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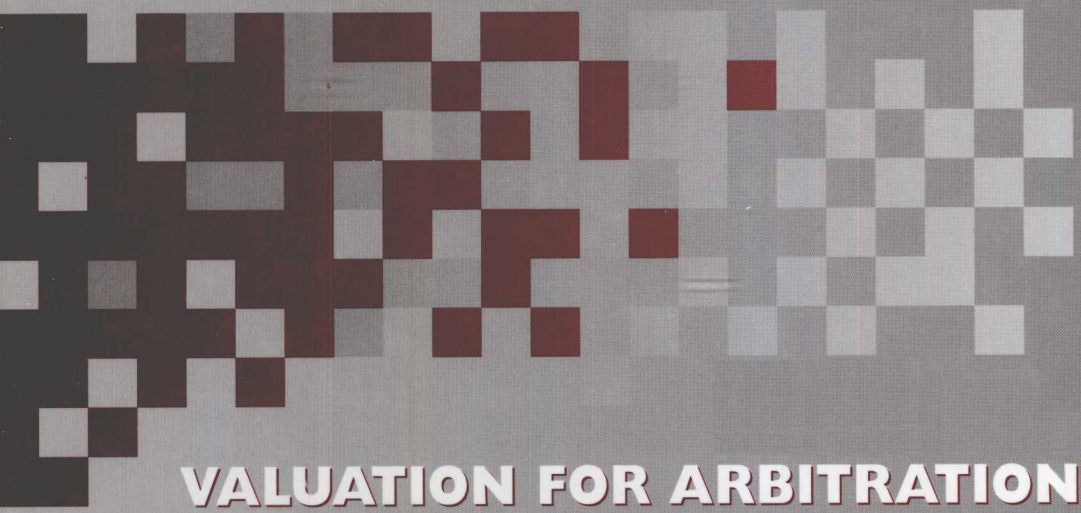

VALUATION FOR ARBITRATION

COMPENSATION STANDARDS VALUATION METHODS AND EXPERT EVIDENCE

BY MARK KANTOR

Wolters Kluwer
Law & Business

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Valuation for Arbitration: Compensation Standards, Valuation Methods and Expert Evidence

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Wolters Kluwer
Law & Business

AUSTIN BOSTON CHICAGO NEW YORK THE NETHERLANDS

Published by:
Kluwer Law International
P.O. Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.care@aspenpubl.com

Sold and distributed in all other countries by
Turpin Distribution Services Ltd.
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

ISBN 978-90-411-2735-8

International Arbitration Law Library

Series Editor Dr. Julian D.M. Lew QC

In the series *International Arbitration Law Library* this book,
Valuation for Arbitration: Compensation Standards,
Valuation Methods and Expert Evidence,
is the seventeenth title

The titles published in this series are listed at the end of this volume

Acknowledgments

A large number of individuals deserve my thanks for their considerable assistance. Their comments and criticisms have persuaded and prodded me towards a better book. Of course, flaws remain and they are mine alone.

I wish especially to thank Hew Dundas, Prof. John Gotanda, Gerry Lagerberg, Prof. Irmgard Marboe, Sophie Nappert, Michael Nolan, Sergey Ripinsky, Dianne Rudo, Thierry Senechal, Geoffrey Senogles, Richard (Rory) Walck, Prof. Thomas Walde and Prof. Louis Wells. I also to wish to thank the many participants in the Oil-Gas-Energy-Mining-Infrastructure Dispute Management (OGEMID) discussion forum for their valuable contributions.

The Georgetown University Law Center, where I teach as an Adjunct Professor, and the Columbia Program on International Investment (a joint program of Columbia Law School and The Earth Institute), where I am a Fellow, provided considerable support and assistance, and I am indeed grateful.

Portions of earlier drafts of this volume were published in the online journal *Transnational Dispute Management* (TDM, <www.transnational-dispute-management>) as Kantor, "Valuation for Arbitrators: Uses and Limits of the Adjusted Book Value Method in Energy-Related Disputes," volume 4, issue 3 (June 2007) and Kantor, "Valuation for Arbitrators: Limits and Uses of Income-Based Methods of Valuation," volume 4, issue 6 (November 2007), and in several articles as part of my "Money Column" series in *Global Arbitration Review*. My thanks to TDM and *Global Arbitration Review* for their publication consent and support.

The American Institute of Certified Public Accountants and the Chartered Institute of Arbitrators each graciously granted permission for republication of their works as appendices to this volume.

Ms. Terri O'Connell deserves special thanks for deciphering my scribbles and her unfailingly cheerful typing and administrative support.

This book is dedicated to my wife, Lawranne Stewart. She is a joy, even if she laughs at my temerity in writing on a topic that involves competence with at least basic arithmetic.

Mark Kantor

May 2008

About the Author

Until he retired at the end of 1999, Mark Kantor was a partner in the Corporate and Project Finance Groups of Milbank, Tweed, Hadley & McCloy and resident in the Washington, D.C. office. He currently serves as an arbitrator and mediator and teaches both International Business Transactions and International Arbitration as an adjunct professor at the Georgetown University Law Center. He is also a Fellow at the Columbia Program on International Investment (a joint undertaking of Columbia Law School and The Earth Institute at Columbia University). Mr. Kantor is listed in *inter alia International Who's Who of Commercial Arbitration; Guide to the World's Leading Experts in Commercial Arbitration; Chambers USA, International Arbitrators;* and *Best Lawyers in America (International Arbitration).* He is the co-chair of the DC Bar International Dispute Resolution Committee and a member of the ADR Advisory Committee for the International Law Institute. He is a member of the editorial board of *Global Arbitration Review*, the editorial board of investmentclaims.com, the board of editors of *The Banking Law Journal* and the editorial board of the *Journal of World Energy Law and Business*. Mr. Kantor is also a contributing editor of *International Legal Materials* and an associate editor of both the online Oil, Gas & Energy Law Intelligence Service and the online journal *Transnational Dispute Management*. In 1990, Mr. Kantor served as the first outside general counsel of the RTC Oversight Board, the US Federal agency with policy oversight responsibility for the savings-and-loan crisis. Further details about Mr. Kantor's background and experience can be found on the web at <http://clik.to/kantor>. Mr. Kantor can be reached at mkantor@mark-kantor.com.

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Chapter 1
Valuation for Arbitration: An Introduction

How often does it happen? The issue before an arbitrator is how to value the injury to an interest in a business. Both sides have engaged experienced valuation specialists as party-appointed expert witnesses. The witnesses testify persuasively to a very large valuation (in the case of claimant's expert) or a very small valuation (in the case of respondent's expert). And each expert witness also does an excellent job highlighting the weaknesses of the evidence from the opposing expert witness. The tribunal is left with widely different valuations of damaged credibility – where is the help to find a better valuation amidst the litigation carnage?[1] As a wise litigator once said, "One expert plus one expert equals no expert."[2]

The purpose of this volume is to provide some practical help to those arbitrators. One distinguished jurist recently stated:[3]

> But I cannot shirk my duty to arrive at my own independent determination of value, regardless of whether the competing experts have provided widely divergent estimates of value, while supposedly using the same well-established principles of corporate finance. Such a judicial exercise, particularly insofar as it requires the valuation of a small, private company whose shares do not trade in a liquid and deep securities market, using a record shaped by adversaries

1. "All too often in appraisal actions, the Court is presented with two competing experts espousing 'wildly divergent' interpretations of the circumstances confronting the corporation. This case is no exception." *Lane v. Cancer Treatment Centers of America, Inc.*, 2004 Del. Ch. LEXIS 108, *33 (Del. Ch. 2004) (footnote omitted).
2. Quoted by David Brynmor Thomas, Esq., conversation in Prague, The Czech Republic, September 27, 2005.
3. Vice Chancellor Strine of the Delaware Court of Chancery, in *Delaware Open MRI Radiology Associates, Inc. v. Kessler*, 898 A.2d 290, 310 (Del. Ch. 2006).

> whose objectives have little to do with reaching a reliable valuation, has at best the virtues of a good faith attempt at estimation. That is what I endeavor here.

We address the following discussion particularly to the many arbitrators with sound commercial knowledge but little hands-on experience with valuation studies or EXCEL spreadsheets. We offer a number of practical suggestions to assist arbitrators in this process, but candidly they are almost all variations on three central recommendations:

- Arbitrators should engage in advance planning to assure that the expert valuation evidence helps the arbitrators reach a principled decision.
- Arbitrators should consider whether an "apples-to-oranges" mis-comparison exists. If appropriate, the arbitrator can request that the parties re-present the evidence on an "apples-to-apples" basis.
- Arbitrators should focus closely on true comparability between the business at issue in the dispute and other examples offered in the expert evidence.

From an arbitrator's perspective, a valuation decision is both a question of law and a question of fact. The law – because the arbitrator must settle upon the legal standard applicable to the valuation (full compensation, adequate compensation, reparations, restitution, actual loss, fair market value, fair value, reasonably equivalent value, lost profits, *damnum emergens, lucrum cessans,* and etc.). The facts – because each valuation will depend on the specific circumstances of the business being valued.[4] The US Internal Revenue Service offers the following practical advice:

> A determination of fair market value, being a question of fact, will depend on the circumstances in each case.... Often an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.[5]

Arbitrators would do well to adopt a similar practical approach to valuation questions.

Our objective is not to argue for, or against, any particular standard of compensation or valuation methodology. Instead, the objective is to provide practical assistance to tribunals presented with complex business valuations in the quantum phase of a hearing. We will review a variety of tools that arbitrators may employ to reach their final compensation assessment on a more principled basis, rather than

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4. "Indeed, many of the arbitral awards seem to be influenced as much by the (lack of) quality of the evidence [as] by the tribunal seeking to apply valuation principles in their theoretically pure form." Comment by Gerry Lagerberg to the author, January 2008.
5. IRS Rev. Rul. 59-60, § 3.01 (1959).

splitting-the-baby or Kentucky windage. As will become apparent, a thoughtful and proactive arbitrator can help him or herself to a considerable extent. If arbitrators and valuation professionals cooperate in the utilization of valuation methods, the arbitration community will move closer towards a common language and consistent principles – a Valuation Mercatoria.

The circumstances we discuss here arise principally in the situation where each party has engaged its own valuation expert, but are applicable as well where the tribunal engages its own expert. Legal systems have historically differed in their approach towards the use of experts in litigation proceedings. The use of party-appointed experts is the norm for many common law jurisdictions, while civil law jurisdictions often rely upon a court-appointed expert.

> There is a key difference between the two traditions in the matter of how the opinion of experts should be made available to the tribunal. The American approach is to treat expert testimony as simply another aspect of the adversarial system: each side is expected to find its own expert on a subject about which the tribunal is likely to need technical information or explanations. When, as tends to happen, those experts disagree, the tribunal is left to decide for itself which information or explanation to believe.
>
> The Continental approach is for the tribunal to appoint its own expert, who will conduct his or her own inquiry into the subject in controversy. That inquiry may be fairly elaborate, and will often include hearing from the parties or from experts put forward by the parties. The tribunal's expert then reports to the tribunal. While parties may be given an opportunity to challenge the findings of the tribunal's expert, the expert's report to the tribunal often becomes the finding of the tribunal on the subject entrusted to the expert.[6]

Practice in international arbitration regularly follows a middle path between these two approaches. Arbitrators in complex valuation disputes will commonly see party-appointed experts, while themselves often employing a tribunal-appointed expert.[7] Much of the following discussion is particularly relevant to evidence from party-appointed experts.

Throughout this book, we rely to a great extent on pronouncements of several internationally respected institutions. National valuation organizations from over fifty participating countries have established the International Valuation Standards Committee (IVSC) to publish Valuation Standards for use in financial statements and to promote their worldwide observance.[8] While best known for its real estate valuation work, the IVSC has developed guidelines and standards covering

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6. Elsing & Townsend, "Bridging the Common Law – Civil Law Divide in Arbitration," 18 Arb. Int. 59, 63–64 (2002).
7. *See* e.g., *CMS Transmission Company v. The Argentina Republic*, ICSID Case No. ARB/01/08, Award ¶ 418 et seq. (May 12, 2005) (hereinafter, "*CMS v. Argentina*") and *LG&E Energy Corp., et al. v. Argentine Republic*, ICSID Case No. ARB/02/01, Award, July 25, 2007, at ¶ 6 (hereinafter, "*LG&E v. Argentina Final Award*").
8. *See* generally <www.ivsc.org>. Illustratively, as of November 2007 some of the member organizations of the IVSC included the *Instituto Argentino de Tasaciones*, the *Instituto Brasiliero*

all aspects of valuation, including Concepts Fundamental to Generally Accepted Valuation Principles (GAVP). The latest public iteration of valuation standards issued by the IVSC dates from 2007 (IVS 2007). The IVSC has issued as well a series of Standards and Guidance Notes, including International Valuation Standard (IVS) 1 on the Market Value Basis of Valuation and IVS 2 on Valuation Bases Other than Market Value, Guidance Notes on Valuation of Intangible Assets (GN 4), Business Valuation (GN 6), Discounted Cash Flow (DCF) Analysis for Market and Non-Market Based Valuations (GN 9) and Valuation of Properties in Extractive Industries (GN 14). The IVSC has issued as well a White Paper on Valuation in Emerging Markets.

In addition to the IVSC's valuation standards and guidance, valuation procedures adopted by the *Fédération des Experts Comptables Européens* (the representative organization for the European accountancy profession), the American Society of Appraisers (ASA) and the American Institute of Certified Public Accountants (AICPA) are especially influential.

We also employ international investment arbitration cases to illustrate valuation issues in this volume. Of course, international investment arbitral awards regularly address matters such as compensation for expropriation and breaches of international law. They are, accordingly, a fruitful source for examples. Similarly, the decisions of the United Nations Compensation Commission (UNCC) are of considerable assistance in understanding compensation for business interruption claims. The public international investment law environment, where States are invariably the respondents, is clearly subject to different pressures than national courts.[9] Legal standards may therefore develop in different directions than purely commercial disputes. However, a clearer understanding of the nuts-and-bolts of valuation methods may reduce those differences that at bottom are based on a lack of exposure to valuation procedures rather than based on legal principles.

Commercial arbitration cases also address these issues, for instance in disputes involving joint venture investors. However, most commercial arbitration awards are not publicly released. Moreover, the award summaries that are occasionally made

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Avaliacoes, the Appraisal Institute of Canada, the China Appraisal Society, the *Verband Deutscher Pfandbriefbanken* and the *Bundesverband der Immobilien-Investment-Sachverständigen* e.V. (BIIS) (Germany), The Practising Valuers Association of India, the *Consiglio Nazionale Geometri* (Italy), the Korea Appraisal Board, the Japanese Association of Real Estate Appraisal, the National Association of Mexican Valuation Institutes, the Russian Society of Appraisers and the Russian Board of Appraisers, the South African Institute of Valuers, the Tanzania Institution of Valuers and Estate Agents, the Appraisers' Association (Turkey), The Royal Institution of Chartered Surveyors (UK), The Appraisal Institute and the American Society of Appraisers (US) and the *Sociedad de Ingenieria de Tasaciones de Venezuela*. A list of all member organizations through November 2007 can be found at Appendix 1 to this book and a current list is found on the web at <www.ivsc.org/members.html>.

9. *See*, for example, the significantly stricter test of "certainty," the use of "equitable considerations" to limit compensation awards and the apparent desire to give the benefit of the doubt to State parties rather than injured parties that has developed in investment treaty arbitrations, as discussed below in Ch. II.C, II.H and II.K.

public only rarely offer details about valuation methods. However, the valuation principles reviewed here are equally important in commercial arbitration.

Additionally, we offer cases from various US forums to illustrate valuation issues. The US judicial system, of course, has no monopoly on these issues. However, the output from US courts about valuation questions has been prolific, and the opinions of those jurists are an extremely valuable resource. For example, the Delaware Court of Chancery has developed substantial expertise in valuation matters involving dissenting shareholder appraisal cases and other shareholder valuation disputes.[10] US tax forums similarly have a long record of considering valuation issues. Working inside one of the most complex tax systems in the world, the US tax authorities have built up a body of valuation precedents out of tax disputes in such varied areas as M&A transactions, spin-offs, recapitalizations and restructurings, decedents' estate tax disputes, and valuation of executive stock options.[11] US bankruptcy courts, too, have necessarily acquired significant valuation expertise. Bankruptcy courts will, for example, regularly examine complex valuation evidence to decide if a plan of reorganization properly values the insolvent enterprise for purposes of settling creditor and shareholder claims and interests. Bankruptcy courts also assess the debtor's value to decide if a transfer of assets was made at a time when the debtor company was "insolvent" and the assets thus subject to recovery.[12]

Whether looking at international investment awards, shareholder disputes, tax controversies or bankruptcy disputes, it is important to recall that the underlying

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10. The Delaware General Corporation Law provides that, if the controlling shares in a public company vote in favor of a merger with another company, then the remaining shareholders are also required to tender their shares to the successful acquirer. Although forced by operation of law to tender their shares, the dissenters may accept for their shares the share price offered generally by the acquirer or, in some circumstances, they instead may initiate a "fair value" appraisal proceeding under the Delaware General Corporations Law § 262 in the Chancery Court in an effort to obtain a higher price. With so many corporations established under Delaware law, it should come as no surprise that Delaware's courts have produced a large body of valuation precedents in dissenting shareholder appraisal cases. A word of caution to arbitrators relying on these cases in ordinary commercial and investment disputes; the valuation principles in the "fair value" dissenting shareholder cases are occasionally idiosyncratic. For example, as discussed in Ch. 8 below, in many US states minority discounts for lack of control and discounts for lack of marketability may not be applied in those proceedings – the situation differs from state to state. Also, Delaware law does not assign the burden of proof to either the petitioner or respondent in such proceedings. Instead, the court must reach an independent valuation of the enterprise.
11. Here too, a word of caution may be appropriate. Corporate tax advisors often mutter darkly that the US Tax Court has a pro-government, high valuation bias. The US Internal Revenue Service disputes that characterization.
12. Valuation principles employed in confirming reorganization plans, though, seek to free the reorganized debtor from the "heavy hand of the past." Moreover, the concept of "reasonably equivalent value" under the preferential transfer rules of the US Bankruptcy Code is not legally identical to "fair market value." *See In re Commercial Financial Services, Inc., v. Chase Manhattan Bank U.S.A.*, N.A. et al., 350 B.R. 559, 576 (Bankr. N.D. Okla. 2006) and cases cited therein.

purposes of particular bodies of law may differ markedly. Valuation "gathers its meaning in a particular situation from the purpose for which the valuation is being made."[13] For that reason, valuation principles developed in one field of legal endeavor should not be adopted into another field without first considering how they fit into that second field.

13. 7 Collier on Bankruptcy, *supra* n. 13, at § 1129.06[2].