NOVEMBER/DECEMBER 2025

LITIGATION SUPPORT

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In re Marriage of Nelson

Divergent expert opinions lead court to value business

In a contentious divorce proceeding, the Court of Appeals of Iowa in *In re Marriage of Nelson* recently affirmed the trial court's valuation of a business. The parties' experts presented "wildly differing opinions" on the business's value, ranging from between $251,000 and $275,000 to $3.6 million. Neither expert persuaded the trial court, so it performed its own analysis, essentially "splitting the baby."

Background

In 2007, a newlywed couple formed a construction company that eventually became a successful roofing business. It specialized in storm restoration and insurance claim work. The couple allocated 51% ownership to the wife and 49% to the husband to take advantage of the benefits of operating as a female-owned company.

When the company started experiencing collections issues in 2016, the owners began using an "Assignment of Claim and Benefits" form. It required homeowners to assign their rights and benefits from insurers directly to the roofing company. But in 2020, the Iowa Supreme Court held that the company's use of the assignment forms caused it to effectively act as an unlicensed public adjuster. As a result, the forms were deemed void and unenforceable.

> The appellate court upheld the trial court's decision, finding that its valuation was "well within the range of permissible evidence."

The COVID-19 pandemic further impaired the company's performance in early 2020. However, two large storms offset some of the negative impact.

In early 2021, the wife filed a petition for marital dissolution. During the proceedings, the husband offered to buy the wife's 51% interest for $550,000. She rejected his offer, leaving the parties to settle their differences in court.

Dueling valuations

The wife hired a business valuation professional. Her expert concluded that the business was worth approximately $276,000 under the income approach and $251,000 under the asset-based (or cost) approach. The company's biggest asset was more than $4 million of accounts receivable, including many overdue accounts. Given the accounts' age and doubts about their collectability, the wife's expert ascribed little value to past-due receivables. He also subtracted a 20% discount for lack of marketability (DLOM) when valuing the business.

The husband hired a separate expert who valued the company at $3.6 million under the asset

Do controlling interests warrant DLOMs?

It's generally accepted in the business valuation community that *noncontrolling* interests in closely held companies are entitled to a discount for lack of marketability (DLOM). The International Glossary of Business Valuation Terms defines marketability as "the ability to quickly convert property to cash at minimal cost." Unlike publicly traded shares, noncontrolling interests in privately held companies lack access to an active market. As a result, the value of a noncontrolling interest is typically adjusted downward to reflect this lack of marketability.

But what about controlling business interests? The application of DLOMs for these interests is somewhat controversial and may vary based on case facts and circumstances. Some valuation experts believe that discounts should apply to controlling interests in privately held companies — even to 100% interests — albeit at lower rates than discounts applied to noncontrolling interests in the same company. They argue that private companies are at a disadvantage relative to public companies when it comes to marketability. Three rationales for this argument are:

1. Unlike publicly traded stock, which usually can be sold quickly, transactions involving private companies can take months to complete.
2. There are significant transaction costs involved with selling a private company.
3. There are significant costs associated with preparing a private company for sale.

Conversely, critics of DLOMs for controlling interests acknowledge that selling a private business involves significant time, effort and cost. However, fair market value is the price at which the universe of hypothetical willing, informed buyers and sellers would consummate the transaction on the valuation date. DLOM critics argue that this standard of value already reflects marketability considerations. So, they believe that applying a DLOM would essentially double-count marketability-related factors.

approach. His expert assumed all the company's receivables were fully collectible and applied no valuation discounts.

Bridging the gap

The trial court found both sides' expert testimony to be unpersuasive and not credible. Both also ignored the significance of the husband's $550,000 offer to buy out the wife. After reviewing the expert's conclusions, the court valued the business at $1.5 million based on its own assessment of the accounts receivable. Notably, the court also applied a 20% DLOM to 100% of the business based on evidence presented by the wife's expert. (See "Do controlling interests warrant DLOMs?" above.)

The appellate court upheld the trial court's decision, finding that its valuation was "well within the range of permissible evidence." It also commented that the 20% DLOM was consistent with Iowa precedent that "has affirmed discounting the valuation of a closely held business or its stock in a property division when there is no ready market."

Splitting the baby

The trial court's $1.5 million valuation translated into an undiscounted value of $1.875 million, roughly the midpoint between the experts' valuations. When experts arrive at divergent valuations, the parties may be left to the whim of the court, and courts often resort to simply averaging the experts' conclusions.

While this approach might seem fair, it can also be arbitrary or inequitable, depending on the situation — for example, if an expert lacks independence or valuation credentials. To stay in control of a case's outcome in similar situations, consider obtaining a rebuttal report that pinpoints specific sources of the valuation discrepancy for the parties to reconcile *before* going to court. ■

Business sellers need to look at the big picture

It's easy to understand why a selling business owner would assume that the highest offer is the best option. However, selling a company is more complex than simply picking the top dollar. Sellers must consider a range of factors — some of which may end up being more important than price.

More than the bottom line

Many factors affect the ultimate value of a deal for sellers, including:

Financing risk. If a buyer's financing is uncertain, the deal could break down before it crosses the finish line. In such cases, a bidder offering less, but standing on firmer financial ground, may be a better bet.

Deal structure. How a deal is structured also affects risk and the offer's desirability. Most sellers prefer cash over stock deals because they involve less market vulnerability. If the highest bidder proposes a transaction largely financed with company stock, the seller could be at risk if the share price drops before the deal closes or after the two organizations merge.

> Evaluating alternative deal structures is essential to optimize tax outcomes.

Likewise, the deal structure may have tax implications. For example, installment sales may allow sellers to spread their tax obligations over several years rather than paying it all at once. Evaluating alternative deal structures is essential to optimize tax outcomes.

Regulatory concerns. The likelihood that the highest bidder's acquisition will be challenged by government regulators is another valid reason for concern. Going with a lower bid from a company not likely to draw regulatory attention could mean fewer hurdles and greater assurance that the deal will go through.

Organizational compatibility. Continuity and compatibility matter. Business owners need to consider how the company they've built will fare under new ownership. And although ease of integration is primarily a concern for buyers, a difficult merger of operations could affect the employees' futures. Sometimes, selling to a group of managers at a lower price or transferring the business to a relative may make more sense than selling to outsiders who don't understand or respect the company's culture and values.

Gut feelings. Some deals just don't feel right — regardless of the potential payout. If the seller doesn't see eye-to-eye with the buyer or senses the buyer is being evasive, it might be prudent to step back and consider other offers.

Resolving red flags

None of the previously discussed issues need to be deal-breakers. For example, if a buyer offers a stock deal, the seller might ask for more shares or request a collar to protect against increased risk. If a buyer doesn't appear to have adequate financing, the seller can ask for evidence that it does or make the buyer agree to pay a reverse breakup fee.

Also, sellers can ask prospective buyers to explain why they're interested in the company and what they plan to do with it. For example, does the buyer intend to retain talent or compensate redundant staff? Do the buyer's expected synergies, such as expanded geographic reach or lower combined operating costs, seem realistic? Is successful integration of the two companies likely? The seller should listen carefully to the buyer's answers to assess whether the deal makes sense.

Don't be fooled by the sticker price

Selling a business is a major milestone. While a fair selling price can compensate a business owner for years of hard work and provide for a comfortable retirement, any offer must be carefully evaluated from multiple angles. Experienced financial and legal advisors can help a seller sift through the details and negotiate a deal that achieves a successful and satisfying exit. ■

Beware the echo chamber

Court excludes expert testimony lacking independent analysis

Does an opposing expert appear to be echoing opposing counsel's damages theories, rather than offering an independent, objective analysis? This can be a powerful basis for challenging the expert's credibility or seeking to exclude the expert's testimony altogether. In litigation, the role of a testifying damages expert is to assist the trier of fact in determining a party's financial loss. Experts perceived as *advocates* for one party risk losing credibility or even being precluded from testifying.

Case in point

In *Hutchins & Hutchins, Inc. v. Airboss Defense Group, LLC*, the U.S. District Court for the Eastern District of Virginia granted in part the defendant's motion in limine to exclude portions of the plaintiff's damages expert testimony. The excluded testimony included a theory that the expert had disavowed in deposition but had been advocated by the plaintiff's counsel.

The case involved an alleged breach of a nondisclosure agreement (NDA) between the plaintiff and the defendant. The defendant was awarded a contract to supply nitrile gloves to the U.S. Department of Health and Human Services. The plaintiff represented several glove manufacturers and offered to help the defendant meet its contractual obligations.

The NDA contained a "noncircumvention provision," prohibiting a party from entering into an

agreement with a business the other party introduced, without written consent. Later, the defendant signed a supply contract with a company that the plaintiff had introduced, without consent. The plaintiff sued the defendant for breach of the NDA, seeking damages in the form of a reasonable finder's fee or resale transaction.

Application of the Lehman Formula

The plaintiff's damages expert offered several damages theories in his report. One theory was the so-called Lehman Formula. The expert described it as a standard method for calculating finder's fees in mergers and acquisitions. He noted that "based on the representations of counsel, it is my understanding that it has been relied upon by courts from other jurisdictions in calculating finder's fees paid to an injured party who brought companies together." Applying the Lehman Formula, the expert opined that a $227,400 finder's fee would be appropriate in this case.

However, during the expert's deposition, he disavowed his opinion on the use of the Lehman Formula in this case. He admitted that he was unaware of any transaction that used the Lehman Formula in connection with the sale of goods. He also said that he wouldn't have used the formula in this context, except that the plaintiff's counsel had urged him to provide it as an alternative.

Court's analysis

The defendant subsequently moved to exclude the expert's testimony regarding what a reasonable finder's fee would be under the Lehman Formula. The court granted that motion.

In applying the Lehman Formula, the court found the expert didn't conduct his own independent analysis.

In applying the Lehman Formula, the court found the expert didn't conduct his own independent analysis. Instead, he merely repeated counsel's damages theory, which isn't helpful to the trier of fact. The court explained, "When an expert repudiates or disavows an opinion at deposition that was expressed in his expert report, such an opinion should be excluded."

Independence is key

As *Hutchins* illustrates, courts expect experts' opinions to reflect independent, objective analysis, not legal strategy. Courts will likely exclude the testimony of so-called experts who merely parrot counsel's theories. ■

How to ground multi-location fraud schemes before they take off

Businesses that operate from multiple locations, such as retailers, restaurants and franchises, face elevated fraud risks. No owner can be everywhere at once, and the more locations in play, the more opportunities for asset misappropriation and other schemes. Strong antifraud controls are critical to prevent and detect dishonest behavior that can lead to financial losses and a reputational nosedive.

Essential controls

A robust, multi-location antifraud strategy includes:

Pre-employment vetting. Background checks help identify previous misconduct and signal to would-be fraudsters that the business is committed to ethical operations.

Formal written policies. Policies on cash handling, credit card data protection, returns and refunds must be formalized, monitored and updated regularly.

Training. A company's employees are its first line of defense against fraud. Education programs should explain the business's antifraud controls, warning signs of common fraud schemes and the role employees play in preventing financial losses.

Business owners also should consider setting up anonymous reporting hotlines. Studies conducted by the Association of Certified Fraud Examiners consistently find tips to be among the most effective tools in early fraud detection.

Additional checks and balances

Employees who have access to a company's books, incoming mail *and* bank account may be able to commit various fraud schemes and prevent their discovery. Segregation (or separation) of duties can help prevent that from happening. For instance, a business might outsource payables and receivables to a third-party provider, receive mail for all locations at one centralized office, and require individual store managers to deposit daily takings according to strict procedures. Periodic job rotation, mandatory vacation policies and surprise audits also make it harder for dishonest employees to steal and avoid detection.

For added protection, a forensic accounting professional can conduct a fraud risk assessment to document existing internal and external fraud threats and recommend cost-effective controls to mitigate those risks. It's possible that some locations are better protected than others, which helps management focus on high-risk sites.

Data analysis

New technologies can help reduce fraud risks in multiple locations. For instance, owners can remotely access point-of-sale systems to monitor transactions. Or they might install live cameras to conduct store surveillance remotely.

Managers can also use artificial intelligence tools to spot behavioral red flags. Examples are employees who process excessive returns or refunds, excessive inventory turnover, and higher-than-expected costs relative to sales. Such red flags don't prove fraud, but they provide a starting point for further investigation.

Navigational guidance

By mapping out effective control systems, multi-location businesses can manage fraud risks before they spiral out of control. A forensic accounting professional can help devise strategies to reinforce a business's controls without throttling growth. ■

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