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Preparing for the unexpected

Buy-sell agreements can steady businesses in uncertain times

Life rarely turns out the way we expect. Multiowner businesses can be rocked by unexpected events such as the death or disability of a partner, the divorce of a family business owner, or a shareholder dispute. Even voluntary transfers arising from an owner retiring or simply wishing for a buyout can throw a wrench into operations.

To guard against the negative consequences that could arise from such events, companies need to be prepared. A buy-sell agreement can steady a business in uncertain times, and valuation considerations play an integral role in effective agreements.

Key appraisal areas

When establishing or updating a buy-sell agreement, an appraiser's help is invaluable. He or she can consult in key areas such as:

The value of the business. An appraiser can estimate the company's value. A reputable appraisal will not only satisfy owners' curiosity, but also curtail surprises and unrealistic expectations should something trigger the buy-sell.

Owners should give thought to how they'd like the appraisal process to unfold if the buy-sell agreement is triggered.

Insurance coverage. Companies often fund buy-sell agreements with life insurance. An appraisal helps assess the adequacy of key person coverage, which should provide enough cash to buy back the exiting owner's business interest and to weather the temporary downturn following his or her loss.

A standard of value. Businesses typically are appraised at fair market value, which is the price at which property would change hands in an arm's-length transaction between willing buyers and sellers with reasonable knowledge and without compulsion to buy or sell. The fair market value of private minority interests typically includes discounts for lack of control and marketability.



Valuation discounts, however, are subjective and often contentious. A buy-sell agreement should specify another standard of value — say, fair value or investment value — if the parties intend that terminating owners receive the pro rata (undiscounted) value of their interests.

The appraisal process. Owners should give thought to how they'd like the appraisal process to unfold if the buy-sell agreement is triggered. For example:

- ◆ Who will pay for the appraisal?
- ◆ How long should the appraisal take?
- ◆ How many appraisers will be hired?

A growing trend is the use of joint appraisers, which minimizes costs and facilitates information sharing. Alternatively, if more than one appraiser is retained, owners should consider how to rectify valuation discrepancies. For example, will they split the difference or hire a third expert?

Buyout terms. An appraiser can help specify buyout terms, including the duration of payments, the interest rate on installment sales, and the allocation between the purchase price and other contractual

arrangements (such as noncompete agreements and consulting contracts).

Some buy-sell agreements also contain right of first refusal or transfer restriction clauses to prevent transfers to undesirable third parties — an appraiser can weigh in here as well.

Formulaic risk

Some buy-sell agreements sidestep the appraisal process to save money and call for the use of valuation formulas or industry rules of thumb. These shortcuts often prove costly, however, as factors that affect value (such as risk and earnings growth) are ignored.

To illustrate, consider the “five-times-earnings” formula. The term “earnings” could be interpreted as accounting net income; earnings before interest, taxes, depreciation and amortization (EBITDA); or pretax earnings normalized for owners’ discretionary spending.

This simplified formula also disregards nonoperating assets and off-balance-sheet items, such as excess cash

reserves and contingent liabilities. And a divorce or tax court may view predetermined formulas as attempts to “force” a convenient value regardless of its accuracy.

Another problem is that formulas can become outdated, depending on market conditions. Going back to the example using the five-times-earnings formula, suppose the industry is consolidating and businesses are selling for *ten* times earnings. Would an investor be satisfied with the five-times-earnings formula chosen years earlier?

No time like the present

Many business owners are surprisingly remiss when it comes to buy-sell agreements. Some draft a rudimentary buy-sell agreement and neglect to review and update it regularly, while others put off creating one entirely. Yet as business and market conditions fluctuate dangerously, buy-sell agreements are more important than ever. ♦

E-discovery: Avoiding inadvertent disclosure

Electronic evidence has assumed a prominent role in discovery. In turn, the massive amounts of data in such evidence have increased the risk of inadvertent disclosure of privileged materials. While the Federal Rules of Civil Procedure (FRCP), and the state and local rules that largely mirror them, provide a procedure for claiming protection for “trial-preparation material” mistakenly produced in discovery, savvy attorneys are taking proactive measures to minimize the risk.

Between discovery deadlines and the daunting amount of data, it may not be possible to individually review each document. Attorneys can, however, use technology to screen evidence for potentially privileged materials.

The screening might begin with a search of electronic data for the names of in-house and outside counsel. Attorneys need to also run a search for the names of relevant law firms and their attorneys’ and paralegals’ e-mail addresses. To generate more hits, consider searching for “@lawfirmname.com” instead of “pmason@lawfirmname.com.”

In addition, the search should query abbreviations used for law firms and attorneys. And, of course, the screening needs to seek documents with the terms “privilege,” “work product” and “attorney-client.”

Bear in mind that screening materials in this way is no substitute for actually reviewing documents. The process won’t capture documents that don’t allow text searches and is likely to return documents that aren’t privileged. Consider, for example, the breadth of documents that would turn up in a search for the name of a corporation’s general counsel. The general counsel may well serve as both attorney and business executive, so many of the materials with his or her name might not be subject to attorney-client privilege.

Additional review of returned documents and nonsearchable documents is critical before producing discovery materials. Ideally, though, the screening process will streamline the production process and catch any privileged information before it falls through the disclosure cracks.



What standard should be used for divorce valuations?

Fair market value vs. fair value

Divorce cases often require the valuation of closely held businesses in which one spouse owns an interest. For many years, courts have typically applied the fair market value (FMV) standard to estimate the value of businesses in divorce proceedings. Recently, however, attorneys for nonowner spouses have been increasingly requesting the use of the fair value (FV) standard instead. A look at a variety of cases over the last couple of decades reveals that this battle is far from over.

A landmark decision

Proponents of the FV standard in divorce cases typically cite the Delaware Supreme Court's landmark 1989 decision in *Cavalier Oil Corp. v. Harnett*, a dissenting shareholder case. Here the court reviewed the Delaware Chancery Court's decision to deny discounts for lack of marketability and lack of control in calculating FV.

The Delaware high court found that failing to give a minority shareholder the full proportionate value of his or her shares "imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process

by cashing out a dissenting shareholder, a clearly undesirable result."

The court also noted that allowing discounts would be contrary to the FV standard's requirement that the business be valued as a going concern. Unlike FMV, FV doesn't assume a hypothetical pro forma sale. Rather, it assumes that the minority shareholder was willing to maintain his or her investment in the business.

Courts in a few states have held that discounts weren't appropriate in divorce cases.

Subsequent decisions

Since 1989, a few attorneys representing nonowner spouses have seized on *Cavalier* to argue that allowing discounts in a divorce case unfairly enriches the owner spouse. In fact, since 1996, the issue has been addressed by courts in states such as Florida, New Jersey, North Dakota and Washington. The New Jersey, North Dakota and Washington courts held that discounts weren't appropriate in divorce cases.

A Florida court, however, found that the nonowner spouse was more like a shareholder seeking dissolution for corporate deadlock than a dissenting shareholder. Because Florida's business corporation act gave courts discretion to apply a marketability discount in a dissolution-of-business case, the court concluded that courts hearing divorce cases should have the same discretion.

The latest case

The issue came to the fore again in the summer of 2008, when the Colorado Court of Appeals heard the case of *In re Marriage of Thornhill*.



FMV vs. FV: Understanding the difference

Although easily confused, fair market value (FMV) and fair value (FV) — the most common standards of value — are not interchangeable.

FMV is used most often to value business interests. It's typically defined as the price at which the subject property would change hands between a hypothetical willing buyer and seller when neither is under any compulsion and both parties have reasonable knowledge of relevant facts. FMV is generally the standard used for gift and estate tax valuations as well as buy-sell agreements, among other purposes.

Dissenting shareholder or minority oppression litigation, however, usually turns on FV — which is generally defined by state statute or case law. In many states, FV in the context of shareholder litigation is defined as the proportionate share of the value of the entire company without reference to discounts. For example, if a company worth \$100 million has 100 million shares outstanding, the FV of each share equals \$1.

FV is also frequently used for financial reporting purposes. The Financial Accounting Standards Board defines FV as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

In this dispute, the Thornhills executed a separation agreement, including disposition of the husband's 70.5% interest in a business, but the wife wasn't represented by counsel. When she later realized that, at the time she signed the agreement, she didn't possess a good understanding of the value of the marital assets, she disavowed the agreement as unfair to her. The trial court, however, ratified the agreement. The wife appealed.

As part of her appeal, the wife contended that no marketability discount should have been applied to the valuation of the husband's business, citing a 2003 Colorado Supreme Court case, *Pueblo Bancorporation v. Lindoe, Inc.*, in support of her argument. The court there held that, when determining the fair value of a dissenting corporate shareholder's interest pursuant to the dissenter's rights statutes, no marketability discount may be applied.

According to the *Thornhill* court, those statutes were “intended to protect minority shareholders from the vagaries of cash-out mergers, in which they are involuntarily ‘cashed out of their investment,’ and to ensure ‘that minority shareholders will be properly compensated for the involuntary loss of their investment.’” The court found that such considerations didn't apply to a divorce proceeding for several reasons, including that the divorce statutes didn't contain the FV language used in the dissenter's rights statutes.

The court also specifically declined to adopt a New Jersey court's decision in a similar case,

Brown v. Brown. It instead was persuaded by the decisions of many other jurisdictions that concluded marketability discounts may be applied in divorce proceedings.



Ultimately, the court concluded that “a trial court's failure, in an appropriate case, to apply a marketability discount to an equitable division of marital property ... could unfairly penalize a party for ownership that cannot be readily sold or liquidated.”

The future of FV

While the cases mentioned here have limited applicability outside their respective states, courts will likely consider their reasoning when hearing the FV issue in a case of first impression. The arguments are worth noting, as the monetary difference between FMV and FV — for both owner and nonowner spouses — can prove substantial. ♦

ACFE study quantifies employee fraud

The Association of Certified Fraud Examiners' (ACFE's) latest *Report to the Nation on Occupational Fraud and Abuse* estimates that U.S. organizations lost about 7% of their annual revenues — or \$994 billion — to fraud in 2008. Understanding the most common types of fraud and their costs can make it easier to identify these costly schemes.

3 primary methods

The ACFE breaks fraud schemes into three main categories:

1. Asset misappropriation. In these schemes the perpetrator steals or misuses an organization's resources. Misappropriation schemes were the most commonly reported frauds in the ACFE survey. But they were the least costly, with a median loss of \$150,000.

2. Corruption. This occurs when, in business transactions, employees use their influence to obtain a benefit for themselves or another party in a way that violates their duties to their employers. Examples include offering or accepting bribes and extorting funds from third parties. Corruption occurred in more than 25% of the survey cases, with a median loss of \$375,000.

3. Financial statement fraud. These types of fraud involve the intentional misstatement or omission of material information on an organization's financial statements. An employee may report fictitious revenues or conceal expenses or liabilities. Financial statement fraud was the least common type of scheme in the survey but had the highest median loss at \$2 million.

The ACFE points out that financial statement fraud differs from other forms in a key aspect: It's typically intended to mislead third parties such as investors, owners or regulators about the organization's profitability and viability rather than to enrich the perpetrator. Losses from financial statement fraud, therefore, frequently measure lost market capitalization or lost shareholder value instead of direct financial losses.

9 asset misappropriation categories

As the most common form of fraud reported in the study, asset misappropriation merits a closer look.

The ACFE identifies nine distinct categories of asset misappropriation:

1. Skimming,
2. Cash larceny,
3. Billing schemes,
4. Check tampering,
5. Expense reimbursements,
6. Payroll schemes,
7. Cash register disbursements,
8. Cash-on-hand misappropriations, and
9. Noncash misappropriations, which involve the theft or misuse of physical assets such as inventory or equipment and misappropriation of proprietary information.



About 85% of asset misappropriation cases in the study involved theft or misuse of cash, with fraudulent disbursements (numbers 3 through 7 in the list above) being the most common cash schemes.

Cash-on-hand schemes were less common than those targeting receipts or disbursements, and the scheme's median loss of \$35,000 was among the lowest of any category — but still significant. Check tampering had the highest median loss of asset misappropriation cases: \$138,000. Billing schemes (second most common, behind corruption) and noncash appropriations (fourth most common) both rang in with median losses of \$100,000.

A persistent problem

In the cases where the respondent could determine how long the fraud scheme ran before detection, the median length was 24 months. Check tampering and fraudulent financial statements continued 30 months, while theft of cash-on-hand went a median period of 17 months.

In other words, when fraud occurs, it can persist for a long time. All the more reason to contact a fraud prevention professional who can help uncover schemes on a timelier — and, thus, less costly — basis. ♦

RECENT FLP CASE ILLUSTRATES IRS ATTACK STRATEGIES

For attorneys, an in-depth understanding of recent case law regarding family limited partnerships (FLPs) is a prerequisite to helping clients establish and operate these estate planning vehicles. One recent case, *Holman v. Commissioner*, illustrates a few of the strategies the IRS may use to challenge an FLP.

An FLP is established

As a Dell employee in the late 1990s, Thomas H. Holman, Jr. earned and exercised many employee stock options. In November 1999, Tom and his wife established Holman FLP to serve four purposes: 1) long-term growth, 2) asset preservation, 3) asset protection, and 4) business management education for their children.

The Holmans initially transferred 70,000 shares of Dell stock into the FLP. Over the next three years, the Holmans contributed 41,000 additional shares of Dell stock to the partnership and made a series of gifts, claiming a 49.25% combined discount. The FLP had no business plan, financial statements, employees or telephone listing.

Discounts under siege

The IRS's first line of attack against Holman FLP was that the 1999 gift — which occurred just six days after the FLP's formation — was an indirect gift of Dell shares under Internal Revenue Code Section 2501(a) and the step transaction doctrine and thus the full value of the shares should be subject to gift tax. The Tax Court ruled that Section 2501(a) didn't apply because the facts of the cited cases, *Shepherd* and *Senda*, differed significantly from *Holman*. Moreover, Dell's stock price varied significantly from the formation date to the gifting dates. By delaying the gifts even for six days, the Holmans bore the risk that the stock value could change materially.

The second IRS argument was that the partnership's transfer restrictions should be disregarded and, accordingly, valuation discounts should be reduced pursuant to Section 2703(a). The IRS won this argument. The

court ruled that the partnership's transfer restrictions didn't serve bona fide business purposes and were merely ways to transfer property to family members for less than full and adequate consideration.

In trying to find the right discounts to support their discounts for lack of control (DLOC), both experts observed net asset value discounts on closed-end mutual funds. The court found the IRS expert's fund selection and analysis "more thoughtful" and, therefore, adopted his interquartile mean discounts of 11.32%, 14.34% and 4.63% for 1999, 2000 and 2001, respectively.

More controversial was the court's determination of the discount for lack of marketability (DLOM). Here both experts relied on restricted stock studies, which the IRS's expert segregated into three groups: 1) pre-1990, before the SEC adopted Rule 144A, 2) from 1990 to 1997, when restricted stock was granted limited access to a resale market, and 3) post-1997, after the restricted stock holding period was reduced to one year.

From these groups, the IRS expert isolated a 12% discount for liquidity. He successfully argued that holding period had no influence on the FLP's marketability. Moreover, the IRS hypothesized that, if a limited partner wanted to liquidate his or her interest, the partnership could simply dissolve, distribute Dell stock and reorganize. Accordingly, the court lowered the taxpayer's 35% DLOM to 12.5% for all three years.

Credentials make the difference

Holman provides insight into how the IRS may target an FLP. It also holds one fundamental truth: Choose your expert carefully. The IRS expert was more experienced and had earned a professional designation — factors that weighed heavily in the court's ruling. ♦





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CAUSATION

The lights are flashing, the gates are down, but the train's not coming!

A good friend of mine uses that expression to indicate that someone "just doesn't get it". Damage experts sometimes fall into that category. Some experts spend most of their time calculating damages before they know if there are any damages.

This case example illustrates the importance of analyzing causation in damages. I was retained by the defendant, a brake hose manufacturer, in a product liability suit to evaluate if the plaintiff, a major railroad company, suffered any lost profits due to a train derailment. The plaintiff retained a very experienced railroad auditor from a prominent Big 4 accounting firm.

Along with his analysis, his work papers were well organized and documented. His analysis followed a classic "before-and-after" approach where he analyzed the average monthly shipments before the accident (approximately 750 trains) and compared that to the shipments for the month of the accident (approximately 330 trains). His conclusion was that the railroad suffered approximately \$15 million in lost profits damages (not counting any property damage or clean up costs).

His work papers appeared to be flawless; nevertheless, the result did not seem to make sense. How could the railroad have lost \$15 million in profits when only two tracks were impassable for one day? We were immediately suspicious of the result when we realized that there was no documentation of actual losses in the expert's file. We requested customer contracts and other documentation showing that the railroad did not deliver on specific orders/contracts due to the derailment. The plaintiff refused to provide any documentation due to confidentiality concerns.

After our review of thousands of documents produced, we found one piece of paper that showed the daily shipments over these tracks for a six month period. It was obvious from this information that there were several major problems with the expert's analysis. First, the 15 days prior to the accident showed the lowest daily shipments of the year. Obviously, there was another reason why the monthly average was so low for the month of the accident. As it turned out, extreme cold and snow caused major problems for the railroad before the accident. Second, about four days after the accident, daily shipments increased to the highest level of the year. The railroad had mitigated its lost profits by sending more trains through the system after the tracks had been repaired.

With this new information, we replaced the monthly average data in the expert's model with the daily shipment data. The result showed no lost profits. The case settled that day for the property damage costs only.

In conclusion, it is very easy to develop a methodology and calculate lost profits, but without a critical evaluation of the causation, that model will not stand up in court.

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