the property.

For example, is the hypothetical buyer of a partnership interest automatically entitled to become a partner, or is the buyer limited to the status of a mere assignee (with no management rights, limited or no information rights and no right of withdrawal)?

The valuation analyst should not try to render a legal opinion. Where complex questions of law exist, the valuation analyst should rely on the opinion of qualified counsel as to the likely understanding of

the rights and privileges attached to the interest being valued.

For example, if a buy-sell agreement exists for a closely held entity and its application is uncertain, it is not the valuation analyst’s responsibility to opine on whether the buy-sell agreement is valid.

A knowledgeable buyer or seller of the subject ownership interest would likely consult with an attorney to analyze his or her rights in connection with the enforceability of such a buy-sell agreement.

Working with Accountants

Valuation analysts know that there is some latitude permitted in the preparation of financial statements. Even within the broad confines of generally accepted accounting principles (GAAP), rarely do any two companies follow exactly the same set of accounting practices in keeping their books and preparing their financial statements.

When it comes to the typical closely held company, most are not audited, and many prepare financial statements that deviate from GAAP, to put it kindly.

Therefore, the analyst should evaluate each item and adjust for differences in accounting practices, where appropriate, in order to compare two or more companies or to measure a company against some industry or other standard.

When there is a choice among accounting practices, private companies tend toward a more conservative selection in order to minimize taxes, while public companies may account more aggressively in order to report more income so as to please shareholders.

Also, some public companies have been accused of “managing” their earnings in order to minimize earnings peaks and valleys by making more conservative



accounting decisions in good years and more aggressive accounting decisions in bad ones.

Furthermore, the smaller the private company, the more pronounced the difference between public companies and private companies tends to be.

It is important to remember, then, that shareholders that have control over the company may have the right to change things, including the accounting policies followed by the company. When the interest subject to valuation depends on the control versus minority premise of value, this fact should be recognized.

The purpose of analyzing income statements is to better understand and interpret the earning power of the subject company, since earning power is usually the most important element of the value of a business.

The valuation analyst may work with the company's accountant in order to understand and analyze the company's financial statements, especially involving accounting matters such as the following:

- Allowance for doubtful accounts—accounts and notes receivable
- Inventory accounting methods (FIFO, LIFO, write down and write off policies)
- Depreciation methods and schedules
- Capitalization policy
- Recognition of revenue and expenses
- Taxes—built-in gains, net operating loss carryforwards
- Treatment of interests in affiliates
- Extraordinary or nonrecurring items
- Management compensation and perquisites
- Contingent liabilities

Working with the Client—Reconciling Indications of Value

Business managers use indications of value for a variety of business purposes. As a result, indications of value may be identified within the type of information that corporate legal, sales, accounting and tax departments assemble and develop.

Parties in litigation may locate those indications of value and use them as either an offensive or defensive weapon in commercial litigation. All interested parties should understand how indications of value (or other data) have been derived and used before deciding their relevance to the subject valuation assignment.

The legal department may use an indication of the value of the business for previous legal proceedings, loan collateral commitments, business interruption insurance, or for insuring a key man, for instance. In some instances, a buy-sell agree-

ment requires an annual valuation of the company's equity, which may be documented in the minutes of the board of directors meetings.

Any discussion of a business combination, such as an offer from an outside party to buy the company, may have been discussed by the board. If the company uses employee incentive stock options or has an employee stock ownership plan, valuations have probably been performed. A marital dissolution of one of the owners of the business may have triggered a request for a business valuation.

The sales department may maintain customer or competitor brochures and catalogs with budgets and forecasts. The sales department often keeps trade association publications that can be a source of relevant facts and reliable surveys, including transactions involving the subject company and its competitors. In some instances, advertising expenditures can be used to derive meaningful value indications.

The accounting and treasury department documents may have business valuation information, such as fair value analyses for purchase price allocation purposes, stock options, and other purposes including board presentations.

The tax department may have business valuation information that is used as support for net operating loss carryforward analyses, income tax planning positions, international transfer pricing provisions, and sales and property tax filings.

Increasingly, the value of the closely held business is an important part of the information management uses to operate the business. Corporate legal, sales, accounting, and tax departments may all maintain indications of business value. Don't be surprised by last-minute discovery of information that could be used to help arrive at and support the appropriate business valuation.

Working with Other Experts

In complex valuation assignments, the need for more than one expert often arises.

To avoid allegations of collusion, the experts are usually either kept apart while they are formulating their opinions or communicate only under the supervision of the attorney. However, they should be aware of each other's work in order to be efficient, to rely on a consistent set of facts, and to circumvent cumulative opinions.

Serious damage can be done by one expert simply agreeing to a leading and seemingly unimportant (from the vantage point of that expert) question that the expert has not really had time to consider. If one expert's opinion depends on the opinion of another expert (or facts provided by a fact witness) or if the attorney is going to use more than one expert on a subject, then the witnesses should read and understand

each other's reports. This should help prevent one witness from unintentionally impeaching the other.

It is not uncommon, however, for a testifying expert to rely on work performed by others either within or outside the expert's own firm, who may compile, summarize, or even analyze data that are material or critical to the expert's opinion.

In such instances, the credibility of the expert's opinion may depend on the reliability of the underlying work performed for the expert by others. For that reason, the expert should be familiar with, and be prepared to testify about, the controls put into place and the methodologies followed to ensure the integrity of the work product prepared for, and relied upon, by the expert.

SUMMARY AND CONCLUSION

The relationship between the attorney and the valuation analyst can be complicated, especially for the inexperienced valuation analyst. Most assignments begin with the valuation analyst in the role of a consultant. When the attorney determines that work product of the consultant is going to be used in litigation, the valuation analyst becomes a testifying expert.

Communication between the attorney and the expert may be discovered by an adversary in litigation. Experienced valuation experts are careful about how they communicate with the attorney.

Experienced valuation experts generally know exactly what sort of source materials are needed to form a plausible opinion. Experienced valuation experts work efficiently to gather the necessary information and to generate that opinion.

During every assignment, information is gathered from others. The experienced valuation analyst is sensitive to various concerns, including the purpose for which the information was prepared, when gathering information from attorneys, accountants, the client, and from other experts.

The experienced valuation analyst knows not to create a paper trail of notes and drafts leading up to testimony in a given case and how such a trail can be used for impeachment purposes. The analyst knows that testimony provided in prior cases adds up to its own paper trail, which can come back to haunt the analyst in any number of ways.

The experienced valuation analyst is conversant with *Daubert* jurisprudence. The experienced valuation analyst is familiar with the examination techniques used in litigation. The experienced analyst is not easily trapped into damaging admissions and may be able to assist the attorney in applying examination techniques when questioning an adversary.

There are direct costs associated with the experts' fees but there are also the indirect costs

of time the attorney spends educating the experts, shepherding them through the report and deposition process, and defending any *Daubert* motions that might be leveled against them.

Retaining an experienced expert witness is usually the best approach—for example, retaining an experienced valuation analyst who specializes in valuing businesses and business interests.

The expert's testimony in past cases may be relevant or it may be distinguished from the current case because the prevailing fact pattern is different. Chances are, too, that the other side's damages expert also will have quite a bit of testifying experience, so your expert's status as an experienced expert is unlikely to raise eyebrows.

It is cost effective for the attorney to select an experienced valuation expert who is familiar with the practical aspects of the relationship between the attorney and the valuation analyst.

Notes:

1. For purposes of this discussion a business interest includes a fractional interest in a business, intangible assets, intellectual property, and economic damages allegedly suffered by a business.
2. A testifying expert is one who has acquired facts or developed opinions in anticipation of litigation or for trial. Ultimately, it is the court's prerogative to accept the expert and the expert's testimony.
3. The 2010 amendments to Federal Rules of Civil Procedure Rule 26(b) expanded work product protection to a number of categories of information in a testifying expert's file.
4. *Uniform Standards of Professional Appraisal Practice*, 2012-2013 edition (Washington, DC: The Appraisal Foundation, 2012).
5. Under Tax Court rules, depositions of experts are also more constrained than they are in tax litigation tried in the district courts or the Court of Federal Claims, where the pre-trial deposition of an opposing expert is routine. See generally Tax Court Rule 74.
6. *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993) is a United States Supreme Court case.
7. For a discussion on the *Daubert* standard, see, for example, *The Application of Daubert Challenges to Economic Damages Expert Testimony in Commercial Litigation Matters*, Robert P. Schweih, Willamette Management Associates *Insights* Spring 2007, p. 84.
8. In tax litigation matters, jury trials are only permitted in cases tried in the U.S. district courts. Cases tried before the Tax Court or the Court of Federal Claims are bench trials only.

Robert Schweih is a managing director of the firm and is resident in our Chicago office. Bob can be reached at (773) 399-4320 or at rpschweih@willamette.com.

