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LITIGATION AND VALUATION ADVISER

In This Issue…

Buy-Sell Agreement Fails Test: A Case in Point
Deconstructing Construction Damage
Valuing Retirement Plans in Divorce
Buy-Sell Agreement Fails Test: A Case in Point
The Quiet Component: How Prejudgment Interest Affects Damages
Interesting & Helpful Statistics

Weighing Your Options

The Impact of FAS 123(R) on Employee Stock Option Value

The valuation of stock options and similar compensation incentives is often an important component of an individual's marital state. Further guidance may be gleaned from recent pronouncements by the accounting profession on how to recognize the compensation cost of employee stock options.

To provide financial statement users with a more accurate picture of a company's earnings, the Financial Accounting Standards Board (FASB) amended Statement of Financial Accounting Standards (FAS) No. 123 to *require* companies to recognize compensation cost based on the grant-date fair value of employee stock options and other share-based compensation. As a result, many companies may experience an adverse effect on their bottom line.

Under earlier rules, companies were permitted to value employee stock options at their "intrinsic value" — that is, the excess of the underlying stock's market value over the exercise price on the grant date. In most cases, the exercise price was equal to the grant-date market value, so the intrinsic value was zero. This is commonly referred to as "options under water." The result: A company could provide executives and other employees with a valuable benefit at no cost — at least on paper.

Just because companies weren't required to report the employee stock options' fair value on their financial statements didn't mean that valuators ignored these options in valuing the business. Prospective buyers definitely considered the options' impact on the company's value.

But now FAS 123(R) provides further guidance on how to calculate the options' fair value. The preferred approach is to base this value on an option's observable market price "with the same or similar terms and conditions." Because such market prices are rarely available, however, most companies will need to use an option-pricing model.

FASB doesn't mandate a particular model, as long as the model used takes certain factors into account, including the:

- Exercise price,
- Term,
- Current stock price,
- Expected volatility,
- Expected dividends, and
- Risk-free interest rates.

Several types of models meet the FASB's standards, including closed models such as the popular Black-Scholes model, as well as Lattice models and Monte Carlo simulations.

Significant differences can result based on the approach taken (i.e. intrinsic value vs. fair value). We recommend appraisers work closely with matrimonial and trust & estate attorneys, as well as other counsel, to understand the case law and standards of their jurisdiction. h

From Marty…

Welcome to the inaugural issue of the *Litigation and Valuation Adviser*. Our timing coincides with a beautiful spring in New York and the opening of Le Cirque at the Bloomberg Building on May 31st. (From what I can see, Sirio and his family have gone all out! Find the entrance in the Courtyard just off 58th Street.)

The *Adviser* will be published quarterly and our objective is to provide you with articles that will HELP YOU BUILD A BETTER CASE.

In time, friends on our mailing list will be given access to a section of our website to view past articles, as well as computer modules that will allow you to test variables to assist in your litigation strategy.

I welcome your input, comments, and good cheer.

Martin P. Landau

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- Wrongful termination

Commercial Damages

- Breach of contract
- Lost profit
- Business interruption
- Construction claims
- Real estate claims

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Deconstructing Construction Damages

Building construction is an inexact science. Despite the best-laid plans, drawings and specifications, changes after builders break ground are the norm rather than the exception. Weather, unexpected site conditions, changes in scope, and design or engineering problems all can dramatically affect a project's costs and profits.

Complicating matters further, construction projects involve a complex sequence of interdependent actions involving several interrelated parties, including owners, architects, engineers, contractors, subcontractors and suppliers. One unanticipated event can have a ripple effect, altering a project's complexion for everyone concerned.

Reasons for Claims

Construction claims can arise for many reasons. A change in the project's scope, for example, may require a contractor or subcontractor to perform extra work. An owner-caused delay may force a contractor to extend the contract's duration or accelerate the work. A disruption caused by another party — delayed or defective drawings, for example — may affect worker efficiency or productivity.

Assessing a party's entitlement to damages requires a close examination of the construction contract and related documents. A "no damages for delay" clause, for example, may preclude a party from recovering damages for delays caused by other parties (though exceptions may exist for bad-faith or unreasonable delays). Even without such a clause, a party may not be able to recover damages caused by "excusable delays," such as severe weather or other unforeseeable events beyond the parties' control.

Calculating the Damages

Calculating and documenting damages in construction cases can be a challenge. Why? Delays and disruptions can have a far-reaching and sometimes surprising impact on a contractor's costs and revenues. A delay that extends the contract increases a contractor's equipment and labor costs. Further, depending on the length of the delay, moving equipment or workers to other jobs may not be practical. In addition, the contractor may continue to incur supervisory and security costs. So the contractor needs to be able to recover all these costs.

An extended contract also means that workers and equipment may not be available to begin other scheduled jobs. So the contractor may be entitled to recover the increased costs it must incur to start other jobs on time.

If a delay requires the contractor to accelerate work to complete the job on time, it will incur increased labor costs in the form of additional workers, additional overtime or higher wage rates for added shifts. The contractor also may have to pay vendors a premium to deliver materials more quickly and allocate additional equipment to the job.

Courts generally prefer detailed records that document a contractor's additional costs caused by a delay or disruption. But in many cases, such documentation may be impractical or impossible (often due to the owner's

(continued on page 5)

Valuing Retirement Plans in Divorce

In marital dissolution cases, retirement plans are often among the largest assets to be divided. When a couple has been married a long time or when a spouse has participated in a retirement plan for many years, these benefits can easily make up more than half of the marital estate.

In some cases, retirement benefits are divided between the spouses using a Qualified Domestic Relations Order (QDRO). In others, a spouse retains the rights to his or her benefits in exchange for surrendering other marital assets. Under either approach, an accurate valuation of the retirement plan benefits is essential to help achieve an equitable property settlement.

Valuation Challenges

Valuing retirement plans can be challenging because the valuator must compute the present value of expected future benefit payments. The process is complicated further by the need to determine the marital and nonmarital portions of the benefits and to address vesting schedules, life expectancies and other uncertainties.

Here's an overview of some, but certainly not all, of the valuation issues that can arise.

Defined Contribution Plans

Defined contribution plans — such as 401(k) plans and profit-sharing plans — are usually the simplest to value. That's because the present value of the benefits at any given time is generally equal to the participant's vested account balance.

If the participating spouse joined the plan during marriage, a formal valuation may not be necessary. If the account predates the marriage, however, a valuator will need to determine the marital and nonmarital portions of the account. In most states (including many community property states), premarital contributions — and earnings attributable to those contributions — are excluded from the marital estate.

To calculate the marital and nonmarital portions of the retirement account, the valuator scrutinizes account statements from the date of marriage through the valuation date. The valuator may determine the marital portion by taking all contributions during the marriage and computing the investment gains and losses attributable to those contributions through the valuation date.

An alternative, and often simpler, approach is to start with the account balance on the date of marriage and add investment gains and losses on that amount through the valuation date. The valuator subtracts that figure from the total account balance on the valuation date to arrive at the marital portion of the account.

Defined Benefit Plans

Defined benefit plans make retirement payments out of a general pension fund rather than individual participant accounts. At any given time, a participant's accrued monthly benefit is determined by a formula based on years of service, earnings history and other factors.

Typically, when valuing pension benefits in connection with a divorce, the valuator begins with the accrued benefit on the valuation date. It's generally inappropriate to use the participant's projected benefit at retirement because it reflects benefits earned after the marriage.

The valuator charts a monthly income stream beginning on the expected retirement date and uses actuarial or economic valuation techniques to convert the income stream into a lump-sum value on the retirement date. That value is then brought back to a present value on the valuation date. The valuator may also discount the present value to reflect the probability that the participant will survive until retirement.

Valuation Has its Benefits

When retirement plans make up a significant portion of a divorcing couple's wealth, the first step toward an equitable settlement is to conduct a valuation of the retirement benefits. Valuing retirement benefits can be complex, especially when defined benefit plans are involved, so it's important to retain the services of an experienced valuation professional. h

Vested vs. Unvested Benefits

When handling retirement benefits that aren't fully vested at the time of divorce, a valuator typically employs one of two basic approaches. The first is to adjust the present value to reflect the probability that the unvested benefits won't be received. The disadvantage of this approach is that, if the participant never becomes fully vested, the benefits will have been overvalued.

The other approach is to value only the vested benefits and use a qualified domestic relations order (QDRO) to divide the unvested benefits between the spouses. This protects the participant from potentially harsh results in the event those benefits never vest.

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Buy-Sell Agreement Fails Test: A Case in Point

In *Estate of Blount*, the 11th Circuit Court of Appeals affirmed the Tax Court's ruling that a buy-sell agreement should be disregarded in valuing a closely held business for estate tax purposes. But the appellate court reversed the Tax Court's finding that $3.1 million in life insurance proceeds were includible in the company's fair market value.

Background

At the time of his death in 1997, William C. Blount owned 83% of Blount Construction Company (BCC). In 1981, Blount and the corporation's only other shareholder, James M. Jennings, entered into a buy-sell agreement with BCC. The agreement restricted a BCC stock transfer and provided that, on a shareholder's death, the corporation would purchase that shareholder's stock for a price based on the corporation's book value in the previous year.

In the early 1990s, the company purchased $3.1 million in insurance policies on the lives of Blount and Jennings to ensure that the company could continue operations while fulfilling its obligation to buy a deceased shareholder's stock under the buy-sell agreement. The company also established an employee stock ownership plan (ESOP) and, under ESOP rules, BCC had annual valuations conducted by an independent third party. In 1995, for example, the appraiser valued the company at approximately $7.9 million.

Jennings died in January 1996, and the company redeemed his shares using the life insurance proceeds. The purchase price was just under $3 million, based on the previous year's book value.

In October 1996, Blount was diagnosed with terminal cancer. Soon after, he amended the buy-sell agreement to provide that, upon his death, BCC would redeem his shares for $4 million without any adjustments to reflect future changes in book value. At the time Blount amended the buy-sell agreement, the fair market value of his shares (based on the most recent ESOP valuation) was approximately $6.7 million.

After Blount died in September 1997, his estate filed an estate tax return valuing his BCC stock at $4 million. The IRS filed a notice of deficiency, claiming that Blount's stock was worth about $7.9 million, implying that the company's fair market value exceeded $9.5 million.

Tax Court Stance

The Tax Court disregarded the buy-sell agreement in valuing BCC for estate tax purposes because the agreement failed to satisfy the requirements of Internal Revenue Code Section 2703. Although that section didn't take effect until October 1990, it applied to the buy-sell agreement in this case because the 1996 amendment constituted a "substantial modification" of the original agreement after Sec. 2703's effective date.

Under Sec. 2703, for a buy-sell agreement to establish the value of closely held stock, the agreement must:

1. Be a bona fide business arrangement,
2. Not be a device to transfer wealth to family members for less than full and adequate consideration, and
3. Be comparable to similar arrangements negotiated at arm's length.

In addition, under applicable case law, the buy-sell agreement must:

4. Establish a price that's either fixed or determinable and is reasonable at the time the agreement is made,
5. Require a shareholder's estate or beneficiaries to sell the shares at the price specified, either automatically or at the other parties' option, and
6. Restrict shareholders' disposition of their shares during their lifetimes and at death.

In *Blount*, the buy-sell agreement violated the sixth requirement because Blount had the ability to modify the agreement unilaterally. The Tax Court also found that the agreement's terms were not comparable to similar arm's-length agreements.

Disregarding the buy-sell agreement, the Tax Court determined BCC's base fair market value to be $6.75 million. The court then added the life insurance proceeds to arrive at a value of $9.85 million.

The estate argued that the insurance proceeds shouldn't be included because they were offset by the company's corresponding liability to purchase Blount's stock. But the Tax Court held that, because the buy-sell agreement had been disregarded for valuation purposes, the obligation to redeem Blount's stock would be disregarded as well.

Appeals Court Ruling

The 11th Circuit agreed with the Tax Court that the buy-sell agreement should be disregarded under Sec. 2703 for estate tax valuation purposes. But it found that the insurance proceeds should have been excluded in valuing BCC. "Even when a stock-purchase agreement is inoperative for purposes of establishing the value of the company for tax purposes," the court explained, "the agreement remains an enforceable liability against the valued company."

The appellate court held that nonoperating assets, such as the life insurance proceeds in this case, should not be included in the company's fair market value when there is an enforceable contractual obligation that offsets those assets. To suggest that a prospective purchaser of the company would ignore a $3 million liability, the court concluded, "strains credulity and defies any sensible construct of fair market value."

Follow the Rules

Keep in mind that the parties' circumstances and business entity values may change over time. So it's wise to review buy-sell agreements annually.

This case illustrates the fact that, to establish value for estate tax purposes, a buy-sell agreement must meet all the requirements — both statutory and under applicable case law — under Sec. 2703. When one objective of a buy-sell agreement is to establish value for estate tax purposes, this fact must be considered.

Construction Damages

(continued from page 2)

acts or omissions). Under these circumstances, a court may allow a contractor to compute its damages using the total cost method.

Under this method, the contractor's recoverable damages are equal to the excess of its total costs on the project over its bid costs. These damages may be adjusted to exclude unrecoverable costs or to correct estimating errors. Courts allow this method only if the bid price was realistic, the actual costs are reasonable and the contractor isn't responsible for the increased costs being sought.

Recovering Unabsorbed Overhead

One of the more confusing aspects of a contractor's damages is unabsorbed home office overhead. Home office overhead consists of costs that benefit a contractor's business as a whole, rather than a specific job. Examples include rent, administrative salaries and office supplies.

When a contractor prepares its bids, it includes not only the direct costs involved with a job, but also a portion of its "indirect" overhead costs. The contractor recovers its overhead costs by allocating them over its direct cost base. Suppose, for example, that a contractor is performing two jobs in 2006. It expects to incur $750,000 in costs on Job A and $250,000 on Job B. Typically, the contractor would include 75% of its home office overhead in pricing Job A and 25% in pricing Job B. Put another way, each job "absorbs" its proportionate share of the company's overhead.

If Job A is delayed by six months beginning July 1, 2006, then 37.5% of the

contractor's overhead for the year is unabsorbed (assuming the contractor is unable to secure other work to replace the lost job).

The most common method of calculating unabsorbed home office overhead, particularly in the federal courts, is the Eichleay formula. (See the sidebar, "Eichleay formula.")

To recover unabsorbed overhead using the Eichleay formula, a contractor must show it was unable to secure other work to absorb the overhead during the delay period. Some state courts reject the use of the Eichleay formula. Others allow it only if the contractor also can demonstrate a relationship between the formula and its actual overhead expenditures during the delay period.

Building a Strategy

These are just a few examples of the complex issues that can arise in calculating construction damages. Attorneys and financial experts need to work together closely to be sure they understand the applicable state or federal law and to gather the documentation and other evidence they need to build a better case.

Eichleay Formula

The Eichleay formula estimates unabsorbed home office overhead, which a valuator can use to help determine damages when a contract has been delayed.

Step 1:

Total contract billings
Total billings for contract period X Total overhead for contract period =
Total overhead allocable to contract

Step 2:

Total allocable overhead
Days of contract performance = Daily overhead allocable to contract

Step 3:

Daily overhead allocable to contract X Number of days' delay =
Unabsorbed overhead

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The Quiet Component

How Prejudgment Interest Affects Damages

Prejudgment interest can significantly affect damages, so it's a good idea to analyze the potential interest effects early in a case. For one thing, any prejudgment interest can substantially augment a plaintiff's recovery, particularly when litigation will take several years to complete. This may give defendants an incentive to settle, and settle sooner rather than later. Also, from a plaintiff's perspective, the availability of prejudgment interest may depend in part on the nature of the claim or claims.

Assessing the Impact of Interest

Interest can become a surprisingly significant component of a plaintiff's damages. Suppose, for example, that P sues D for a breach of contract that occurred in January 2002. The litigation drags on for several years and P wins a $1 million judgment in January 2006. If state law provides for prejudgment interest at a rate of 8% per year, P's recovery is boosted to $1,320,000.

By considering the impact of interest on a future damage award, defendants can gain a more realistic picture of an award's potential economic impact and better evaluate their settlement options.

The Expert's Role: Federal vs. State Law

In most states, prejudgment interest is fixed by statute (or, in contract cases, by a lawful interest rate specified in the contract). Thus, in state courts — as well as in federal courts applying state law — calculating interest is relatively straightforward (though there may be debate over the extent of the time period during which interest accrues).

In federal courts applying federal law, a financial expert's testimony may influence the interest amount the court awards. Some federal statutes preclude prejudgment interest or establish the interest rate or computation method. But in many cases, federal courts have discretion to award interest in a manner that properly compensates the plaintiff for its economic losses.

Take compounding, for instance. Most states limit a plaintiff's recovery to simple interest. But when the court allows expert financial testimony on prejudgment interest, the plaintiff may argue that compound interest is needed to make the plaintiff whole. The purpose of prejudgment interest, after all, is to compensate the plaintiff for the lost use of money it would have earned but for the defendant's actions.

Depending on the types of alternative investments that would have been available to the plaintiff at the time of the loss, a financial expert may find that annual, monthly or even daily compounding is appropriate. This can make a significant difference in the amount of damages.

Consider the plaintiff who recovered a $1 million judgment after four years of litigation in our previous example. Simple interest applied at a rate of 8% added $320,000 to the judgment. Annual compounding would have increased prejudgment interest to more than $360,000 ($375,000 if interest is compounded monthly; $377,000 if interest is compounded daily).

Contract or Tort

Historically, prejudgment interest has been limited to contract-type actions and, in some cases (according to the court's discretion), to a plaintiff's *economic* losses in a tort-type action. Prejudgment interest usually is limited to "liquidated damages." This generally means that the amount is reasonably calculable based on the facts, without judicial intervention. Unliquidated damages — which often are associated with nonpecuniary losses, such as pain and suffering — cannot be quantified until a court establishes the amount.

The precise definitions of liquidated and unliquidated damages vary from court to court. In some courts, for example, liquidated damages must be in writing or must be known or knowable by both parties. Sometimes otherwise unliquidated damages may be rendered liquidated by the defendant's rejection of a good-faith settlement offer.

Some states have passed legislation permitting tort plaintiffs to recover prejudgment interest on all types of damages, including liquidated and unliquidated, pecuniary, and nonpecuniary — but often subject to limits (such as a dollar cap or time limit).

Take an Interest

Regardless of the jurisdiction, attorneys and financial experts need to understand the applicable rules on prejudgment interest. Without an understanding of these rules, it's impossible to accurately assess a case's value.

Further, because the availability and amount of interest may depend on both the nature of the claim and reliance on a specific state or federal statute, it's important to consider both the applicable statutes and case law when drafting the pleadings. h

Postjudgment Interest

Unlike prejudgment interest, which generally is limited to economic losses, postjudgment interest applies to virtually all money damage awards and is designed to compel the defendant to pay damages promptly.

The rate used to calculate postjudgment interest often, but not always, is the same as the one used for prejudgment interest. And when prejudgment interest is based on a contractually established rate, that rate often, but not always, carries over to postjudgment interest as well.

Interesting & Helpful Statistics

Treasury yields[1]

30 day – 4.65% | 5 year – 4.82% | 20 year – 5.07%

Prime lending rate[2]

7.75%

Dow Jones 20 year bond yield[3]

6.18%

Barron's intermediate grade bonds[3]

6.86%

High yield estimate[1]

Median – 8.51%

IBBOTSON: Total rate of return for years 1926–2005[4]

Small Cap – 17.4% | Large Cap – 12.3%

Dow Jones Industrials P/E Ratios[3]

On current earnings – 21.61
On 2006 operating earnings estimate – 15.00

Long term inflation estimate[5]

2.5%

Unemployment

US – 4.7[6] | NYC – 5.1[7]

Zagat Survey – NYC Most popular restaurants[8]

1. Gramercy Tavern
2. Union Square Café
3. Babbo
4. Daniel
5. Le Bernardin

Average vacancy rates NYC[7]

Hotels

26.0% This year | 28.0% Last year

Office space

6.6% This year | 6.8% Last year

1/Source: US Treasury, Daily Treasury Yield Curve as of March 31, 2006
2/Source: *Wall Street Journal* as of March 31, 2006
3/Source: *Barron's*, as of January 30, 2006
4/Source: Ibbotson, *SBBI Valuation Edition, 2006 Yearbook*; Total returns for 1926–2005 Table 2-1, Arithmetic Mean
5/Source: 10 year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, December 8, 2005
6/Source: United State Department of Labor, Statistics as of March 31, 2006
7/Source: New York City Economic Development Corporation, *A Summary of New York City's Economy*; March 2006; rate as of January 31, 2006.
8/Source: *Zagat Survey; Zagat.com*

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