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Lawyer Liability in QDRO Cases

By Marshal S. Willick, Esq.

This article is designed to prevent you from being sued; it will identify the problem, give examples, explain the risk, and suggest means of avoiding the problem.

I. INTRODUCTION

In too many cases, attorneys withdraw from divorce cases knowing that a pension exists, but before a Qualified Domestic Relations Order (QDRO) is actually entered. Doing so leaves counsel susceptible to suit if anyone who might have received money from that pension (during life or upon the death of the other party) does not get it, even many years later.

Some lawyers try to deflect liability by including language in their withdrawal motion (or by letter to the client) that the client was informed that a QDRO was required, but that withdrawing counsel did not draft QDROs. Such efforts seek to make it the client's responsibility to figure out how to have the QDRO prepared, entered, and filed with the plan.

Such deflection efforts are a bad idea for at least three reasons. First, they often don't work and counsel gets sued anyway. Second, it does not solve the clients' actual problem – which is what the attorney was hired to do – and is therefore an ethics lapse that can bring the attorney right back to the first point. Third, at least in Clark County, the new court rules will render such efforts insufficient work by counsel (again returning to the first point: liability).

Nevada divorce lawyers should also be aware of the cottage industry that has grown up involving out-of-state pension experts who pretend to be neutrals but actually have an agenda of doing spouses out of the benefits they are owed under Nevada law – and creating a malpractice risk for the spouse's attorney in the process.

Counsel can't avoid liability that attaches to a divorce case because they "don't know how to draft QDROs" or don't want to learn how to deal with pensions. Attorneys are required to ensure their clients' interests are protected, period. And it really is not that difficult to avoid the problem entirely by taking a few simple steps to deal with the asset.

II. KNOWING IT WHEN YOU SEE IT

There are lots of different pensions, and they are all governed by different rules; a single person can have ***multiple*** pension interests. For example, an employee of a defense contractor may have two or three different retirement accounts, plus a private Individual Retirement Account (IRA).

A federal employee may have a pension through the Civil Service Retirement System (CSRS) or the Federal Employee Retirement System (FERS), ***plus*** a Thrift Savings Plan (TSP), which is the Federal Government's defined contribution plan with matching contributions.

An active duty or reserve military member should be expected to be earning a military pension and will also have the opportunity to contribute to either a Roth or traditional TSP.

Even a journeyman electrician, pipe-fitter, or carpenter could have several different pension interests, both

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A Letter from the Family Law Executive Council

Dear Section Members,

We are excited to announce that the Family Law Conference will be taking a road trip to Bishop, California in 2017. The dates of the conference will remain the same: March 2 and 3, 2017.

In the past few years, the Family Law Executive Council has heard the call to explore alternative locations. In response to these requests, the FLEC conducted a survey at the 2016 Ely Conference regarding the possibility of moving the conference, taking into account travel distance, accommodations, cost and facilities. Several options were considered and it was determined that Bishop, California was the best option in light of the section's requests. With this feedback, eight (8) members of the Council went to Bishop for two (2) days to survey the conference facilities, accommodations, and entertainment options. All members were very impressed with Bishop. Bishop is similar in distance for both Southern and Northern attendees and will be very similar in cost to prior conferences. The conference will be held at the Tri-County Fairgrounds and we are planning an extensive array of activities for the section.

2017 will be an opportunity for the Family Law Section to consider whether Bishop, California will be the future site for the conference. Before making any long-term decisions about a permanent location, we are open to exploring options and look forward to 2017 as a joint venture in a new direction.

We hope that you will all attend the 2017 Bishop Family Law Conference and look forward to a new and exciting experience.

– The Family Law Executive Committee

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defined benefit and defined contribution.

And each and every one of those plans has a different survivor benefit plan or scheme with completely different rules for opting in, opting out, and paying for the benefits.

If counsel is not fully informed on these issues, the proper means of dealing with a pension – as soon as it is identified – is to consult with, associate, or retain a qualified pension expert to draft the necessary orders. As illustrated below, however, counsel must be careful, because there are those claiming to be neutrals who actually have rented out their skills for the purpose of finding (often subtle) ways of taking advantage of non-employee spouses – and their lawyers.

Though the law on this issue is scant in Nevada, the issue of liability of attorneys has been determined in other jurisdictions.[1] There is no reason to think that the same results would not occur here if the case were brought before the Appellate or Supreme Court.

III. LIABILITY

A brochure provided by a leading malpractice carrier, entitled *Avoiding Malpractice Traps*, stated one of the two main issues raised in malpractice cases for domestic relations attorneys is "Failing to investigate and/or protect retirement and other benefits."

The carrier is right. Courts hearing such cases have stated that ***any*** attorney practicing divorce law is charged with knowing about the existence, value, and mechanics of dividing any retirement benefits that might exist. And the potential liability is the value of the benefit lost by the client. Since the pension is often the single most valuable asset of the marriage, ***that*** is the measure of counsel's risk.

It happens a lot. About half my work as an expert witness in recent years involved liability claims against attorneys accused of not properly securing retirement or survivorship benefits for a spouse.

IV. TIMING

All retirement orders should be completed and submitted for signature before or – at ***latest*** – when the *Decree* is submitted.

Why? Every day that ticks by between the *Decree* and the QDRO increases the risk that a party could die, or the employee could retire, locking out benefits to the other party and – again – making counsel liable if parties happen to die in an inconvenient order. For detail, see Legal Note Vol. 16 — When QDROs Should Be Drafted (May 11, 2010).[2]

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And the soon-to-be-approved new rules for the Eighth Judicial District require counsel to deal with the matter before leaving the case. EDCR 5.520(b) ("Issuance of decisions") provides:

> (b) Counsel for the parties must provide such orders, provisions, and documents as are necessary to achieve distribution or finalization of all interests at issue in the proceedings, or specify on the record when, how, and by whom that distribution or finalization is to be achieved.

There are also very practical reasons for dealing with pension interests during the divorce rather than "later." The non-employee loses all leverage to negotiate terms once the MSA or decree is completed, and discovery is only available under NRCP 16.21 ***prior*** to the completion of the divorce.

What this means, among other things, is that it is the responsibility of ***trial counsel*** to figure out who is going to actually submit the orders and documents required to achieve distribution of interests in the proceedings (e.g., QDROs), or specify on the record how, when, and by whom that will be accomplished.

Counsel who do not want to deal with the subject personally need not panic. The rules permit trial counsel to do what is necessary either directly or through others, and help is readily available, as discussed below.

V. THE MINIMUM DUTY REQUIRED

If potential liability and the court rules were not sufficient motivators, there are also the general ethical duties of competence and diligence.[3]

As the cases in endnote 1 indicate, an attorney can be found negligent just for failing to "check" to see if there are any retirement accounts in the name of either party. Simply asking the client if there are any such accounts will not satisfy the requirement of due diligence. At a minimum, a limited investigation as to the employment of each spouse during the marriage and then a review of possible pension plans afforded employees at those places of employment is necessary.[4]

This is because many people do not know what they

have. We recently had a case involving a low wage housekeeper from one of the local casinos. She told her lawyer that there were no pensions, which she believed since she lived from paycheck to paycheck and had no clue. However, being a hotel housekeeper required membership in a union, and ***that*** meant that she was building up a defined benefit pension ***as well as*** having the ability to contribute to a defined contribution plan, whether she knew it or not.[5]

An attorney who knows (or should learn) that a pension or retirement plan exists has the duty of ensuring that the client actually receives that client's share of that pension. At least until and unless the case law changes, the lawyer ***also*** has the responsibility of ensuring that the order recites that the client will receive the proper ***survivorship*** interest, since current case law indicates that if the right is not recited in the decree, it is forfeited.[6] This is a huge malpractice trap if not properly attended to during divorce.[7]

As the cases referenced in endnote 1 make clear, even an attorney who is substituted out or fired has a duty –

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ignored at the lawyer's peril – to inform the former client of the need for the QDRO if there is a retirement to be divided. As a matter of defensive practice, that notice should be in writing with a description of the potential consequences of not obtaining the required order.

The work is not finished when the QDRO or other retirement order is drafted, either, as illustrated by the *Kennedy* case.[8] In 1974, Bill designated his then-spouse Liv as beneficiary of his ERISA-based account balance (savings) plan. In 1994, the parties divorced, and their *Decree* included a provision stating that Liv waived all interests in the plan.

In 2001, Bill died, having never sent the "beneficiary change" form to the pension plan. His heir made a claim, but the plan paid the ex-wife, Liv, anyway, notwithstanding her explicit waiver of the benefits in the *Decree*. And after eight years of litigation, the United States Supreme Court said the plan was right in doing so, because plan administrators should be able to rely on the documents in their files, without having to look at "extraneous" documents – like divorce decrees.

In other words, the highest court in the U.S. has said that the administrative convenience of plan administrators is more important than obeying divorce court orders, or following the intent of parties.

The divorce lawyer, who probably thought he had finished his job when he got the waiver put in the *Decree*, faced a possible malpractice suit from the intended beneficiary for not ensuring that the right form was sent to the plan at the conclusion of the divorce.

There have been many such cases illustrating the need to complete the process of obtaining plan approval during the divorce.

In *James River Ins. Co. v. Rinella and Rinella*[9], the attorneys identified an ESOP ("Employee Stock Option Plan"), included language in the decree that a QDRO was necessary, and even drafted one and submitted it to the plan. The plan responded stating that the ESOP was not a qualified plan, making it not subject to the Employee Retirement Income Security Act (ERISA) and thus requiring a different kind of order than a standard QDRO to divide the account.

The attorneys, for whatever reason, ignored the response from the plan and filed suit for enforcement of their QDRO. While the suit was pending, the plan sponsor dissolved and the stock options became worthless, making the attorneys liable for the loss that could have been avoided if they followed the directions of the plan and submitted the correct order.

Similarly, in *Sippe v. Sippe*[10], the attorneys submitted a QDRO for the division of the pension, but failed to have it pre-approved by the plan to ensure that it met the requirements of ERISA and the plan specific provisions. It did not matter that a court had ***entered*** the QDRO because it was ineffective to actually divide the plan benefits.

The lesson is that it's not enough to just draft the order, and its not enough to just file the order with the court. The QDRO must also be served on, and approved by, the plan.

It is a very good idea to get verification that it ***was*** served on the plan. Anecdotal reports continue to appear of pension plans that pay benefits out contrary to court orders, and when challenged, simply deny having received the orders in the first place. So a little paranoia on the part of divorce lawyers is justified – to get verification of

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We Need Your Articles!

The Family Law Section is accepting articles for the Nevada Family Law Report. The deadline for the Winter 2017 edition is December 10, 2016.

When submitting an article to NFLR, please note that automatically embedded footnotes/endnotes do not carry over into the State Bar of Nevada's publishing program. As such, if at all possible, we would ask that you utilize endnotes that are not automatically embedded. Please do not use the Footnote/Endnote function of your word processing program.

Please contact Jason Naimi at jason@standishnaimi.com or Margaret E. Pickard at nevadamediator@gmail.com with your proposed articles anytime before the next submission date. We're targeting articles that are between 350 words and 1,500 words, but we're always flexible if the information requires more space.

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service, and to make sure the client gets a copy of that verification. Filing the proof of service with the court entering the decree and QDRO may also be a good idea.

VI. LURKING DANGERS OF BAD QDRO PREPARERS

Even lawyers who know that they must get pension division orders entered make mistakes in getting the task done. We see three recurrent errors.

A. Using the Model Order

Never rely on a model form QDRO provided by the plan for the division of a pension, especially if your client is the non-employee spouse/alternate payee.

The sample forms are designed for administrative convenience of the plan administrator only, and while they will (presumably) be adequate to "qualify" an order as a QDRO (so as to protect the ***plan*** from any disqualification) they are ***not*** designed to protect the rights of either party, and are surely not designed to look out for the best interest of the former spouse/alternate payee – or that person's lawyer.

For example, many plan form orders don't address "surviving spouse" protections for a former spouse, or have provisions for post-divorce early retirement subsidies. The plan could not care less that not including such provisions could leave the lawyer open to suit by the client for violating the requirements of *Henson*[11] or *Forrest*[12].

Some plan forms are better than others, of course, but typically, such forms do not provide at all for things of great importance to one or both parties, and using them leaves the attorney at great risk of malpractice liability. Just because a model form QDRO "qualifies" under ERISA does ***not*** mean that it satisfies Nevada law, the divorce court's orders, your ethical duties, or provides protection for you or your client. Use the plan's form and you might luck out. Or not.

B. Feral Paralegal Drafting Services

Nationally, there are dozens of non-licensed legal pleading mills purporting to draft proper QDROs, but really just filling the blanks in on forms – sometimes the model forms referenced above. You can often spot them by postcard advertisement or box ads saying things like "years of experience, "we take care of everything," "you don't even have to read it," etc. – all for $99.99! What could possibly go wrong?

Problems with the plague of unlicensed paralegal services pretending to do legal work, but mainly just operating form services, have been discussed before.[13] In the world of QDROs, using such a drafting service is no better – and often worse – than using a plan's model form.

C. Non-Neutrals with an Agenda

Perhaps worst, we have picked up on a pattern of out-of-state preparers being brought in as supposed "neutrals" but actually using slanted language to subvert Nevada law regarding pension divisions – leaving the attorney for the spouse in grave danger of a malpractice suit if the spouse ever figures out how badly he or she was cheated, and that the lawyer failed to protect against it.

Specifically, we have seen the same gambit in different cases out of one such office, trying to cheat the former spouse in several ways without ever disclosing that the QDRO preparer was doing so. My QDRO staff identified and labeled them "attempted screws 1, 2, and 3."

The first sought to remove the spouse's separate property interest in Cost of Living Adjustments ("COLAs"), diverting the COLAs on the spousal share back to the employee so he got his COLAs ***and*** her COLAs. This violated the fundamental principle of community property division that each spouse receives an immediate, present, and vested separate property interest in the property awarded to him or her by the trial court.[14]

The language used by the purported "neutral" to ac-

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QDRO
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complish this bit of attempted larceny was technical enough that only someone versed in pension division law would have noticed it. If it had been accepted, the spouse would have been cheated out of vast sums for life.[15] As detailed in the endnote, this one point could have cheated the spouse out of hundreds of thousands of dollars over time and, again, that becomes the measure of potential damages against counsel.

The second attempt tried to "freeze" the spousal share and deny the spouse any increases due to service credits or any other interest gained subsequent to the date of divorce but prior to the date of retirement, in direct violation of multiple holdings of the Nevada Supreme Court.[16]

The third would have prevented the spouse from collecting payment at first eligibility by prohibiting payments until "actual retirement" in direct violation of *Fondi*, *Sertic*, and *Henson*.[17]

The point is that some divorce lawyers for participants have been seeking out these out-of-state preparers, falsely claiming that their work product complies with the law, and using the QDRO preparation process to subvert divorce court orders and community property law to try to quietly cheat the spouse out of vast sums of community property. Wherever they are successful, they are also creating massive malpractice liability for the attorney for the spouse – if and when that spouse ever figures out that she has been short-changed.

Less malevolent, but equally dangerous for trial counsel, there are some lawyers in Nevada claiming to be "experts" in the pension and retirement area who can "talk the talk," but really don't "walk the walk," at least very well – some of the work we review is sloppy, incomplete, and poorly researched and executed. Good help is available, but *caveat emptor*.

The lesson is that if the opposing counsel has suggested using a preparer for the pension division order who you are not entirely sure is qualified and ethical, you must read the proposed order carefully, or if you think you do not have the information and experience to do so, hire someone else to do so.[18]

VII. CONCLUSIONS

Preparation of QDROs should always be accom-

plished by an attorney skilled and experienced in their construction. The legal landscape, however, is one in which few parties appreciate the importance of retirement benefits, and relatively few lawyers understand what they are and how they work.

This has led to massive confusion, delay, and accidental (and not-so-accidental) loss of benefits, mainly by non-employee spouses. It also created a cottage industry of folks claiming to "help" with such orders, the large majority of whom are mere form peddlers with no real clue of what they are doing or how anything works (or outright frauds and con artists), who often make things worse.

The simple reality is that every divorce lawyer must understand the liability involved in drafting a mistake-laden QDRO and the invitation to liability resulting from the failure to draft, enter, and get approved a QDRO prior to withdrawing from a case. ***Every*** case involving a pension must deal with retirement and survivorship benefits ***before*** entry of the decree.

The potential cost of not doing so could easily be in the hundreds of thousands of dollars. Worse, and perhaps most unsettling from a malpractice perspective, is how long such a claim can lay dormant. Several courts have adopted a "discovery rule" for attorney malpractice cases.[19] In other words, divorces involving pensions, but in which full provision was not made for both retirement division and survivorship interests, are malpractice land mines, lying dormant for years or decades until the right combination of events sets them off.

It is ***possible***, of course, that with adequate CYA letters, etc., lawyers could make it their clients' problems to figure out what to do after the divorce and try to get it

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QDRO

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done. But it is far better lawyering – in the client's interest and that of the attorney seeking to avoid potential liability – to deal with the retirement benefits before completion of the divorce. Doing so means making sure the proper orders are in place at the time of entry of the decree – and making sure the relevant retirement plans acknowledge getting them.

For those reading this article who think some land mines might have been left in prior cases, it may not be too late to prevent damage (and liability). Review your case list for the past 10 years (or longer if you can), and try to glean from it those cases in which retirement orders (PERS, military, Civil Service, or private-employer QDRO) might have been drafted – or should have been drafted. And then check to see if they were filed with the court and approved by the plan. Doing so, or having your staff do so, could result in an enormous benefit to former clients in avoided losses, and a significant reduction in your own exposure to possible future malpractice claims.

CITATIONS

1. *See Smith v. Lewis*, 530 P.2d 589 (Cal. 1975) ($100,000 malpractice award for failing to list and divide a military reservist retirement), overruled on other grounds, *Marriage of Brown*, 544 P.2d 561 (Cal. 1976); *Cline v. Watkins*, 66 Cal. App. 3d 174, 135 Cal. Rptr. 838 (Ct. App. 1977) (first attorney's liability for negligence not cut off by substitution out of case and assumption of representation by second attorney who was negligent in failing to assert community interest in federal pension benefit); *Medrano v. Miller*, 608 S.W.2d 781 (Tex. Civ. App. 1980); *Aloy v. Mash*, 696 P.2d 656 (Cal. 1985); *Martin v. Northwest Washington Legal Services*, 43 Wash. App. 405, 717 P.2d 779 (Wash. Ct. App. 1986) (lawyer and firm found to liable for failure to inquire about, discuss, or seek division of client's husband's military pension in a dissolution case where the attorney was on notice that one of the parties was a member of the Armed Services); *Bross v. Denny*, 791 S.W.2d 416 (Mo. Ct. App. 1990) ($108,000 malpractice award where attorney did not know that he could seek division of military retirement after change in the law).

2. Posted at http://www.willicklawgroup.com/vol-16-when-qdros-should-be-drafted/.

3. NRPC 1.1 and 1.3. The Nevada Rules of Professional Conduct Rule 1.16(b) states that: "Except as stated in paragraph (c), a lawyer may withdraw from representing a client if: (1) Withdrawal can be accomplished without material adverse effect on the interests of the client."

4. For a guide of what to do and how to do it, *see* Marshal Willick, Retirement Plan Division: What Every Nevada Divorce Lawyer Needs to Know (State Bar of Nevada CLE, Ely, Nevada, 2013), posted at http://www.willicklawgroup.com/published-works/.

5. A defined contribution plan can take the form of a deferred compensation plan, a stock option plan, 401(k), 403(b), 457(b), SEP, or by many other names. Not only can these have many names, the plan may be a traditional (tax deferred) plan, or a Roth (tax free) plan. Lawyers needs to understand the difference.

6. *See Henson v. Henson,* 130 Nev. ___, 334 P.3d 933 (Adv. Opn. No. 79, Oct. 2, 2014); analyzed in detail in Marshal Willick, Partition Actions: What Every Nevada Divorce Lawyer Needs to Know (in *Advanced Family Law* CLE, State Bar of Nevada, Las Vegas, Nevada, 2015), posted at http://www.willicklawgroup.com/published-works/.

7. Edwin Schilling, Esq., of Aurora, Colorado, estimated that 90% of his malpractice consultations involve failure to address survivor beneficiary issues. Lawyer's Weekly USA, Oct. 18, 1999, at 22 (99 LWUSA 956). My experience is similar – I have been hired as an expert witness for plaintiff or defense in several cases involving practitioners accused of not securing survivorship benefits.

8. *Kennedy v. Plan Adm'r for DuPont Sav. and Inv.*, ___ U.S. ___, 129 S. Ct. 865, 172 L. Ed.2d 662 (2009).

9. *James River Insurance Company v. Rinella & Rinella, LTD.*, No. 07 C 4233 (N.D. Ill. Sept. 10, 2008). The case holding actually involved the finding that the malpractice carrier was required to defend the attorneys.

10. *Sippe v. Sippe*, 398 S.E.2d 895 (N.C. App. 1990), *cert. denied*, 407 S.E.2d 840 (1991).

11. *Henson v. Henson,* 130 Nev. ___, 334 P.3d 933 (Adv. Opn. No. 79, Oct. 2, 2014).

12. *Forrest v. Forrest*, 99 Nev. 602, 668 P.2d 275 (1983); *see also Blanco v. Blanco*, 129 Nev. ___, 311 P.3d 1170 (Adv. Opn. No. 77, Oct. 31, 2013).

13. *See, e.g.*, Legal Notes Vol. 10 (Feral Paralegals, Feb. 17, 2010) and Vol. 15 (Feral Paralegals Part 2, Apr. 27, 2010), posted at http://www.willicklawgroup.com/newsletters/page/3/.

14. *See, e.g.*, *Wolff v. Wolff*, 112 Nev. 1355, 929 P.2d 916 (1996); *Koelsch v. Koelsch*, 713 P.2d 1234 (Ariz. 1986). Each spouse is entitled to the "rents, profit, and issue" of their respective share which is their separate property, including all cost of living adjustments on that share.

15. Inflation is insidious and cumulative. Even at low rates, it greatly affects the value of money over time. For example, I just completed an agreement a few months ago involving an arc of 22 years, which I investigated for illustrative purposes, and discovered that over the ***past*** 22 years, inflation has been such that the value of $100,000, 22 years ago, is $55,134.14 today – about half, and that is after multiple recent years of record-***low*** inflation. Over the years, I have reviewed, upon divorce, multiple premarital agreements where the weaker spouse agreed to terms that seemed reasonable in the 1960s – for $500 per month to live on, for example – that today provide essentially no value at all. It just is not possible to predict what the ***value*** of any stated quantity of dollars will be at any time more than a few years out.

16. *See, e.g.*, *Gemma v. Gemma*, 105 Nev. 458, 778 P.2d 429 (1989); *Fondi v. Fondi*, 106 Nev. 856, 802 P.2d 1264 (1990); *Sertic v. Sertic*, 111 Nev. 1192, 901 P.2d 148 (1995).

17. Nevada uses the "time-rule" formula. In *Sertic*, clarifying both *Gemma* and *Fondi*, the Court made it clear that the normal distribution of a spousal share of a pension is upon the participant spouse's first eligibility for retirement, and if the worker does not retire at first eligibility, the worker must pay the spouse whatever the spouse would have received if the worker did retire at that time.

18. Partially because of such practices, this firm started a "QDRO Checkup" service. *See* http://qdromasters.com/qdro-checkup/.

19. *See Petersen v. Bruen*, 106 Nev. 271, 792 P.2d 18 (1990); *Semenza v. Nevada Med. Liability Ins. Co.*, 104 Nev. 666, 765 P.2d 184 (1988).

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Litigation Support and Valuation Fundamentals

By Mark Bailey, CPA, ABV

The Judge's final decree was clear:

"The assertion of value of XYZ Corporation presented by Counsel is not supported by the written report of your valuation expert. His testimony was not relevant with respect to a standard of 'fair value', nor were his conclusions of value based on the methodologies employed."

As professionals – we all agree – this is never an acceptable situation or outcome. The attorney blamed the valuation expert, and the valuation expert blamed a lack of communication on the part of the attorney. The loser was their client.

This result not only can be avoided, but it must. To do so requires not only a thorough understanding of the engagement purpose and scope by the retained expert, but also understanding by counsel of the fundamentals and limitations of valuation. There are a variety of reasons why business valuation analysts are retained. For purposes of this article they can best be broken down into two categories.: business consulting and litigation support.

Mergers, acquisitions, reorganizations, buy-sell agreements, ESOP's, estate planning and financial reporting engagements typically fall into the consulting category as

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Litigation Support

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defined here. The standard of value most commonly used is 'fair market value' (fmv). Litigation related valuation engagements may include such things as marital dissolution, stockholder disputes, damage calculations and insurance claims. While the standard of value may be fmv for certain assets or liabilities, it is most frequently 'fair value' particularly in the case of marital dissolution in California and Nevada. There are two other common standards of value – liquidation value (common in bankruptcy cases) and intrinsic value. The balance of this article will address the two most common standards – 'fair market value' and 'fair value' and the differences between them. The purpose of any valuation engagement will inevitably influence the standard of value used by the analyst. Let's begin with Fair Market Value.

Standards of Value

The most commonly used standard of value is fair market value. Revenue Ruling 59-60 defines fmv as: "The amount at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts".

The fmv can best be thought of as the cash price that would be paid for the item at a specific date by a hypothetical buyer. It is imperative that it is a hypothetical buyer and not a specific buyer or a strategic buyer who may receive some other synergistic benefit. This is particularly important in certain litigation scenarios. An offer from a strategic buyer does not generally represent a fair market value. The valuation analyst must be able to assume the item is available to the market. For many assets in a marital dissolution this is not the case which will be discussed along with other differences.

Fair value is defined under US generally accepted accounting principles as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This hypothetical transaction is normally considered from the perspective of the holder of the asset, and is not necessarily the price that would be required to acquire the asset. The fair value is not adjusted for selling or transactional costs, nor are minority discounts taken into account. Different jurisdictions may modify their definition of what is included in the calculation of fair value, but ultimately the court is concerned with fairness and that an equitable distribution is affected between the parties. It is important to note that the concept of 'fair value' is modified by case law and is ever changing.

The concept of 'market value' embraced in a fair market value determination is absent in a fair value opinion and replaced with a concept of 'fairness'. The most common application of fair value is in marital dissolution, and dissenting/oppressed shareholder actions. Where fair market value requires a willing buyer and a willing seller, neither under compulsion, fair value does not. Nor is there an assumption of reasonable knowledge by both parties in a fair value calculation. These differences become critical when defining the scope and purpose of your engagement to your valuation analyst. After having communicated the purpose and determined the scope of value, it is time to address the various methodologies available.

Methodology

There are three basic approaches to business valuation: the asset based approach; the market approach; and the income approach. Under each approach there are several methodologies frequently employed.

Asset Based Approach

This approach is frequently referred to as the 'cost approach'. The most common methodologies utilized under this approach are: (1) the adjusted book value method; (2) the liquidation value method – frequently used in bankruptcy cases; and (3) the replacement cost method.

The valuation analyst will adjust the various balance sheet accounts to fair market value. The resulting net difference is then the value of the entity. This serves to ignore any intangible items not recorded on the balance sheet, such as patents, trademarks and goodwill. These items should then be calculated and valued using other methods and added to the net value. Unrecorded liabilities, such as future purchase obligations should also be considered and may result in a reduction of entity value.

This approach is commonly used for asset intensive

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Litigation Support

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entities, such as manufacturing and holding companies along with non-income producing entities such as not-for-profits. It typically is not used for service businesses lacking significant tangible assets and is generally not appropriate to value minority interests given the minority does not have control over sale particularly in a liquidation scenario.

The primary advantage of this approach is that it is straightforward and easy to understand given that it focuses heavily on tangible assets and liabilities. The primary disadvantage is that unless adjusted properly for intangibles – which can be extremely difficult to value separately – it may not accurately reflect the earning power of the entity.

Market Approach

The most common method under this approach is the 'guideline company method'. Depending on the nature of the entity being valued, when properly applied, this approach would seem to make the most sense given it derives a value from third party 'market' information. The value is determined based on the use of pricing of other traded public company surrogates comparable to the entity being valued. The subjective determination of comparability between the surrogates and the entity can make this methodology extremely difficult to apply when taking into account size, liquidity, market share, longevity, location, and much more.

Other methodologies under this approach are: industry method (rules of thumb); sales of a company's own equity; and the merger and acquisition method (comparable sales).

Income Approach

Philosophically, this approach reflects an investor's estimate of value of the enterprise based on a desired rate of return derived from cash flow or an earnings stream either in the past or projected for the future. There are two methodologies used in the income approach – capitalization and discounting. Both methodologies are based on a benefit stream. Some of the benefit streams used are: net income either before or after tax; earnings before interest and taxes (ebit); earnings before interest, taxes, and depreciation and amortization (ebitda); and cash flow.

A capitalization model is typically a single period earnings stream divided by a rate of return. The earnings stream is normalized for unusual and non-recurring items and is frequently weighted with prior periods to affect market fluctuations over some period of time.

Under a discounting model the valuation analyst relies on a projected earnings stream for multiple future periods and discounts that to a present value based on a desired rate of return reflecting risk. In both models the underlying value of the operating assets is reflected in the benefit stream under the assumption they are worth the return they produce. Once that is determined then the value of any non-operating assets must be added to obtain the entity value.

In Nevada and California discounted methodologies are not generally accepted by the courts. Many valuation analysts believe discounted future benefits are a more reliable reflection of present value than are capitalized historical benefit streams given that perceived value today by an investor is predicated on the future benefits anticipated. When using a capitalization approach, significant consideration must be taken in 'normalizing' and weighting the benefit stream and calculating the capitalization rate.

Some of the advantages of the income approach is that: it is reflective of the benefit stream generated; it utilizes simple mathematical calculations that are easy to understand and defend; it is widely accepted by financial markets; and it is inclusive of tangible and intangible assets. On the contrary, it requires significant subjectivity in determining the proper benefit stream to be used and calculation of the capitalization and discount rates can be extremely subjective. This is particularly true for smaller companies in a dynamic market.

Communicating the scope of the engagement is critical to determining the standard of value needed and the methodologies to be employed.

Ultimately this will lead to the appropriate valuation report. In part two we will discuss the various reports available.

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