



What's Wrong With Most Forensic Valuations?

By Jerry Reiss

Fairness in disclosure is the key behind generally accepted accounting principles. When these principles are not observed disaster results and company stock can be greatly overpriced and real people can get hurt. ENRON should have provided proof of just how bad things get when other opinions are substituted for generally accepted accounting principles.¹ The same thing occurs when other opinions substitute for generally accepted actuarial principles. Congress understood this driving principle when it created the Joint Board for the Enrollment of Actuaries and it created standards whereby actuaries would demonstrate proficiency by passing several examinations. I thought that this discussion ended in 1997 when Michael Walsh and I wrote an article for the Florida Bar Journal entitled Cross-Examining the Pension Expert published in June of 1998. That article addressed a number of different certifications that were used by Personnel Departments of major corporations in assessing the knowledge of candidates interested in becoming benefits managers as well as people interested in obtaining employment from insurance companies and Third Party Administration firms (TPA'S). Corporations retain TPA'S to design and manage their compensation programs. They make certain that these plans and packages comply with rules set forth in ERISA and are properly funded when necessary. Yet the high standards set by the industry are completely ignored with forensic work.

This article will address the basics behind property valuation because there is one heck of a lot of misinformation circulating in forensic work. Basic procedures are not followed when pensions are valued, the need and ability to pay alimony is measured,² and damages are determined in litigation for wrongful termination of employment³ or when the court requires information about a loss for

a personal injury. In short very few valuations are correct when it comes to forensic applications. This is true in nearly every area of law. It is not as if there isn't a viable pool of real experts to retain. But it is all about money and how much money will be spent hiring "experts". Thus when decisions are made about what money a client has to spend and it only permits retaining less-than-qualified experts that shifts greater responsibility to the attorneys trying the case to make up the difference. Real people get hurt because most attorneys do not do their job properly challenging credentials in voir dire or properly cross-examining expert findings.

Purpose of a Valuation

The purpose for the valuation must be clearly established before undertaking it. Different purposes lead to different valuation results and this is true for the exact same underlying data. When the purpose is clearly established before doing the valuation, the results are understood to apply to the limited purpose for which the calculation is sought. When it is not the conclusions are absolutely meaningless and they are misconstrued by lay people.

Legal Parameters Govern

No valuation provides correct or meaningful results unless the person doing the valuation understands all of the legal parameters that apply. This requires understanding the law and how it applies to the particular facts. Then different legal parameters apply for different valuation purposes just as different valuation purposes begin with different premises. Too few people who offer testimony understand these basics and thus violate something so fundamental to valuation integrity. Attorneys are partly to blame for this because some believe that only they can interpret the law,

not the experts they retain. Courts too are to blame when they rule that such procedures invade the court's sole discretion. This error was clearly set to rest in 1990 by our supreme court ruling that interpreting the law and applying it to a specific area of expertise is not an unauthorized practice of law but counseling clients about the law is.⁴ This Florida Supreme Court Advisory Opinion is based on a US Supreme Court ruling.⁵ It is a pity that too few judges are familiar with the ruling. No valuation should be undertaken without a discussion of the laws that apply, how they should apply and how they affect the valuation result. Such information should be provided to the court as testimony support. The Court then decides whether the legal parameters used are correct and whether to accept or reject the valuation findings.

Part of the licensing requirements for actuaries tests an understanding of ERISA and how it applies to the valuation process. Congress understood just how important an understanding of the law is for meaningful valuation results. Fifty percent of the enrollment examinations test understanding the law that applies and proper application of the legal requirements to various sets of facts. Similarly, accountants demonstrate in their certification examinations an understanding of the state legal requirements applicable to accounting procedures and principles in deciding who is certified as a public accountant and who is not. Yet CPA's are queried in accounting. They are not tested in valuation principles. Most experts lack credentials for the services they offer in forensic work. Is there little wonder why they fail to properly value anything in issue or understand why and how the legal parameters drive the valuation results? Undisciplined, the results vary without boundaries and clients are hurt in the process.



Valuation Methodology

No valuation is meaningful without a summary of the methodology used. It should be stated in the report and carefully explained. Any assumptions used should be justified by the purpose for the valuation and by any legal requirements that may apply. Assumptions have not been supported when the report claims that this is what other experts use or when caveats appear in the valuation report that its use results in unbiased conclusions because the government uses the same assumptions. The government has its own set of purposes in measuring valuation results and its assumptions vary widely by whether it wishes to protect policyholders of an insurance company in meeting its claims or whether its purpose is to limit tax deductions or measure garnishment exposure. There are so many governmental agencies with so many different oversight responsibilities within each agency that it is ludicrous to suggest that an assumption used is legitimate solely because the government uses it in

certain circumstances. If the government uses the assumption the report should state the full context over which the bureaucracy uses it and the purpose it serves when it is used by that agency. If none of that is known the valuator has no basis to use the assumption and has not supported its use.

Valuation Results

Valuation results do not exist in a vacuum. They trace back to the purpose established before commencing the valuation. This is so fundamental. Yet forensic experts seldom demonstrate an understanding of this. That is why there is so much criticism about how many results vary by so many who perform valuations. The valuation results should be explained. It should be understood what the results represent and what they do not.

Applying the Basics Above to Pension Valuation

The principle term used in a pen-

sion valuation result is a "present value." The "present value" is a widely used term in all areas of forensic work. This is why we will explore its meaning. But as its meaning does not exist in a vacuum we must apply it to a specific area of law. For that reason I choose to explain present values in the context of dividing accrued benefits under F.S. 61.075(5)(a)(4). Most forensic experts are not really experts and this is why they do not understand what is meant by a "present value." The confusion with the term begins with non-experts using misnomers to describe a "present value," such as "cash value." But before beginning any inquiry on the topic we state the purpose of its value and to begin this process we limit the focus of the inquiry to pensions because the purpose for a present value of a pension benefit is different from a present value of a different property.

When a present value is sought in the context of a value for an accrued benefit under F.S. 61.075(5)(a)(4), what is really sought is a market value of the accrued benefit in ques-

continued, next page

**Moore,
Ellrich &
Neal, P.A.**

CERTIFIED

PUBLIC

ACCOUNTANTS

Accounting and Auditing
Income Tax Planning, Consulting and Preparation
Business Valuation
Forensic Accounting and Litigation Support
Fraud Deterrence

W. David Ellrich, Jr.
Becky B. Moore
Karyl H. Neal
Rick Hoagland
Matthew S. Stohlman
Matthew C. Smith



4400 PGA Boulevard, Suite 400
Palm Beach Gardens, FL 33410

Phone: (561) 624-0355

www.mencpa.com

**Forensic Valuations***from preceding page*

tion. It is so important to begin by defining the purpose this precisely because the legal parameters that apply to an accrued benefit make finding a market value impossible because all benefit plans contain a non-assignment clause, which prevents selling the benefit in the open marketplace.⁶ But understanding the law that applies is essential because it also allows that understanding to assist counsel in making proper arguments to the court for dividing the perk as property. This non-assignment provision dates back to the earliest days of collective bargaining, because its purpose was to protect pension benefits for participants when they could no longer work and it specifically exempted earned benefits from attachment by creditors.⁷ Thus understanding the law that applies does more than provide correct valuation results, it helps assist counsel in explaining why rulings like *Bd. of Pension Trustees v. Vizcaino*, 635 So.2d 1012 (Fla. 1st DCA, 1994) run countermand to the very principle established by the City of Jacksonville in adopting the non-assignment clause in the first place. There was no higher purpose to protect the participant from creditors in its adoption than to protect family beneficiaries to the benefit.⁸ In fact, when the equitable distribution statute changed in 1988 making pension property divisible it elevated the stature of the other spouse from a beneficiary under the city plan to a co-owner of the pension property, thereby making the non-assignment clause work to equally protect both spouses. When the court ruled the way it did in *Vizcaino* it may have set up a claim that F.S. 61.075(5)(a)(4) is interpreted to violate the Fourteenth Amendment of The US Constitution under "Equal Protection Under the Law" by affording pension participants greater protection under F.S. 61.075 than their spouses.⁹ These are pension participants under state law. There is no corresponding issue under federal law because ERISA changed in 1984 by adding REA "Retirement Equity Act", which allows assignment for

spouses under 29 USC 1056(d)(3).

Terms like "cash value" also are very harmful when used to describe market value because it has a very specific meaning different from present value or market value and it implies that the benefit could be exchanged for a specified amount of cash in a contract. This is possible only when the retirement plan allows cash benefits be paid and often when they do the participant receives a refund of employee contributions, not any underlying value supporting the benefit. Failure of experts who offer valuation testimony to fully comprehend what a present value represents often leads to these witnesses valuing benefits with ERISA requirements that only apply when lump-sum benefit may be paid from plans when in fact they do not contain such provisions that allow such benefits be paid. Even when they do the value of the perk may be far greater than the value of the lump-sum benefit available, particularly those paid by state and municipal plans.¹⁰ Thus as the present value is all that can be offered in testimony in order to comply with the legal requirement that all significant properties be valued,¹¹ it is vital that it be understood what a present value represents and what it does not.

The inquiry for whether present value adequately represents market value for the above stated purpose begins with a definition. We define a Present Value as the value today of a future stream of payments. This is very basic and very simple. If it is kept this simple the understanding will not be lost on us as valuation becomes more complex. Keeping basics simple a present value for a stream of payments is the sum of each such payment discounted to its present day value. How long the stream lasts is not known and could never be known. This is science not witchcraft. Hence a life expectancy serves no role in the inquiry.

The inquiry shifts to what is the present value of a particular payment? The discount discussed above has two components: 1) a discount for the time value of money; and 2) a discount representing that its receipt is only as certain as the person lives to receive the payment. The first discount is universally understood so

we will concentrate on the meaning of the second. If it can be shown that only 99% of those alive at that age will live to receive the payment in question the discount related to mortality is 1% or the present value may be measured as the product of the probability of survival to receive the payment multiplied by the payment. But that product must also be discounted for the time value of money. Thus the present value of each future payment is the payment amount, multiplied by a discount for the time value of money, and further discounting it by multiplying the product by the probability of living to that age to receive the payment. Each possible payment is considered even one made at age 109, except the probability is so small and the discount for the time value of money so great that the present value of the payment at that age is likely less than a penny. The present value for the stream of payments is then the sum of present values for each possible future payment. As virtually no one lives past age 110 the calculation ends with survival to age 110. We have demonstrated that a life expectancy has nothing to do with present value by keeping the analysis so simple and basic.

Thus the valuation process moves from defining present value to calculating the probability of survival to a given age because this probability is at the heart of everything whether the valuation is done correctly as described above or done incorrectly using life expectancies. This is because a Life Expectancy is, by definition, the sum of the probability of survival of each possible future age, i.e., surviving one year, two years, three years and so on and so forth, until the mortality table ends. Understanding how to calculate the probability of survival requires understanding core actuarial concepts of demography and mortality table construction.

The probability of survival should be calculated from the population receiving pension benefits not the entire census table reflecting everyone currently alive, because everyone alive does not receive pension benefits. The purpose of a life expectancy is to enable us to compare one census table to another and this allows us to understand whether medical discov-



eries are allowing us, as a people, to live longer. It also provides an objective standard for measuring how well our health care system compares with other health care systems of other countries, in which United States ranks 37th by the World Health Organization. Accordingly, it should be little surprise that a life expectancy result for a pension population offers no useful information; hence it is not made available and requires user knowledge to calculate it. Do you really think that the expert using a life expectancy to value pensions does a manual calculation for a life expectancy, which is every bit as tedious and complicated as doing the present value correctly? Or is it infinitely more likely that the result used is from a general census table with the results already calculated and shown in the table. The life expectancy associated with the census table is vastly different from the life expectancy of pension participants, which is a secondary criteria making the results unreliable.

Meaning of Present Value in Family Law

The report before you contains a conclusion on the present value of marital benefit. The report must explain what this present value means and how it relates to the market value. Referring back to the definition, it must not be lost on the person testifying that the present value is just the best estimate of the value but it can be very inaccurate when it is asked to substitute for market value because true value could never be known until the participant dies. While the present value is the closest value to market value that is possible, in some circumstances it could be very inaccurate. Insurance companies and TPA firms use present values to describe collective liability and when it is used in this fashion it often very accurately reflects the value of future benefits on the whole group. But when used in the context of one individual it can be very inaccurate. The likelihood of its inaccuracy increases as the participant's starting age for receipt increases and as actual health of the individual deteriorates from the average of the group. Thus present

values for persons in their 70s and higher should be questioned because there is a much greater chance that the person will die at the older ages making it less likely that future payments will be received. Put another way, the statistical standard deviation increases substantially at the older ages making the chance of dying much less statistically certain. Perhaps benefits should be divided solely with a QDRO at the older ages because the value could be too different from actual value. It should also be questioned when a person is in very poor health for substantially the same reason. Yet no general advice could be given on either point because such advice strictly depends on all of the facts of the case.

Benefits that come from government-sponsored plans are different from benefits that come from private plans because, even though the value may be inaccurate on account of health or age, a QDRO divides interest for both husband and wife simultaneously in government plans, and when no survivor rights are possible it renders inaccuracy moot if divided with a QDRO. But this is only true when the participant spouse is expected on average to live less long than the beneficiary spouse. When the reverse is applicable a QDRO

can create a sizeable terminable interest,¹² making division solely by QDRO impossible. QDRO division is also a problematic method of division when the other spouse receives extra benefit through some form of survivor portion that is either part of the plan design or is locked in as a result that an irrevocable election was previously made.¹³ Either creates the exact opposite phenomenon making division by QDRO without adjustments provide too much benefit for the beneficiary spouse. This is why it is vital to separately calculate the present value of the contracted survivor benefit and what portion of that contracted benefit is marital property and what portion is non-marital.¹⁴ Receipt of the marital portion always requires a 50% adjustment (and is seldom done) because both share marital property not one individual. Receipt of the non-marital portion requires a full adjustment of the value of that portion of benefit (which is rarely done).

Some experts try to deal with terminable benefit issues by structuring division by QDRO by giving the leftover portion to the estate. This is a dishonest way for dealing with this problem because it requires keeping the estate open for years and maybe

continued, next page

The Commentator is prepared and published by the Family Law Section of The Florida Bar.

Scott Rubin, Miami
Chair, 2008 - 2009

Peter L. Gladstone, Ft. Lauderdale
Chair-elect

General Magistrate Diane Kirigin, Delray Beach
Treasurer

Patricia Alexander, Boca Raton
Editor

Allyson Hughes, New Port Richey,
Immediate Past Chair

Summer Hall, Tallahassee
Administrator

Lynn M. Brady, Tallahassee
Design & Layout

Statements of opinion or comments appearing herein are those of the authors and contributors and not of The Florida Bar or the Family Law Section.

**Forensic Valuations***from preceding page*

a decade or more and this will never happen in practice. Plan sponsors will refuse to do this citing that doing it constitutes an administrative burden. Estates cannot remain open indefinitely either. It will cost far more to do this than will be gained by receiving the residual perk because administrators and attorneys of estates are paid for their services. If a terminable benefit issue cannot be corrected by a new classification of recipient that we shall call a contingent alternate payee, it can only be corrected as additional property considerations outside a QDRO. But one should never try to create a payment for circumstances when underpayment is less likely than overpayment because the latter contingency is provided for in the definition of a present value.

A terminable interest is often created when the beneficiary spouse is in poor health. This can be disposed of by requiring that the participant furnish the beneficiary spouse with offsetting assets. But when too much payment is afforded by QDRO where the health of the participant is an issue, the only way to correct this problem is to provide present values tied to the health of the participant. This requires medical testimony and special calculations of present value incorporating that anticipated testimony. This will require special corrections of a mortality table or changing existing table to reflect much higher mortality, like a multiple of three or four times what's reflected in the normal table.

Conclusion

Valuations that do not follow the

recommendations of this article do not comply with what is generally accepted by industry standards and should either be rejected or given little weight. A valuation is often needed even when it is anticipated that the property will be divided directly because a proper valuation will disclose purpose and the relationship that purpose bears to result. This will expose all difficulties inherent in direct division and it is true of all properties, not just pension properties.

Endnotes:

1 Arthur Andersen showed anticipated profit that had not yet been earned instead of actual profit, which was not realized. This allowed dividends to be paid to shareholders thereby elevating the price of its stock. Other schemes were used to also inflate the value of ENRON stock. This stock was used to buy other corporate entities with real cash flow, which was similarly stripped. Unprecedented growth was shown on its books for over a decade and was only called into question following the stock market crash of 2000.

2 *Geoghegan v. Geoghegan*, 969 So.2d 482 (Fla. 5th DCA, 2007)

3 *Duke v. Uniroyal*, 925 F.2d 1413 (4th Cir. 1991); *Carter v. Sedgwick County*, 929 F.2d 1501 (10th Cir. 1991); and *Williams v. Pharmacia*, 137 F.3d 934 (7th Cir. 1998)

4 *The Florida Bar re: Advisory Opinion - Non-lawyer Preparation of Pension Plans*, 571 So.2d 430 (Fla. 1990).

5 *Sperry v. Florida ex rel. Florida Bar*, 373 US 379; 83 S.Ct. 1322; 10 L. Ed. 2d 428 (1963).

6 Some will argue that pensions should be valued with IRC 417(e) rates, which represent an average of what insurance companies charge their clients for annuity products. They maintain this is the market value for the accrued benefit. These annuities sold by insurance carriers vary in price as short-term interest rates vary with market conditions. If pensions could be sold in the open marketplace this would make sense because an annuity that already made many payments could increase in value even when fewer future payments are left because they could still compete with insurance products replacing future payments for less money than insurance companies currently charge. This then would be similar to an old house increasing in value over the purchase price paid for it when new because the price

of the older house competes with the current prices of new homes in the open marketplace and the person could receive the higher value simply by selling it. But pension and annuity products replacing pension benefits have non-assignment clauses preventing their sale in the open marketplace and applying an open market concept to a product that cannot be sold in the marketplace leads to absurd results.

7 Naturally creditors include attorneys who represent their clients. Despite this obvious conclusion attorneys continue to try and get paid with a QDRO or QDRO-like assignment.

8 See Presidential Fact Finding Commission reporting on the Steel Industry Labor Dispute, September 10, 1949, p. 55; *Inland Steel Company v. National Labor Relations Board*, 170 F.2d 247 (1949); *Also See the Non-Diversion Rule in the Revenue Act of 1938*; H.R. Rep. No. 5331, 93rd Cong, 2nd Sess, 1974, II-Background 1973 W.L. 12599 (Leg. His.), 1974 U.S. Code Cong. & Adm. News 4639, 4640-4641, S.Rep. No. 93-127 1974 U.S. Code Cong. & Adm. News 4838, 4839-4840

9 Whether it does or does not will probably center on whether participants and non-participant spouses fit within intended classifications of individuals receiving different treatment under the law within the context of what the framers had in mind. Even if it does not it still violates the spirit of equal protection.

10 This is because state and municipal plans lack minimum value guarantees afforded ERISA plans.

11 F.S. 61.075(3). The appellate court will routinely reverse a trial court ruling that did not incorporate a finding for a retirement plan value under F.S. 61.075(3) (See *Haydu v. Haydu*, 591 So.2d 655 (Fla. 1st DCA 1991); *Barnes v. Barnes*, 592 So.2d 1260 (Fla. 5th DCA 1992); *Levitt v. Levitt*, 592 So. 2d 253 (Fla. 2nd DCA 1991); *Hatcher v. Hatcher*, 533 So. 2d 917 (Fla.2nd DCA 1988); *Moon v. Moon*, 594 So.2d 819 (Fla. 1st DCA 1992); *Criswell v. Criswell*, 589 So.2d 427 (Fla. 1st DCA 1991); *Mullen v. Mullen*, 825 So.2d 1078 (Fla.4th DCA 2002).

12 As defined in both *Waite v. Waite*, 6 Cal. 3d 461, 473 (Cal. 1972) and *Benson v. City of Los Angeles*, 60 Cal. 2d 355, 360-361 (Cal. 1963).

13 *Diaz v. Diaz*, 970 So.2d 429 (Fla. 4th DCA, 2007)

14 *Richardson v. Richardson*, 900 So.2d 656 (Fla. 2nd DCA, 2005)

Visit the section web site:
www.familylawfla.org