

## Commercial Litigation Insights

## EFFECTIVE BUSINESS VALUATION/SECURITY ANALYSIS REPORTS FOR COMMERCIAL LITIGATION PURPOSES

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*Financial advisers are commonly asked to prepare business valuation (or solvency/insolvency, transfer price, or lost profits/economic damages) analyses for various litigation support and dispute resolution purposes. These various litigation purposes may relate to taxation, financing, shareholder, SEC public disclosure, GAAP compliance, intellectual property, contract, joint venture, condemnation/eminent domain, and other controversies. Financial advisers try to make all valuation (or solvency, transfer price, damage, etc.) reports clear, convincing, and cogent. However, this objective is particularly important in reports that are prepared for litigation and expert witness testimony purposes. This discussion presents guidelines and suggestions to valuation analysts (and other damages experts) related to the preparation of written business valuation/security analysis reports. Accordingly, this discussion includes a list of positive attributes that effective business valuation/security analysis expert reports should manifest. And, this discussion includes a list of negative attributes (or common errors) that effective business valuation/security analysis expert reports should avoid.*

### INTRODUCTION

Valuation analysts are often called on to prepare business valuation/security analysis reports for a variety of transaction, taxation, accounting, financing, litigation, and strategic planning purposes. Many of the more common business valuation purposes within each of these categories of client motivations are summarized below.

The transaction purposes include fairness opinions, adequate consideration opinions, and private inurement opinions related to the sale of (1) the entire business enterprise or (2) a block of stock or a class of security of the business enterprise. Such transactional business/stock valuations relate to mergers, acquisitions, joint ventures, ESOP formations, and so forth.

The taxation purposes relate to (1) federal income taxation, (2) gift and estate taxation, and (3) state and local property taxation. Such taxation-motivated business/stock valuations may be prepared for either tax planning or tax compliance purposes.

The financial accounting purposes typically relate to the implementation of a provision of generally accepted

accounting principles (GAAP), such as: FASB SFAS Nos. 133, 141, 142, 144, and 123R, and of AICPA SOP 90-7.

The financing purposes include solvency analyses, insolvency analyses, and collateral valuations related to corporate financings, refinancings, restructurings, and troubled debt workouts.

The litigation purposes include dissenting shareholder appraisal rights, shareholder oppression, fraud and misrepresentation, fraud on the market, noncompetition agreement violations, breach of contract, lender liability, tortious interference with business, family law bankruptcy, and other claims.

And, the corporate strategic planning purposes include the identification of restructuring, reorganization, intercompany asset/equity transfer, or spin-off/divestiture opportunities.

This discussion focuses on the valuation of businesses and business interests for litigation support and dispute resolution purposes. Accordingly, the topic encompasses the preparation of business/security valuation (and lost profits/economic damages) reports related to contract disputes, expropriation and infringement claims, condemnation and eminent domain actions, tax audits and litigation (including gift and

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estate tax, income tax, and property tax), fraud and misrepresentation allegations, shareholder disputes, and other commercial disputes.

This discussion assumes that the analyst (1) performs the business/security valuation analysis, (2) prepares a written valuation opinion report, and (3) serves as an expert witness in an administrative hearing or judicial proceeding.

## BUSINESS VALUATION REPORT OBJECTIVES

For purposes of this discussion, the term “business valuation” will encompass the analysis and appraisal of:

1. corporations—total invested capital, total equity, a class of equity, or a block of stock,
2. the total operating assets of a going concern business,
3. a fractional ownership interest in a closely held business,
4. the restricted securities of a publicly traded company,
5. a tax pass-through entity, such as a partnership or S corporation,
6. a limited partnership or limited liability company,
7. a professional services company,
8. a professional practice,
9. a joint venture,
10. a franchise,
11. a sole proprietorship,
12. a division or subsidiary of a parent corporation,
13. a line of business or product line,
14. a portfolio of securities, and
15. other ownership interests.

Of course, every valuation analyst attempts to make every business valuation report clear, convincing, and cogent. This valuation report objective is relevant for analysts who prepare valuation reports for transaction, financing, accounting, taxation, bankruptcy, and management information purposes.

However, this valuation report objective is particularly important within a controversy (e.g., commercial litigation or tax audit, appeal, or litigation) environment. In addition, this valuation report objective is particularly relevant when the valuation analyst expects to provide expert witness testimony regarding the subject business/security valuation.

First, this discussion summarizes the common attributes of an effective business valuation/security analysis report. Second, this discussion summarizes common errors to avoid in the preparation of the business valuation/security analysis report. Third, this discussion summarizes the basic quality control procedures that valuation analysts should consider before issuing the written business valuation/security analysis opinion report.

## BUSINESS VALUATION REPORTS PREPARED WITHIN A CONTRARIAN ENVIRONMENT

Commercial litigation and tax disputes involving the value of a business enterprise or business interest are often decided by a judicial or administrative finder of fact. In such a contrarian environment, an effective business/security valuation report should be both well-written and well-organized.

In addition, an effective business/security valuation report should satisfy:

1. all of the valuation analyst’s professional standards and
2. all of the litigant client’s engagement requirements.

Of course, controversies/disputes related to business enterprise franchise fee, royalty rate, economic damages, lost profits, and so on, are also often decided by a judicial or administrative finder of fact. The above-mentioned professional quality expectations also apply to the written expert reports prepared on related types of business valuations/security analyses.

Such related analyses that may be relevant in a commercial litigation or tax appeal context may include: intercompany transfer price analysis, remaining useful life (RUL) study, arm’s-length fair royalty rate/license agreement opinion, business enterprise solvency or insolvency, lost profits/economic damages analysis, or a sale/license transaction fairness opinion.

In such a contrarian environment, the written valuation report may be the only tangible documentation before the court (or other finder of fact) as to how the business/security value was concluded. Accordingly, both the content and the appearance of the valuation report are important to the process of convincing the finder of fact with regard to the reliability of the analyst’s business/security value conclusion.

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This discussion reviews the attributes of an effective business/security valuation report, particularly within a contrarian (e.g., commercial litigation or tax controversy) environment. However, this discussion of effective valuation report attributes also applies to business/security valuation reports that are:

1. prepared for any controversy/dispute resolution purpose and/or
2. subject to any contrarian review or audit.

## ATTRIBUTES OF AN EFFECTIVE BUSINESS VALUATION REPORT

A clear, convincing, and cogent business valuation report should demonstrate several effective report writing attributes. These effective business valuation report attributes include:

1. **Thoroughness**—As they may affect the business/security value conclusion, the written report should include:
  - a. all relevant quantitative/qualitative data and
  - b. all relevant quantitative/qualitative analyses.

The valuation report should disclose:

- a. the purpose and objective of the valuation and
- b. the analyst's client (or employer).

In addition, the valuation report should adequately describe:

- a. the subject business enterprise or security interest;
- b. the bundle of legal rights, preference, and restrictions subject to analysis;
- c. the ownership rights related to the subject securities regarding degree of ownership control (or lack thereof) and degree of marketability (or lack thereof);
- d. the owner and operator (if different) of the subject business;
- e. the valuation assignment standard of value, premise of value, valuation date, level of value, etc.;
- f. what is the relative ownership interest of the valuation subject—compared to the total business enterprise; and
- g. any contracts, agreements, or licenses that may affect the ownership, use, or transferability of the subject business interest.

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An adequate explanation of the subject business interest should allow the report reader/finder of fact to understand exactly:

- a. which ownership interest the analyst has valued,
- b. what the subject business assets or equities are (and are not), and
- c. how the subject business enterprise operates, in terms of products and services.

For example, the analyst does not want the finder of fact to be uncertain as to the following questions:

- a. what classes of securities are included in the analysis;
- b. what are various classes of debt and equity securities that capitalize the subject company; or
- c. does the subject equity interest enjoy (or not enjoy) voting rights, dividend rights, appreciation rights, liquidation rights, etc.?

2. **Objectivity**—The written report should discuss both the positive and the negative factors affecting the subject business enterprise or equity interest. Typically, the valuation analyst's client will presumably have an economic interest in the subject business/security value conclusion.

However, the valuation analyst should remain unbiased and objective. And, this objectivity should be evident both in the valuation analysis and in the valuation report.

Again, this objectivity is equally appropriate for the analyst working for the plaintiff litigant/taxpayer as for the analyst working for the defendant litigant/taxing authority.

Accordingly, the business/security valuation report should manifest that objectivity by presenting an impartial discussion of all relevant facts and factors affecting the subject business enterprise. This impartial discussion is often presented as an assessment of the competitive strengths, weaknesses, opportunities, and threats of the subject business enterprise.

3. **Understandability**—The finder of fact or other contrarian reader of the business/security valuation should be able to follow, understand, and replicate (a) the data analyzed, (b) the analyses performed, and (c) the value conclusions reached. The valuation report should be written in a clear and concise style.

The report narrative should avoid the use of technical jargon whenever possible. When technical financial or economic jargon is absolutely necessary, that jargon should be adequately defined in plain English. Any empirical data and/or analytical assumptions presented in the report should be adequately described, so that the valuation report reader can understand them.

4. **Specificity**—The valuation report should clearly and accurately explain (a) the subject valuation interest and (b) the subject valuation conclusion. Valuation reports that describe a value conclusion related to the subject business, business enterprise, or capital can be misleading and confusing.

The report reader/finder of fact should clearly understand what is the subject valuation target—that is, total invested capital (long-term debt and equity), total stockholders' equity, common stockholders' equity, a particular category or class of equity, total operating assets, total assets (operating and nonoperating, total net assets, etc.).

5. **Coherence**—The valuation report content should logically flow from the empirical data presented to the final value conclusion. Also, the business/security valuation report analyses and conclusions should be internally consistent.

Data sources and valuation variables should be consistent between the generally accepted business valuation approaches and methods used in the analysis. And, the reconciled value conclusions should be consistent with (and supported by) the value indications produced by the various analyses.

The business/security valuation report should present a narrative story that logically leads the report reader from the initial description of the valuation assignment to the analyst's final business value conclusion.

6. **Documentation**—The business/security valuation report should adequately document (a) each valuation approach, method, and procedure performed and (b) each value indication reached.

In addition, the valuation report should indicate (a) why each selected valuation approach and method was selected and (b) why each rejected valuation approach and method was rejected.

An adequate level of documentation generally implies:

- a. the identification of all empirical data sources relied on,
- b. the presentation of all quantitative and qualitative analyses,
- c. the description of all of the analyst's professional judgments, and
- d. the explanation of all value indications.

That way, a finder of fact (or an auditor, opposing expert valuation analyst, etc.) can (a) recreate the specific valuation procedures that were performed and (b) confirm the reported business/security value conclusion.

7. **Full Disclosure**—The valuation report should disclose all relevant information about:

- a. the subject business enterprise (e.g., existence of non-operating assets, existence of discontinued operations);
- b. the subject business operations (e.g., the existence of intangible assets and/or contingent liabilities);
- c. the subject securities (e.g., the effect of any put/call operations or other liquidity influences);
- d. the subject business ownership (e.g., recent offers to purchase/sell all or part of the subject business);
- e. the data/documents considered in the valuation analysis (such as buy/sell, shareholder, and other agreements); and
- f. the qualitative and quantitative analyses performed (such as the effect of financial statement normalization adjustments).

8. **Composition**—The analyst should consider all of the following report composition guidelines with respect to the business/security valuation report:

- Stick to the point—avoid discussion of extraneous topics that are not related to the subject valuation.
- Make the report prose coherent—clearly link related ideas, and distinguish unrelated ideas.
- Support the report statements with specific evidence—use facts and statistics to support the report statements and conclusions.
- Use lists to display facts—use charts, graphs, tables, and diagrams to display data.
- Make the report point of view consistent—maintain consistent verb tenses; make verbs consistent in both mood and voice.

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*"The business/security valuation report should present a narrative story that logically leads the report reader from the initial description of the valuation assignment to the analyst's final business value conclusion."*

- Untangle the grammatical structure of sentences and paragraphs—straighten out the logical connections between paragraphs and report sections/chapters.
- Use a variety of sentence structures—use a variety of sentence openings.
- Avoid wordy sentences—eliminate redundancies and avoid the unnecessary repetition of words.
- Eliminate pretentious language—simplify sentence structure and reduce clauses to phrases and phrases to single words.
- Use the active voice (unless there is a good reason to select the passive voice) in the report narrative.
- Use correct punctuation—the technically correct use of commas, colons, semicolons, quotation marks, and other marks can make any valuation report much more reader friendly.
- Use footnotes, citations, and bibliographies to explain data sources—the appropriate citation of reference sources both (a) documents the analyst’s research and due diligence and (b) augments the credibility of the analysis and the report.
- Use the appropriate level of formality in the report—the ultimate report reader will likely be a judicial or administrative finder of fact—and not a casual acquaintance.
- Avoid and eliminate sexist language in the report—use gender neutral references (e.g., “the taxpayer should do this or that . . .” instead of “he should do this or that. . .”)
- Use/imply the appropriate level of precision—a valuation conclusion should be accurate, but it is not always precise; the report should avoid implying a degree of precision that the analysis cannot support. For example, an 18.0 percent discount rate implies a precision range between 17.95 percent and 18.05 percent; while an 18 percent discount rate implies a more realistic range between 17.5 percent and 18.4 percent.
- Use a consistent rounding convention in the report—avoid rounding to different levels of precision within a particular analysis (e.g., capitalization rate calculation), avoid rounding to different levels between valuation approaches and methods, and avoid averaging

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value indications derived from different rounding convention in a final value synthesis and conclusion.

9. **Professional Standards**—The business/security valuation report should comply with all applicable professional or regulatory standards. Of course, first, the analyst should conclude what set or sets of professional standards apply in the subject valuation assignment.

Some (but relatively few) business/security valuations may be subject to the *Uniform Standards of Professional Appraisal Practice* (or USPAP), as promulgated by The Appraisal Foundation. This is because USPAP compliance is only applicable to business valuations when USPAP is required by (a) law, (b) regulation, or (c) agreement with the valuation analyst’s client (that is, when the engagement client specifically requests a USPAP-compliant appraisal).

Of course, the analyst should become informed as to whether the courts in the subject jurisdiction require USPAP compliance, as a result of either law or administrative regulation.

Some business/security valuations may be subject to the professional standards of the membership organizations that the analyst belongs to. For example, the subject analyst may be a member of the International Association of Assessing Officers, the Appraisal Institute, the Institute of Business Appraisers, American Society of Appraisers, American Institute of Certified Public Accountants, or other relevant professional organization.

Some business/security valuations are intended to comply with Internal Revenue Service (or other government agency) regulations or administrative rulings. For example, the subject business/security valuation may be intended to comply with Internal Revenue Service Revenue Rulings 59-60 and 68-609. If such compliance is intended, the valuation report should make that fact obvious to the finder of fact.

In some contrarian environment situations, the subject business/security valuation report may not be intended to comply with any promulgated professional or organizational standards. Nonetheless, the controversy-related valuation report should still be prepared in accordance with the generally recognized practices and standards of the business/security valuation profession.

10. **Litigation Standards**—When appropriate, the analyst should be careful to prepare the business/security valuation report to comply with any applicable statutory

or judicial requirements related to the subject dispute. This caution should also relate to any expert witness disclosure requirements or rules of evidence requirements.

For example, as an expert's opinion, the business/security valuation report may have to comply with the requirements of the Federal Rules of Evidence Rule 26 in the federal courts. Specific courts, such as the U.S. Tax Court or the federal Bankruptcy Court, may have specific reporting requirements for expert reports and opinions.

Of course, the valuation analyst should confer with—and take direction from—the client's legal counsel with regard to all statutory and/or judicial expert reporting requirements. While the analyst is not expected to have legal expertise, the valuation analyst should be aware that certain expert opinion disclosure and expert reporting requirements may exist with regard to the particular litigation.

In other words, the valuation analyst should be aware of the importance of (a) conferring with the client's legal counsel and (b) considering that legal counsel's instructions so that the subject valuation report will comply with all applicable reporting requirements.

## COMMON ERRORS TO AVOID IN BUSINESS VALUATION REPORTS

Within a contrarian environment, it is very common for two (or more) business/security valuation reports to be prepared by two (or more) analysts. This can occur, for example, when the plaintiff litigant (or taxpayer) and the defendant litigant (or taxing authority) disagree on the applicable valuation approaches/methods, the reasonable analytical assumptions, or the subject business value conclusion.

Differences among the parties in interest to the litigation may require the finder of fact to judicially (or administratively) determine the business value based on his or her assessment of the two (or more) different valuation reports.

Courts (and other finders of fact) may appropriately disregard a business/security valuation report that has obvious deficiencies. Before issuing the written expert report, the analyst should review the business/security valuation report for one or more of the following common errors:

### 1. Failure to follow the defined standard of value.

Generally accepted valuation terminology is used in most valuation reports. This terminology is used to inform the judicial (or other) report reader as to how the business value was concluded. The stated standard of value—or definition of value—is an important disclosure in any valuation report.

This statement of the defined standard of value is important because the subject's value can vary significantly depending on which definition of value is selected for the controversy-related valuation engagement. For example, using the standards of fair value versus fair market value versus investment value versus use value, and so on, will typically result in different value conclusions for the same business or business interest.

One of the common errors in a business/security valuation report is the analyst's failure to consistently follow the standard of value defined in the subject report. This error may cause the finder of fact to assign little or no weight to the business/security valuation report.

Therefore, the valuation analyst should (a) carefully define the selected standard of value in the expert report and (b) ensure that the defined standard of value is applied consistently throughout the expert report.

### 2. Analytical internal inconsistencies.

All of the valuation data, analyses, calculations, and conclusions should be internally consistent throughout the business/security valuation report.

Some common examples of analytical internal inconsistencies include:

- application of the selected valuation pricing multiples to the wrong economic income measure (e.g., applying an after-tax pricing multiple to a pre-tax measure of operating income);
- failure to match the selected direct capitalization rate or present value yield capitalization rate to the corresponding economic income measure (e.g., applying a net cash flow discount rate to an incremental or residual income measure based on net income);
- failure to use a consistent expected growth rate throughout the various valuation methods (e.g., using a growth rate in a direct capitalization method

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analysis that is inconsistent with the growth rate used in a discounted cash flow method analysis);

- comparison of current business enterprise operating data to comparative data for a different time period without making appropriate adjustments (e.g., for changes in market conditions or for changes in the business owner/operator’s accounting methods);
- normalization of the financial statements for the subject business enterprise without normalizing the corresponding financial data for the selected guideline publicly traded and/or acquired companies;
- use of inconsistent extraordinary assumptions or hypothetical conditions (e.g., estimating the expected future operating income assuming the existence of increased levels of tangible and intangible assets—but without allowing for the capital expenditures to build or buy those expansionary assets);
- failure to perform (or to report on the performance of) a highest and best use analysis with regard to the subject business enterprise;
- failure to coordinate the valuation variables (e.g., level of income subject to capitalization, income tax rates, expected growth rate, discount/capitalization rate, etc.) used in each valuation approach/method with the corresponding valuation variables used in the all other valuation approaches/methods;
- failure to consider the use of the asset-based approach and/or failure to consider the existence of intangible assets within the subject business enterprise; and
- failure to consider the revaluation of recorded business liabilities and/or failure to consider the existence of contingent liabilities.

*“. . . the business/security valuation report should adequately document (a) the data used, (b) the procedures performed, and (c) the value conclusions reached.”*

*“Industry or other rules of thumb are not generally accepted as a business/security valuation method.”*

**3. Arithmetic errors in the valuation analysis.**

One of the easiest valuation report errors to prevent is also one of the most common valuation report errors. All mathematical calculations within the report should be reviewed for accuracy. This review should include the report text as well as the report schedules and exhibits. In addition, all mathematical rounding conventions should be reviewed for consistency.

An obvious (and easily correctable) mathematical error may make the finder of fact question the reliability of an otherwise well-supported business/security valuation report.

**4. Insufficient support for the selected valuation variables.**

Inadequately documented valuation reports are easy targets for the opposing business/security valuation experts during the commercial, litigation, or tax controversy. Depending on the professional reporting standards applicable to the subject report, the business/security valuation report should adequately document:

- a. the data used,
- b. the procedures performed, and
- c. the value conclusions reached.

The data used in quantitative analyses should be able to be traced to the business enterprise owner/operator financial statements or to other empirical data sources.

In addition, the finder of fact/report reader should be able to trace the value indications presented in the various report schedules and exhibits to the business value conclusion presented in the report narrative.

**5. Reliance on industry or other rules of thumb.**

Industry or other rules of thumb are not generally accepted as a business/security valuation method. However, transactional rules of thumb (e.g., dollars per subscriber, per patient, per population unit)

are sometimes used to provide confirmatory evidence of a more rigorous valuation analysis.

In other words, a valuation analyst may sometimes use a rule of thumb as a “reasonableness check” on the value indications derived from the generally accepted business valuation approaches and methods. However, the value indicated by a rule of thumb should not be assigned any significant weight when the expert report actually concludes the final business/security value.

**6. Insufficient data and inadequate market research.**

Unfortunately, some business valuation analysts cut corners either (a) because of engagement fees and time budget constraints or (b) because of their lack of familiarity with publicly available merger/acquisition or other transactional data sources.

Accordingly, the effective business/security valuation report should make it clear to the finder of fact that

the valuation analyst did, in fact, consider all relevant data that may significantly affect the value conclusion.

#### 7. Inadequate due diligence procedures.

Some examples of inadequate due diligence procedures in the preparation of the business/security valuation report include:

- failure to consider all three generally accepted business valuation approaches;
- failure to review the actual tangible evidence of the subject business ownership interest existence and ownership;
- failure to review relevant shareholder agreement, buy-sell agreement, license, franchise, or other contractual documentation that may affect the subject business interest;
- failure to inquire about any recent sales and/or offers involving the subject business interest;
- failure to consider the highest and best use of the subject business interest;
- failure to consider the business owner/operator's actual use of the subject business enterprise;
- failure to consider the specific bundle of legal rights encompassed in the subject business interest analysis;
- failure to recognize that the total bundle of legal rights (i.e., the fee simple) for an ownership interest is often allocated among several parties/several time periods—such as life estate, residual estate—with corresponding effects on value, damages, royalty rates, and so on;
- failure to search for, identify, and analyze comparable or guideline merger, acquisition, divestiture transactions; and
- failure to consider the appropriate market or level of trade in which the subject business enterprise or sale would take place.

*“. . . the business/security valuation report should be clear, convincing, and cogent.”*

1. educate the finder of fact regarding both the subject business ownership interest and the appropriate business valuation approaches and methods and
2. persuade the finder of fact as to the concluded value for the subject business ownership interest.

In addition, whether prepared for commercial litigation, tax controversy, financing, transaction, accounting, management information, or other purposes, the business/security valuation report should comply with:

1. any applicable valuation professional standards and
2. any applicable expert opinion or other reporting requirements.

An effective business/security valuation report should include evidence of the report attributes summarized above. And, the valuation analyst (particularly when the analyst is serving as an expert witness in a litigation matter) should be careful to avoid the common business valuation report errors described above.

When the valuation analyst invests the time and effort to prepare a well-written and well-documented valuation report, that report should be able to:

1. withstand a contrarian (e.g., opposing valuation expert) review and challenge and
2. convince the finder of fact of the concluded business value.

This report objective is as applicable to the valuation analyst serving the plaintiff litigant/taxpayer as to the valuation analyst serving the defendant litigant/taxing authority.

In addition, when the valuation analyst invests the appropriate time and effort, the same favorable results will occur with regard to effective expert analysis reports that conclude: a fair royalty rate, a reasonable level of executive compensation, an arm's-length transfer price, an RUL estimate, a lost profits/economic damages conclusion, a transactional fairness opinion, or a transactional solvency/insolvency opinion.

## SUMMARY AND CONCLUSION

Particularly within a commercial litigation, tax appeal, or other contrarian environment, the business/security valuation report should be clear, convincing, and cogent.

The objectives of a business/security valuation report prepared within a litigation context are to:

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