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ADVOCATE'S EDGE

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It's been more than a decade since Bernie Madoff made headlines for his massive Ponzi scheme. That case reinforced an old lesson: If an investment seems too good to be true, it probably is.

Unfortunately, some investors are still being duped by slick con artists who promise quick and easy returns. An indictment last fall — and a related U.S. Securities and Exchange Commission (SEC) enforcement action and complaint alleging securities law violations — illustrates the risk of securities fraud.

Lucrative fraud

In September 2018, a federal grand jury indicted three men on charges of conspiracy, wire fraud, identity theft and money laundering. The charges stem from an alleged $364 million Ponzi scheme that deceived more than 230 investors. The scheme began in January 2013.

According to the indictment, two men invited investors to join them in purchasing consumer debt portfolios filled with defaulted debts to bank and credit card issuers, student loan lenders and vehicle financers. These portfolios were to be sold to third parties that would attempt to collect on the debts.

The two perpetrators falsely represented that they would make money for investors by collecting payments on debts or selling portfolios for a profit to third-party debt buyers. The latter practice is also known as "flipping." The indicted third man allegedly assisted the plot by creating fake paperwork, including due diligence documents, purchase agreements, collection reports and profit projections.

> Ponzi schemes generally collapse when the perpetrators can no longer attract new investors and/or existing investors cash out.

The con artists allegedly purchased no underlying debt portfolio and, instead, created bogus companies with names similar to actual consumer debt sellers or brokers. Then they opened bank accounts in the names of the bogus companies and falsely represented that the monies they paid investors were proceeds from collections or flipping. In reality, the payments came from money collected from subsequent investors.

Fraud categories

Last fall's securities fraud indictment and the infamous Bernie Madoff case are examples of "Ponzi" schemes. Such scams require a constant flow of new investors to continue. They generally collapse when the perpetrators can no longer attract new investors and/or existing investors cash out.

Other types of securities fraud include:

Pyramid schemes. Like Ponzi schemes, pyramid schemes pay investors with funds from subsequent victims. They promise low or no-risk investments with high rates of return that aren't possible with traditional investments in stocks and bonds. The victims also can earn "recruitment commissions" for introducing new investors into the scam.

Victims may be offered a franchise or distributorship to market specific products. However, the actual profits come from the sale of these franchises, not from selling products.

Pump-and-dump scams. In these market manipulation schemes, the perpetrators create artificial buying pressure for a certain security, usually in a micro- or small-cap company. The perpetrator controls the company and uses deceptive sales practices or false and exaggerated statements to persuade investors to purchase shares. These scams are offered increasingly through email, messaging apps and social media.

Artificially inflated demand causes the price of the security to skyrocket. Then the fraudster quickly sells (or dumps) the shares, often reaping a substantial profit in the process. For example, the fraudsters behind a 2015 pump-and-dump scam pocketed $78 million in illicit profits before getting caught.

Experts know the signs of securities fraud

When large securities fraud schemes are discovered, forensic accounting experts may be hired to locate missing funds (assuming any remain) and trace the illegal transactions that led to the loss. In addition, experts can provide valuable assistance when securities fraud is suspected but not yet confirmed.

Qualified experts will look beyond potentially fraudulent financial reports. They can evaluate other sources of evidence, such as:

- State and federal tax returns,
- Bank accounts,
- Purchase orders,
- Invoices, and
- Digital communications.

For example, a text between perpetrators in a recent Ponzi scheme said, "Need all of this to be discreet. … we do not want anyone to know details." Another, less discreet, message said, "Thanks, my shady friend!"

Forensic accounting experts can identify the red flags that, on their own, might not seem unusual or conclusive, but together can signal fraud. For example, the perpetrators in the aforementioned Ponzi scheme claimed returns of 10% to 15%. Though the returns might not seem outrageous, the perps' flashy lifestyles, combined with their web of shell companies, likely would raise the suspicions of a trained fraud expert.

To catch a thief

In connection with last fall's high-profile Ponzi scheme, an SEC representative cautioned that "investors should be warned that low-risk, high-return investments that never lose should be a red flag." If someone pitches this type of investment to you, contact your financial and legal advisors before handing over funds.

If you make an impulsive investment decision, your advisors also can help investigate whether the opportunity seems legitimate or should be reported to the authorities. You also may be able to cash out quickly before any damage is done. ■

What's the value of a noncompete?

Noncompete agreements can be valuable to a business. They help retain key employees, safeguard inside information, protect a company's assets and prevent unfair competition. However, assigning value to these contractual arrangements can be complicated. Here's the approach business valuation experts generally use for these intangible assets.

The basics

A noncompete agreement (or "covenant not to compete") is a contract between an employee and an employer. The employee agrees not to compete with the employer for a certain time period and within a specified geographic area. Noncompete clauses also may be entered into by buyers and sellers as part of a merger or acquisition (M&A) transaction.

For example, Jan is the research and development manager of a chemical company. As a condition of her employment, she signs a contract, agreeing not to work for any competing business in the United States for a two-year period following any prospective departure.

The value of a noncompete also might be relevant in divorce cases. Some jurisdictions exclude goodwill (or, more often, the portion of goodwill that's linked to individual owners) from an owner's marital estate. The value of a noncompete agreement may be used to approximate the value of so-called "personal" goodwill.

When valuing noncompetes, financial experts consider the:

- Value of the overall business,
- Probable damages a breach might cause,
- Likelihood of competition, and
- Enforceability of the noncompete agreement.

Without a noncompete agreement, the worst-case scenario is that competition from a former employee or seller will drive the company out of business. Therefore, the value of the entire business represents the absolute ceiling for the value of a noncompete.

With-and-without approach

Most likely, a key employee or seller couldn't steal 100% of a business's profits. Plus, tangible assets possess some value and could be liquidated if the business failed. So, when valuing noncompetes, experts typically run two discounted cash flow scenarios — one with the noncompete in place, and the other without.

The expert then computes the difference between the two expected cash flow streams. Factors to consider when preparing the different scenarios include the company's competitive and financial position, business forecasts and trends, and the individual's skills and customer relationships.

Likelihood of competition

Next, each differential must be multiplied by the probability that the key employer (or seller in an M&A) will subsequently compete with the business. If the party in question has no incentive, ability or reason to compete, the noncompete can be worthless.

Factors to consider when predicting the threat of competition include the individual's age, health, job satisfaction, financial standing and previous

competitive experience. The expert also will consider any postemployment (or postsale) relocation and employment plans.

Enforceability

It's also important to consider whether the noncompete clause is legally enforceable. Generally, noncompete agreements can be enforced only if the restrictions are reasonable. For example, some courts may reject noncompetes that cover an unreasonably large territory or long period of time.

What's "reasonable" varies from business to business, requiring specific consideration of the business, state statutes and case law, and agreement terms. For example, it may violate the law for an employer to ask an employee to sign an agreement before making a full-time job offer. Plus, California and a handful of other states restrict the use of noncompete agreements in certain circumstances.

In addition, employers must update agreements regularly and strictly enforce all breaches in accordance with the stated terms. If they don't, their noncompetes may become unenforceable.

Building a better deal

Noncompete agreements should be a forethought, not an afterthought, in M&As. Effective agreements can benefit sellers by making the business more attractive to potential buyers. They can also provide a buyer with assurance that it won't spend millions of dollars on an acquisition, only to watch the management team leave and open a competing business shortly thereafter.

Contact a business valuation expert for more information. He or she can help value a noncompete for purposes of a divorce, M&A negotiations and postsale financial reporting. ■

Look beyond deal price in statutory appraisals

Statutory appraisals in dissenters' actions are typically based on either the deal price or the company's unaffected market value as a going concern. In contrast to some recent Delaware rulings, the Colorado Court of Appeals in *Crocker v. Greater Colorado Anesthesia* dismissed the dissenting shareholder's argument that fair value should be solely based on the deal price. Here are the details.

Doctor dissents to merger

The plaintiff in this case was an employee and minority shareholder of an anesthesiology practice. He filed a lawsuit against his former employer after dissenting to a February 2015 merger.

Under the terms of the deal, each physician-shareholder who agreed to participate in the merger was entitled to receive:

- $626,000 in cash,
- $224,000 in the merged entity's stock, to fully vest in five years, and
- A signing/retention bonus reflecting his or her prior income.

But the deal also came with some major downsides: Participating doctors were required to sign an agreement that mandated a 21.3% reduction in pay and a five-year employment commitment.

The district court found in favor of the doctor, ruling that the noncompete was unenforceable. However, it found the valuation prepared by the employer's expert to be more credible, ruling that the fair value of the doctor's share was $56,044 plus interest. The employer appealed the enforceability of the noncompete provision; the plaintiff counterappealed the fair value determination.

After going to work for another practice, the plaintiff asked the court to 1) reject a noncompetition provision in his previous employment agreement, and 2) determine the fair value of his 1.1% share in the old (premerger) entity.

District court weighs the evidence

Under Colorado law, dissenting shareholders are entitled to receive the fair value of their interests. The term "fair value" is defined as "the value of the shares immediately before the effective date of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action except to the extent that exclusion would be inequitable."

The district court considered two sources of business valuation evidence. First, the doctor's expert valued his interest at between $893,400 and $987,400. This range of value was based on:

- A reduction in physician income even greater than that which would occur after the merger, and
- The price paid on the date of the merger.

Second, the employer's expert valued the doctor's interest at between $50,549 and $56,044. This model used actual physician compensation prior to the merger.

Ruling is affirmed

The Colorado Court of Appeals upheld that district court's decision on both counts. In terms of the valuation, the appeals court agreed that the deal price didn't reflect the fair value of the practice, which must exclude any appreciation in anticipation of the merger.

It found the deal price to be "an unreliable starting point from which to determine fair value…. The [deal] price reflected the value of [the newly merged entity], a corporation of at least ninety doctors willing to accept 21.3% less pay than the doctors at [the premerger entity]."

The appeals court agreed that the deal price didn't reflect the fair value of the practice, which must exclude any appreciation in anticipation of the merger.

Lessons learned

This case illustrates several key points. Notably, dissenting shareholders can't expect to benefit from synergies and other operational improvements brought by corporate actions to which they dissent. Moreover, deal price is only one consideration when estimating fair value in statutory appraisals. Courts must consider all relevant factors when valuing a dissenter's interest. ■

Kress v. United States

Federal court and the IRS approve tax affecting for S corporation

For decades, the IRS has taken the position that operating as a pass-through entity — such as a sole proprietorship, partnership, limited liability company or S corporation — provides valuable tax advantages. And the U.S. Tax Court has agreed, routinely ruling that the earnings of pass-throughs should *not* be tax affected.

However, the U.S. District Court for the Eastern District of Wisconsin recently accepted a taxpayer's valuation report in which the earnings of an S corporation business were tax affected as if it were a regular C corporation. The court also rejected the IRS expert's application of an S corporation premium.

IRS challenges gift valuations

In *Kress v. United States*, the taxpayers annually gifted shares of their family-owned manufacturing business to younger family members. For three tax years, the IRS claimed that the taxpayers had incorrectly valued the shares and, therefore, paid insufficient gift taxes.

The taxpayers amended the tax returns and paid the gift tax deficiencies. Then they filed a federal lawsuit seeking a refund of gift tax and interest. The case landed in district court, not in Tax Court. So, it has limited precedential value beyond the Eastern District of Wisconsin.

Everyone agrees to tax affect

When valuing a private business interest, "tax affecting" refers to the application of C corporation taxes to the earnings of a pass-through business that doesn't pay taxes at the entity level. In *Kress*, the experts for *both* sides tax affected the company's earnings. The court accepted this methodology without any extended debate or discussion.

The IRS expert also applied an S corporation premium to account for the company's tax advantages as an S corporation. The taxpayer's expert didn't believe the S status added value to a minority shareholder's stock because a minority shareholder couldn't change the company's business structure.

The court found S status to be a neutral consideration with respect to the company's value. It also noted that S status created several disadvantages, including limited access to credit markets and the limited ability to reinvest in the company.

Going forward

It's uncertain whether this ruling will prove influential — and whether the IRS will appeal. Though a Tax Court ruling would carry more weight than a federal court decision, *Kress* suggests that some courts and the IRS may be willing to accept tax affecting when valuing S corporations and other pass-through businesses.

It's also important to note that the Tax Cuts and Jobs Act contains various provisions that reduce the disparity between the effective tax rates paid by C corporations and the owners of pass-through businesses. These provisions went into effect *after* the tax years in question in *Kress*. But you can expect to hear more about this issue in future cases. ■

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