



# Financial Expert

Perspectives on Litigation Services

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# Fraud at the top

## Executive schemes can destroy a company

The Association of Certified Fraud Examiners (ACFE) recently reported that U.S. organizations lose an estimated 7% of annual revenues to employee fraud. That comes to a staggering \$994 billion for 2008. Along with accounting department staff, executives often commit fraud — at a median loss of \$853,000 per scheme. So spotting the signs of executive fraud can literally save a company.

### Abuse of power

In the ACFE study, more than half of the fraud cases involved perpetrators over age 40, and more than one-third were perpetrated by employees age 41-50. Generally, these employees hold higher-level positions with more access to, and authority over, company resources. They're also more likely to be able to override internal controls.

Greater authority and access explains why the median loss in the ACFE study rose with the age of the perpetrator. Schemes carried out by employees in their 50s resulted in

a median loss of \$500,000 — twice as high as any younger age bracket.

Similarly, ACFE found that longer-term employees generally commit much larger frauds, and employees with the highest annual salaries caused the larger median losses. Schemes by employees earning more than \$500,000 per year were associated with a median loss of \$50 million.

*Warning signs include significant downsizing in a healthy economic environment and a high turnover rate for employees leaving voluntarily.*

What's more, executive fraud schemes continue for longer periods before detection. Where the primary perpetrator was a manager, owner or executive, schemes in the ACFE study ran a median duration of two years — twice as long as those involving lower-level employees.

### Watch the signs

So what's a company to do when it suspects executive fraud? Some businesses conduct extensive background checks to sniff out likely perpetrators. The effectiveness of background checks, however, is limited because most fraudsters are first-time offenders.

In 87% of the cases ACFE examined, the perpetrator had never been charged with or convicted of a fraud-related offense before discovery. And 83% had never previously been punished or terminated by an employer for fraud or abuse.

Fortunately, executive fraud raises a few red flags. Perpetrators, for example, often are reluctant to cooperate with internal investigations and outside auditors and may show disrespect for regulators. They may offer unreasonable responses to reasonable questions or become agitated or annoyed when probed about financial discrepancies. Further, these individuals may appear delusional about their own self-importance and surround themselves with employees unlikely to challenge their authority.



## Fraud for the sake of the company

Executive fraudsters sometimes commit fraud for what they believe is the benefit of the company, rather than themselves. Financial difficulties, for example, may make an executive do “whatever it takes” to improve declining profits and loss of market share. Other factors that may cause an executive to act illegally are:

- Tight credit markets or other credit difficulties,
- Increasing expenses in the absence of increasing sales,
- A risky dependence on a small number of products, customers or transactions,
- Significant and regular tax adjustments by the IRS, and
- Pressure to meet budgets and earnings projections, and produce enough capital to finance company growth without turning to equity or debt solutions.

When bottom-line results seem too good to be true, that just may be the case.

Fraud reveals itself in dramatic lifestyle changes as well. An executive thief may begin spending extravagantly on expensive cars, jewelry or vacations. Conversely, a formerly fiscally healthy individual may appear to be mired in debt and have credit problems. In some cases, the motivation for fraud is a substance abuse or gambling problem, so signs of addiction merit immediate attention.

### Blocking opportunities

Certain management and operational factors make executive fraud easier to perpetrate. Primary among them is weak internal controls, but more-specific items include:

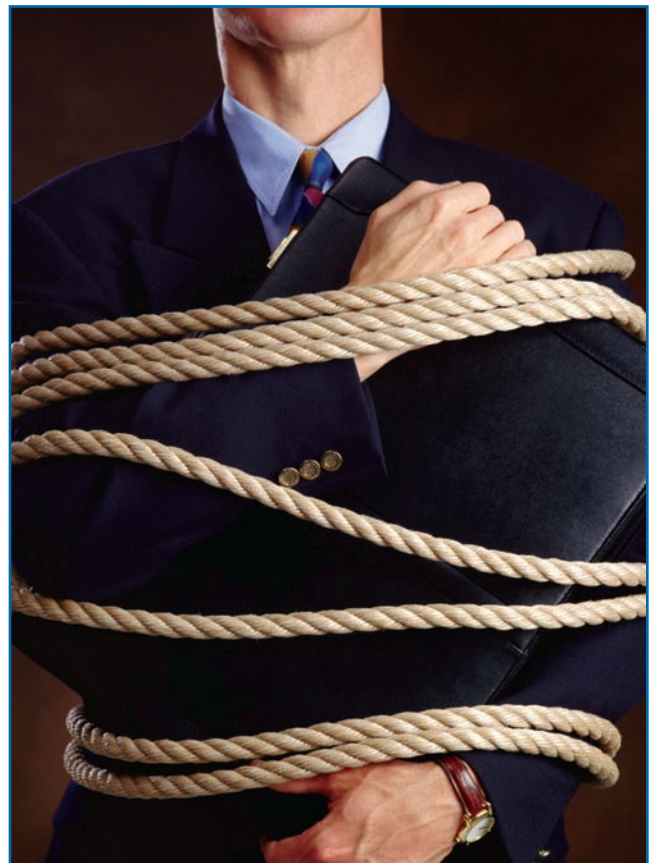
- Little or no segregation of duties,
- Management decisions dominated by an individual or small group,
- Excessive trust in key executives,
- A lax or inexperienced accounting staff,
- Little or no external audit oversight,
- An excessive number of checking accounts,
- An overly complicated organizational structure, and
- Employee conflicts of interest with customers or vendors.

Companies in financial distress, in particular, can provide opportunities for dishonest executives. If the business sells assets for less than their market value, executes an excessive number of year end transactions, routinely rolls over loans or loses important financial documents, it could signal

more than poor management. Other warning signs include significant downsizing in a healthy economic environment and a high turnover rate for employees leaving voluntarily.

### Innocent until proven guilty

It’s important to remember that the presence of fraud indicators alone doesn’t prove that a fraud scheme is occurring or will occur. The indicators do, however, call for tighter controls and further investigation by a qualified fraud expert. ■



# A complex process made easier

## Cox provides stock valuation guidance

Shareholder litigation often calls for the valuation of a company's stock. But this process is easier said than done: Even where statutes directly address such valuations, the task is complicated. The 11th Circuit Court of Appeals opinion in *Cox Enterprises, Inc. v. News-Journal Corp.*, however, illustrates and provides guidance on issues relevant to company stock valuation.



## Fraud and waste allegations

Cox is a privately held corporation that owns 17 daily newspapers. Since 1969, it has held a 47.5% interest in News-Journal Corporation (NJC), a closely held Florida corporation that publishes a daily newspaper and six local shopping guides.

Beginning in the mid-1960s, NJC created several nonprofit organizations to support the arts and has since provided significant financial support to arts programs. By 2000, for example, NJC's annual contribution to the Seaside Music Theater was \$1.8 million. NJC also paid \$13 million for naming rights to a new performing arts center for the theater.

Over time, NJC donations began to exceed the maximum allowed for charitable deductions. In 1993, it started classifying its contributions as business expenses related to corporate promotion.

Cox learned of the naming rights agreement in 2004 and subsequently filed suit, alleging various acts of fraud, waste and mismanagement. Pursuant to a Florida statute, NJC elected to buy Cox's shares at their fair value. Because the parties were unable to agree on a purchase amount, the district court held a trial to determine fair value.

## Experts weigh in

Both sides presented expert testimony. To determine an amount, Cox's expert first established the fair market value (FMV) of NJC as a "going concern." He used a comparable sales (or market) approach, measuring NJC's value against the purchase prices of comparable newspapers.

As part of his analysis, Cox's expert compared NJC's earnings before interest, taxes, depreciation and amortization (EBITDA) margin to the average EBITDA of 11 publicly traded newspapers. NJC's margin was 9.3% vs. a 28.3% average for the 11 papers, prompting the expert to "normalize" NJC's margin to 28.3%. Eventually, he determined that the fair value of Cox's shares was about \$145 million.

NJC's expert also valued the company as a going concern, using a discounted cash flow approach. His definition of "going concern" was informed by NJC's general counsel's "suggestion that valuing a company as a going concern rests on the assumption that a company will operate in the future exactly as it has in the past." The NJC expert determined that the fair value of Cox's shares was about \$29 million.

The district court ultimately concluded that the fair value of Cox's interest was about \$129 million.

## The appellate court decides

On appeal, the 11th Circuit considered several issues. They included:

**The role of FMV.** NJC challenged the district court's use of FMV in calculating fair value. The court noted that Florida courts have explained that determination of fair value under the applicable statute "rests on determining what a willing purchaser in an arm's length transaction would offer for an interest in the subject business."

While fair value is not synonymous with FMV, the 11th Circuit found, "the terms are not mutually exclusive." Rather, a court may use FMV to estimate fair value when potentially distorting corporate actions, such as impending mergers, aren't at issue. No such corporate action existed here, making the use of FMV appropriate — especially as the district court made adjustments to give greater weight to NJC's closely held status.

**The definition of “going concern.”** According to the 11th Circuit, the term is generally understood to refer to a commercial enterprise actively engaging in business with the expectation of continuing indefinitely. The 11th Circuit agreed with the district court that a valuation should assume the business will be managed in a reasonably prudent manner going forward.

The 11th Circuit rejected NJC’s assumption that the business would operate in the future exactly as it has in the past. That assumption would, in the case of previous mismanagement or waste, provide majority shareholders and directors an incentive to violate their fiduciary duties and commit waste to reduce the value of minority shares.

**Normalization of the operating margin.** The district court justified the normalization of NJC’s margin by citing NJC’s poor performance relative to comparable newspapers. It reasoned that normalizing NJC’s financial data would better approximate the value of the corporation as

a reasonably prudently managed business. The 11th Circuit found that the district court’s ruling did not constitute an abuse of discretion.

**Compensation for past misconduct.** The 11th Circuit acknowledged that fair value should take into account any effect of corporate asset waste or other harm from mismanagement. But it found that normalizing the operating margin addressed the effect of previous waste or mismanagement and accounted for any distortion resulting from greater than normal expenses.

## Fair enough?

In affirming the district court, the 11th Circuit in *Cox* demonstrates some of the confusion between fair value and FMV and the complicated issues involved in calculating fair value. A qualified expert can ensure that fair value is determined in a manner that satisfies a court’s expectations and reflects the realities of a company’s circumstances. ■



## When is a discount for lack of marketability warranted?

Whether for purposes of buy-sell agreements, shareholder litigation, marital dissolutions or taxes, business valuations frequently require the application of a discount for lack of marketability (DLOM). This is particularly true when valuing a minority interest.

### 10 relevant factors

A DLOM is applied to reflect the fact that there is no traditional market for closely held stock — making shares illiquid, or not easily bought and sold. Note that the DLOM is somewhat distinct from the minority discount. That discount recognizes that minority shareholders lack control over the direction and management of a company, and that a buyer would presumably pay a premium for shares that convey control.

The appropriate DLOM depends on a variety of factors. Judge David Laro of the U.S. Tax Court has enumerated 10 company characteristics to consider when deciding the appropriate discount:

1. Whether its stock is private or public,
2. Its financial condition according to financial statements,
3. Its dividend policy,

4. The nature of the company and its history, position in the industry, and economic outlook,
5. The amount of control in transferred shares,
6. Its management,
7. Any restrictions on transferability of stock,
8. The stock holding period,
9. The stock redemption policy, and
10. Costs associated with making an initial public offering (IPO).

Other courts and authorities cite additional relevant factors, including the size of revenues and earnings, and product and industry risk.

### 3 main categories

The factors considered relevant to calculating a company’s DLOM generally can be assigned to one of three main categories:

1. **Dividend patterns.** The promise of dividends makes shares more marketable. Stocks with no dividend history or little expectation of future dividends traditionally are less

appealing to buyers. A holder of dividend-free stock can realize gains only by selling it. Conversely, a holder of stock that pays dividends can enjoy returns without selling it.

A history of paying dividends, however, is no guarantee that a company will make future dividend payments. Imagine, for example, an investor who buys into a family business with a strong history of dividends. Once the business includes a nonfamily member with a minority interest, its owners might change the company's policies to prevent dividends being paid to an outsider. So, instead of paying dividends, it might vote to increase family members' salaries.

**2. Holding period.** Generally, the longer the expected holding period, the more illiquid a company is and the greater the DLOM. The holding period can be estimated based on:

- The stock's put rights, which increase marketability,
- The prospect of a liquidity event like a sale or IPO, which also increase marketability,

- The size of the interest, which affects how easy an interest is to sell, with larger blocks typically being more difficult to sell, and

- Contractual transferability restrictions, which inhibit marketability.

**3. Company risk.** Risk is assessed by considering several factors, including stock price volatility, company size, management depth, debt levels and stability of revenue growth. The greater the risk, the harder shares typically are to sell — and the greater the DLOM.

### Case by case

Ultimately, the appropriate DLOM will turn on the subject interest's particular facts and circumstances. With marketability discounts typically ranging from 15% to as much as 35% or more, the amount can have a significant effect on the final value of a company and the outcome of various legal matters. ■

## Joint valuations remove bias from the equation



In disputes involving the value of a business, the parties usually come to the table with experts brandishing opposing valuations. Many attorneys, however, have found that joint valuations can — in some circumstances — benefit both parties. Conducted correctly, they can expedite the valuation process, relieve stress and reduce costs (unless, as permitted in some jurisdictions, a party hires a rebuttal expert).

### No favoritism allowed

In a joint valuation, the parties retain a single valuation expert who works for both and favors neither. The valuator and parties agree in advance on basic ground rules for the engagement and, ideally, the result is a final objective value that represents a reasonable amount acceptable to all.

The valuator's goal, however, is not to arrive at a figure that satisfies both parties. The expert works only to calculate what he or she considers fair market value.

### Party politics

An overriding consideration for a joint valuator is the appearance of fairness to both parties. This consideration affects the expert's communications, information-gathering process and valuation report drafting.

Joint valutors copy all correspondence between themselves and attorneys to both parties. In turn, parties and their attorneys must do the same, communicating with the expert only in writing — unless specifically requested otherwise. The expert will also make his or her document requests in writing, and decide with the attorneys in advance whether documents are to be subject to sharing.

When the expert arrives at the report stage, he or she will submit a draft to both parties. The parties can review the report for accuracy and confirm that the expert had access to all of the relevant information. They are allowed input, but only within a restricted comment period, and they must put their comments in writing and copy the other party.

The parties will have the opportunity to respond to the opposing party's comments during a second comment period. The valuator then incorporates into the final draft any significant issues raised by the parties and resulting changes to the report's content.

### Making it work

Joint valuations won't work in all circumstances. They're best suited to situations in which both parties seek a cost-effective and expedient process and are willing to remain open-minded. You can reassure your client about the unbiased nature of the valuator's job and explain how a joint valuation can produce a favorable outcome.

# Proving the alter ego case

Faced with valid claims against insolvent or cash-poor defendants, plaintiffs increasingly are arguing that these defendants represent the “alter ego” of their financially stronger parent companies. Alter ego litigation generally is sought to breach a defendant’s corporate structure and obtain access to the financial resources of its subsidiaries or individual shareholders. Qualified financial experts can help both plaintiffs and defendants build their arguments in such cases.

## Leading indicators

Financial experts consider a range of factors that can be used to argue that two companies *are* or *are not* one entity with shared liability. The mere existence of related companies doesn’t support a finding of an alter ego relationship — a unity of interest must exist between the companies.

No single factor will prove this unity of interest, but one critical question is whether each of the companies maintains its own corporate structure with proper corporate policies and procedures. If not, the two may be alter egos. The same may be true when they conduct the same business activity; operate out of the same location; and share officers and directors, as well as outside advisors such as attorneys and accountants.

*The mere existence of related companies doesn’t support a finding of an alter ego relationship.*

Of course, companies can legally engage in the same business activity without establishing alter ego liability, but they must distinguish themselves from one another and maintain autonomy.

## Other relevant factors

There are other relevant factors that may require experts to do more extensive digging. These include whether:

- The parent company incorporated the subsidiary and when,
- The subsidiary was undercapitalized,
- The subsidiary fails to act in a stand-alone capacity,



- The two companies share the same corporate minutes,
- The parent company pulls all of the cash out of its subsidiaries and into a consolidated bank account, and
- The parent dictates the policies and procedures of the subsidiary.

Any one of these conditions could signal the existence of an alter ego relationship.

The existence of “related-party” transactions is another red flag. These transactions can represent legitimate business, but they may simply serve as a way for the parent to divert money from the subsidiary to make it judgment-proof. Related-party transactions generally are characterized by special terms or conditions that indicate they weren’t conducted at arm’s length.

## Case-by-case issue

Ultimately, the answer to the alter ego question depends on the totality of the circumstances of the case, making individualized analysis vital. Financial experts with experience analyzing businesses, transactions and corporate structures are well equipped to examine and explain on the witness stand the relationship between a business and its parent company. ■



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**HOLD IT! I DID NOT MEAN THAT!**

*Marriage of Holtemann* (2008) 162 Cal. App. 4th 1175, 76 Cal. Rptr. 3d 615

Estate tax planning is a device intended to help with the eventual outcome of life, that is, death and taxes. The planning process is typically geared to thinking of all the possibilities that can occur upon death in order to properly plan and effectively deal with its outcome.

Mr. Holtemann, while taking the steps to properly manage his estate for estate tax planning purposes, created a transfer document that was intended to transfer his separate property into community property; the purpose being to minimize taxes and avoid probate if either he or his wife, Barbara, died. What Mr. Holtemann did not realize is that sometimes “til death do us part” is pre-empted by “I will have my lawyer call yours!”

The parties were married in 2003, with Frank Holtemann coming into the marriage with considerably more assets than Barbara. The parties jointly retained an estate planning attorney to help them with the estate planning process. In March of 2005, the parties executed a “Spousal Property Transmutation Agreement” wherein Frank’s separate property was clearly designated as subject to the transmutation provisions of the agreement that changed the character of the assets from separate to community.

The parties separated on June 2, 2006 and Barbara filed for divorce on August 1, 2006.

Litigation in this case dealt with the obvious question as to whether Mr. Holtemann really “meant” what he was representing to his wife and the world, when he signed documents which as the Second District Court of Appeal wrote were “replete with language that clearly stated that Frank intended to transmute his separate property to community property and that he intended to change the *characterization* of the property from separate to community”. The Court felt that Mr. Holtemann’s representations clearly qualified under Family Code Section 852(a) wherein it states that “A transmutation of real or personal property is not valid unless made in writing by an express declaration that is made, joined in, consented to, or accepted by the spouse whose interest in the property is adversely affected.”

Mr. Holtemann of course argued that the transmutation was intended for estate planning purposes and not dissolution purposes. The Court, however, could not find any authority which would allow a transmutation to be conditional or temporary, and as such, Frank’s motive in creating the transfer had no impact on its effect.

We should not feel too sorry for Mr. Holtemann as some of the sting of the situation was taken out via his entitlement under the provisions of Family Code Section 2640. Family Code Section 2640 provides that there is a right of reimbursement for traceable separate property contributions to the acquisition of community property, the measure of reimbursement being the value of the property at the time the right arises, not to exceed the property’s net value at division.

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