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# For What It's Worth

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## CBIZ Litigation & Valuation Services

We were recently asked to provide testimony about the pros and cons of the "immediate offset" treatment for pension assets. Here are a few of our thoughts on this subject.

The division of a pension in a divorce is usually accomplished by either immediate offset or deferred distribution. In an immediate offset, the value of the pension is calculated and added to the marital balance sheet for use in allocating property. In a deferred distribution, the rights to the future payments are assigned to the parties and the current value of the pension is not used to offset other assets in the estate. It is not unusual to see pensions divided through a deferred distribution method. The deferred distribution method includes reserved jurisdiction and a domestic relations order.

The main advantage of the immediate offset method is the finality of the conclusion. Each party leaves with their share of the asset. This method also eliminates the risk of future litigation over any unresolved aspects of the pension division. The party receiving the pension gets control over the future benefits and payment options. The other party avoids the risk that the pension never reaches pay status, in most cases receives a source of immediate liquidity, and avoids the risk of future litigation as well.

The main weakness of the immediate offset method is the valuation of the pension asset. Any pension valuation uses assumptions. These assumptions include projections about inflation, risk, and lifespan. A major risk is the chance of the pension holder's death either before reaching retirement or before their predicted life expectancy. If any of these assumptions differ from expectations, one party will benefit at the expense of the other. This often places an uneven amount of risk on the pension holder.

In the immediate offset method, the pension holder effectively buys the benefits of the pension from the spouse and assumes all risk relating to the valuation assumptions. The valuation of the pension is based upon assumptions assuming an average situation.

However, reality is rarely exactly equal to the average. For example, let's assume that one spouse receives the pension and the other spouse receives an offsetting asset. Then, the pension holder, husband, dies before reaching retirement. The husband is not treated equitably in that neither he nor his beneficiaries will enjoy the pension benefits "purchased" with the offsetting asset. Also, changes in interest rates during the term of the pension can have a large impact on the value of the pension itself. The spouse keeping the pension may have paid more at the time of the divorce than the ultimate value of the pension.

It is our opinion that the immediate offset method will usually benefit one party at the expense of the other. Therefore, the Court should strongly consider this reality in their equitable distribution decision.

Please note that we've included an article in this newsletter from Kirk Lynch, the head of our investment advisory practice. Kirk addresses some basic concepts on asset allocations in his guest article.

As always, if you haven't worked with us before, please give us a ring and we'll buy you lunch. And if you'd like to sign up for additional copies of our newsletter, receive it via email, or opt-out of receiving it, please email [LVSnews@cbiz.com](mailto:LVSnews@cbiz.com).

## Court rejects DCF approach where inputs are "untethered to reality"

***Finkelstein v. Liberty Digital, Inc.*, 2005 Del. Ch. LEXIS 53 (April 25, 2005). Judge Strine.**

Liberty Digital, Inc., was merged on March 14, 2002, and survived the merger as a wholly owned subsidiary of Liberty Media. The parties agreed to a fair value of Liberty Digital's assets—except for an "Access Agreement" with AT&T.

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This Access Agreement was a binding “agreement to agree” on terms whereby Liberty Digital would have preferential access to channel space on AT&T’s digital cable network if and when AT&T deployed “advanced set-top boxes.” By 2001, prospects that AT&T would deploy advanced set-top boxes in the near future had dimmed.

Nonetheless, the dissenting shareholders contended that the Access Agreement was worth \$2.2 billion. To arrive at this value, their expert used primarily a discounted cash flow (DCF) analysis. Their valuation started from the assumption that Liberty Digital would ultimately provide 12 interactive channels on AT&T’s digital networks, each channel earning revenues equal to \$0.75 per AT&T digital subscriber to be adjusted upwards 2 percent annually for inflation. They projected that AT&T’s digital subscribers would grow 20 percent annually until they reached 80 percent of AT&T’s overall customer base.

Despite these aggressive assumptions, the shareholder’s expert claimed he was “lowballing” because he calculated the value of nine years of cash flow, and did not include a terminal value.

#### **DCF input unacceptable**

The Delaware Chancery Court “trashed” this clearly optimistic valuation, starting with the following:

There is a well-known phrase, “if wishes were horses, then beggars would ride.” If [the valuation expert’s] wishes were horses, the petitioners would have ridden and owned Secretariat, Seattle Slew, and (the trial judge’s favorite) Affirmed, Triple Crown winners all.

First, the expert admitted that he had no evidence that AT&T had any plans to roll out advanced set-top boxes within any foreseeable time period. The court’s response was:

If Chuck Berry had envisioned the iPod in 1955, he would have had a good idea but no way to make money off it absent technological innovations decades away; thus, he was far better off giving us the gift of Maybelene.

Second, the court next faulted the valuation for disregarding Liberty Digital’s inability to forge an advantageous, definitive affiliation agreement with AT&T in the years leading up to the merger—at least partially because Liberty Digital’s plans for interactive channels were essentially conceptual and turned on its ability to sign up programming and product partners, none of whom would sign with Liberty Digital until it had an advantageous and specific final access agreement with AT&T.

Other problems with the DCF analysis were that it ignored competitors such as Home Shopping Network and QVC, pretended it would cost nothing to bring a channel to market, and inflated per subscriber revenues.

Finally, the court also found that paying lip service to other valuation approaches (e.g., comparable company approach and assumptions) was equally flawed. As to these, the court mused:

Anyone who would place weight on these valuations would be well-advised to ask themselves this question first: If my family had to derive its nutrition during the next six months exclusively from food delivered to our home by Webvan during the next six months, would we live to tell about it?

#### **Precedent transactions analysis preferred**

In contrast with the “flights of fancy,” the court found that the company’s expert, who used a precedent transactions analysis, was essentially on the mark.

## **Report is inadmissible unless expert is certified, uses correct methodology, and does independent analysis**

*In re Med Diversified, Inc.*, 2005 Bankr. LEXIS 2236 (Bankr. E.D.N.Y. November 14, 2005). Judge Bernstein.

In a case of first impression in a bankruptcy adversary proceeding, the narrow issue was whether the proposed business valuation expert witness for Addus Healthcare, Inc. (Addus), was qualified and whether his purported expertise satisfied the standards of relevance and reliability under *Daubert v. Merrill Dow Pharmaceuticals, Inc.*, 509 U.S. 579, (1993).

Addus, the defendant in the case, called the expert to testify on the value of 100 percent of Addus’s shares, as well as on the reasonably equivalent value of an alleged option payment of \$7.5 million paid by Med Diversified, Inc. (Med D) for a 6 ½ month extension to close its purchase of these shares. Med D was insolvent at the time of the payment, and the bankruptcy trustee for Chartwell Litigation Trust (Chartwell), Med D’s successor, was attempting to set aside the payment as a constructive fraudulent transfer.

#### **Qualification and reliability of alleged valuator rejected**

Chartwell filed a motion in limine to exclude all of the

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expert's testimony on the ground that he did not qualify as an expert on valuation of all of the shares of a privately held health care services company. This motion gave rise to the court's exercise of its gatekeeper function under Daubert, to "ensure that the courtroom door remains closed to junk science while admitting reliable expert testimony that will assist the trier of fact."

The expert had no peer-granted certifications or formal education as an expert on business valuations. His support staff was certified business valuers who provided input into the Expert Report, but those valuers were not available for cross-examination.

The court indicated it was not prepared to admit an Expert Report submitted by a corporate entity, saying that "the person who signs the report has to testify until the admission of his Report for all evidentiary purposes has been stipulated to." The court also indicated that it would not qualify the expert because he had neither sufficient experience in the field nor formal training or certification, even though he had worked for over twenty-plus years as an accountant and as a liquidating agent or bankruptcy trustee.

The court also found that even if the expert was found to be otherwise qualified, his testimony would still be inadmissible because he "showed a discernible measure of negligence in purportedly applying the alleged professional standards and techniques found in the published practical treatises, including the standards and techniques published in the writings of Dr. Shannon Pratt and his co-authors, which were repeatedly propounded by both the Defendants and the Plaintiffs." He based his analysis on inadequate data, conflated the discreetly different concepts of gross cash flow and net cash flow from operations, and failed to explain why the DCF method was excluded. If this wasn't enough, he did not independently analyze the data from the databases from which he derived his figures—"Mergerstat" and "Factset;" in choosing the comparable companies and transactions.

## **Basics of Asset Allocation**

*By Kirk D. Lynch, CFA, CPA, CFP*

When it comes time to make investing decisions, it is easy for an individual to get overwhelmed by the amount of information they are constantly being bombarded with from the numerous sources of media. But when it comes down to taking the investment plunge, the two most critical items that an individual has control over are the asset allocation and fees.

Determining the proper asset allocation is the most

important decision an individual will make, as the asset allocation will determine over 90% of their return. This makes intuitive sense. If an individual is invested 100% in investment grade bonds, assuming they are holding a diversified portfolio of bonds, they are going to get bond-like returns. There is just no way around it. When interest rates go up, bond prices go down and vice versa. If you are holding a diversified portfolio of stocks, you are going to get stock like returns. Of course, there is always the slight possibility that an investor is holding a portfolio consisting of 100% losers, but that is just as likely as an investor holding a portfolio of 100% winners. Either case is highly unlikely as long as the investor is properly diversified.

In determining what the proper allocation should be, each investor has to take into consideration their own goals, objectives, preferences, time horizon and risk tolerances. Given the greater expected return that equities provide over bonds, individuals with longer term horizons and greater risk tolerances should generally be more heavily weighted toward equities. If an individual is going to need the money within the near future, their allocation should be more heavily weighted towards cash and bonds. If an individual is going to need the funds within a year, their allocation should be mainly cash.

A qualified advisor can assist in determining which allocation is right for the individual. An advisor can work through several allocations showing the expected risk and return for each allocation. The advisor and individual should focus on the worst case scenario, making sure the individual will be able to stay the course in a market downturn and not panic and sell at the bottom.

Once an investor has determined their proper asset allocation, the next step is implementing the allocation. It is during the implementation process where the individual can control costs. At the low end of the fee spectrum, the "do it yourself" investor can use the low cost approach of investing in index funds and exchange traded funds. Depending on your allocation, fees for this approach can be held well below 1% in most cases. At the other end of the spectrum would be full service firm that, depending on the size of your portfolio, can charge over 2% of assets under advisement.

If an individual is not entirely comfortable investing on their own, it is well worth hiring a qualified advisor who can work with them to sort through all of the investment information, develop an appropriate allocation and keep their costs in check.

*Investment advisory services offered through CBIZ Financial Solutions, Inc. an SEC registered investment advisor.*

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