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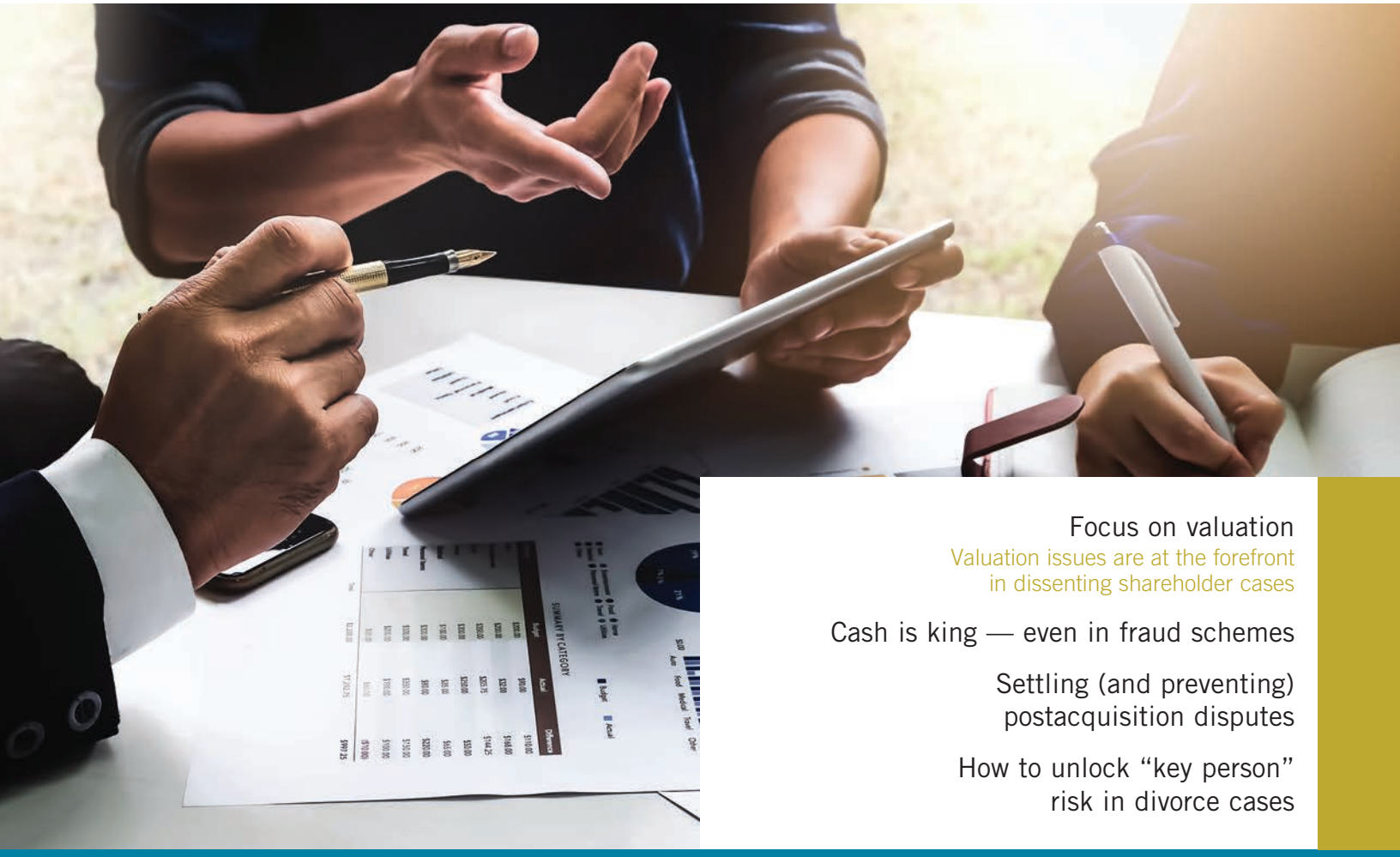
ADVOCATE'S EDGE



Focus on valuation

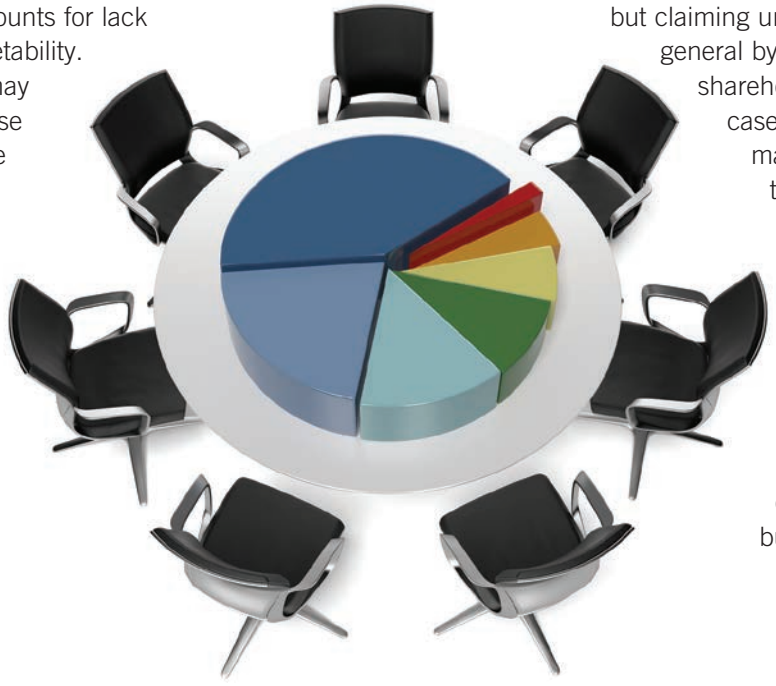
Valuation issues are at the forefront in dissenting shareholder cases

Lawsuits from dissenting shareholders are common. Attorneys involved in these popular types of cases quickly learn that business valuation plays an important role in determining damages. Here are several valuation matters to consider.

Standard of value

The standard of value for dissenting shareholder cases in most states is fair value, although the term is subject to different statutory and judicial interpretations. Generally, though, fair value is defined as the value of the plaintiff's shares immediately before the corporate action that the shareholder objected to. Fair value typically excludes any appreciation or depreciation related to the corporate action unless exclusion would be inequitable.

This definition may not necessarily be synonymous with the "fair market value" standard of value. For instance, the dissenting shareholder is not usually a willing participant in the transaction; nor is the transaction consummated on an objective, unbiased basis. Also, fair value usually doesn't include discounts for lack of control and marketability. Some jurisdictions may recognize one of these discounts — or leave the application of these discounts to the court's discretion based on the case's facts and circumstances. Where such discounts are prohibited, the rationale is that the discounts give controlling shareholders a windfall by cashing out a dissenting shareholder at less than the pro rata value of his or her shares.



Effective date

Statutes in most states say that fair value should be determined as of the day before the contested corporate action. These statutes are based on the notion that the dissenting shareholder shouldn't suffer or benefit from the effects of the contested action.

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Note that different effective dates might be used in shareholder oppression cases where the plaintiff isn't challenging a specific action but claiming unfair treatment in general by the controlling shareholders. In those cases, the business may be valued as of the day the lawsuit is filed (or the day before filing), the date of oppression, or a postfiling date (such as the trial date, the judgment date or the date of the buyback order).

Court turns to failed IPO to value dissenter's interest

In *Kottayil v. Insys Therapeutics, Inc.*, the Arizona Court of Appeals recently found that traditional valuation methods didn't provide a "reliable way" to calculate fair value in a dissenting shareholder case. The court pointed out that valuation of a company's stock isn't "purely a matter for experts": rather, "pre-litigation valuations" used by the company or its directors, officers or shareholders also can be helpful when determining fair value.

The minority shareholder challenged the company's reverse stock split, and the trial court determined that the share price in the split wasn't fair. It found that the best approach to reach the fair value was to define a range of sales, with the low end of the range around $53 million based on discounted cash flow analyses by unrelated third parties. The court set the high end at about $152 million based on valuations prepared for an unexecuted initial public offering (IPO).

The trial court ultimately based the minority shareholder's damages on the failed IPO price. The appellate court upheld the lower court's award, noting that the projections, assumptions and analysis underlying the IPO valuations came directly from the company, representing what management thought the stock was worth based on their intimate understanding of future revenue.

Valuation methods

Appropriate valuation methods vary depending, in part, on the company's industry, assets and operating history. Courts accept several different approaches when valuing a dissenting shareholder's interest:

Income approach. The discounted cash flow method is a common valuation method in these cases, especially in Delaware, where many companies are incorporated. The capitalization of earnings method, which likewise falls under the income approach, is also used to compute fair value, particularly when long-term financial projections aren't available and the company's earnings have stabilized.

Market approach. When comparable transaction data is available, a valuation expert also might apply the market approach or consider prior transactions and offers involving the subject company's stock. (See "Court turns to failed IPO to value dissenter's interest" above.) Courts tend to give significant weight to transactions negotiated by unrelated third parties. But fair value may be less than the price in an arm's length transaction because that price might take into account the corporate synergies that would result from the transaction or the buyer's ability to improve the company's performance.

Cost (or asset-based) approach. Experts occasionally apply the cost approach in dissenting shareholder cases. But courts are split on adjusting the value of a dissenter's interest for the tax consequences of built-in gains under the cost approach. Courts in some states ignore the tax consequences unless the company was actually undergoing a sale or liquidation on the valuation date, but others allow it regardless of the likelihood of incurring capital gains tax.

A complicated matter

Business valuations for dissenting shareholder cases involve complicated issues that may require special treatment based on the venue. Attorneys should work closely with experts to ensure that valuations are based on the applicable requirements for the standard of value, effective date, valuation methods and other factors that will affect the expert's conclusions. ■

Cash is king — even in fraud schemes

It's probably no surprise that cash is the most popular target of fraudsters — after all, once stolen, cash itself is virtually untraceable. But that doesn't mean forensic experts can't unearth cash fraud schemes and the perpetrators behind them.

Identifying cash traps

How do thieves get their hands on your cash? According to the Association of Certified Fraud Examiners, there are three main categories of cash fraud: 1) theft of cash on hand, 2) theft of cash receipts, and 3) fraudulent disbursements.

The last category comprises many of the most frequently executed schemes, such as overbilling and "ghost" vendor or employee schemes. For example, in overbilling scams, vendors usually submit inflated invoices by overstating the price per unit or the quantity delivered. A dishonest vendor also might submit a legitimate invoice multiple times. Overbilling may involve collusion with employees of the victim organization, who typically receive kickbacks for their assistance.

Employees also can conduct billing fraud on their own, submitting bogus invoices payable to a fictitious vendor and diverting the payments to themselves. Similarly, an employee might set up payroll disbursements to nonexistent ghost employees.

Tracing the schemes

Cash can be difficult to trace once it's in the hands of a fraudster. But forensic experts can uncover fraud by tracing the path stolen cash took *before* the fraudster pocketed it, including who "touched" the cash and what prompted its flow out of the organization. The connections they find may well point to the guilty party.

Inflated invoices, for example, often leave a trail of red flags. Experts look for invoices that bill for "extra" or "special" charges with no explanation. They scrutinize cash receipt and disbursement journals, ledger accounts, invoices and other documentation for irregular charges, round dollar amounts, or amounts just below the threshold that requires management's signoff. They also search for discrepancies between invoice amounts and purchase orders, contracts, or inventory counts.

If forensic experts suspect fictitious billing has occurred, they often investigate accounts with no tangible deliverables — such as those for consulting, commissions and advertising — and check vendor addresses against employee addresses. Invoices with consecutive numbers or payable to post office boxes also may raise suspicion.

Returned checks can supply experts with useful information, too. For starters, fraudsters are more likely to cash checks, whereas legitimate businesses will deposit them and rarely endorse checks to third parties. Moreover, checks generally are stamped with the name of the endorser and,

if deposited, the financial institution of deposit. Experts can use that information to discover a perpetrator's identity.

Exposing ghosts

Ghost employee schemes also can be undone by virtue of tracing. Forensic experts can match non-existent employees to current or former employees who receive the fraudulent paychecks by examining:

- Payroll lists,
- Current and former employee lists, with start and termination dates and Social Security numbers,
- Authorized deductions,
- Withholding forms,
- Personnel files, and
- Employment applications.

The information collected from these sources can provide vital links between actual and ghost employees that wouldn't otherwise be apparent.

To catch a thief

The best defense against any type of fraud is a good offense, meaning strong internal controls. But even the strongest of controls sometimes fail to prevent a determined fraudster. When that happens, an experienced forensic accountant can help a business ferret out the fraud and track down the perp. ■

Settling (and preventing) postacquisition disputes

Mergers and acquisitions sometimes fail. Why? Sometimes the buyer simply forecasts unrealistic synergies between the merged companies. In other cases, the seller misrepresents the company's closing-date financial condition and historical earnings capacity. Or, the seller might not receive as much in contingent consideration as expected because the buyer mismanaged the company or understated postacquisition financial results.

A financial expert can help the parties identify the reason a deal failed and evaluate whether it's related to wrongdoing by another party. In addition, an expert, if hired early in the M&A process, can help the parties *prevent* postacquisition disputes.

Avoid unpleasant surprises

When privately held businesses are bought and sold, the parties typically withhold a portion of the payout or hold funds in an escrow account until certain financial matters can be resolved. For example, the deal may include an earnout where a portion of the sales proceeds are contingent on the acquired entity meeting certain financial benchmarks in the future.

> The buyer may claim that the business isn't as valuable as the seller represented it to be when the parties negotiated the purchase price.

Alternatively, to avoid unpleasant surprises after the transaction closes, a deal may call for purchase price adjustments (PPAs) to reconcile any disparities between what the seller represented in

preliminary "reference" financial statements and the company's actual results. For example, if the seller's working capital has increased or decreased between the time of the reference financials and the closing date, the purchase price would be adjusted upward or downward on a dollar-for-dollar basis. In such cases, when a buyer discovers facts that the seller failed to disclose, the buyer may claim that the business isn't as valuable as the seller represented it to be when the parties negotiated the purchase price.

Buyer vs. seller

Let's take an example. A seller loses a major contract shortly before the acquisition but doesn't disclose this fact to the buyer. The buyer might seek damages based on a revaluation of the target in light of this new information.

This is where a financial expert's business valuation skills are critical. The buyer's expert might testify that the loss of the contract had a material negative impact on the seller's value and calculate damages based on the alleged diminution in value.

The seller's expert could counter that, based on the target's forecasts and other evidence, loss of the contract isn't expected to hurt its future financial performance or market value. Perhaps this type of customer turnover is an ordinary part of the seller's business. Perhaps the seller was in the process of negotiating new contracts that would replace the lost revenues.

Another important consideration is the materiality of an alleged misrepresentation. The buyer may argue that it would have paid less for the business had it known about the lost contract. But from the seller's perspective, the loss may have had no impact on the price it was willing to accept.

In some cases, the seller's actual performance may be relevant. If subsequent events demonstrate that the seller's postclosing performance was consistent with the buyer's expectations at the time the transaction was negotiated, the seller might argue that the buyer still benefited from the deal.

An ounce of prevention

Too often financial experts aren't consulted until *after* an M&A deal closes. But their expertise can be essential when drafting PPA or earnout provisions. In particular, when drafting sales contracts, attorneys should consider addressing the following financial issues:

- The appropriate definition of "materiality,"
- Relevant accounting practices and standards (for example, U.S. Generally Accepted Accounting Principles (GAAP) or agreed-upon non-GAAP standards),
- Specific accounts (assets or liabilities) that the buyer has concerns about, and
- PPA and earnout formulas.

The contract should also identify the party responsible for preparing closing-date and postacquisition financial statements. For example, will they be audited by a CPA or prepared in-house?

Expert advice

A financial professional can help the parties identify potential sticking points during M&A negotiations, allowing them to iron out the details before closing. But if a deal doesn't live up to the parties' expectations, the buyer and seller shouldn't hesitate to contact a valuation or forensic accounting professional to evaluate what went wrong — and by how much. ■

How to unlock "key person" risk in divorce cases

In divorce, when a marital estate includes a closely held business interest, its value can have a significant impact on the division of assets, as well as in the determination of support payments. If the owner-spouse or another individual disproportionately accounts for the business's success, it's important to consider whether the risk of losing such a "key person" warrants an adjustment to the company's value.

What's a key person discount?

A key person discount may be appropriate if a single owner or employee who would be difficult to replace is responsible for much of the company's profitability and continued viability, especially when none of the company's management team members are qualified to assume the key person's responsibilities. The discount — usually a specific dollar amount or percentage — is taken to reflect the actual or potential departure of a key person.

Instead of taking a separate, discrete discount at the entity level, some experts incorporate a key person discount into their valuation methodology. For example, under the income approach, a valuation expert might adjust the discount rate, capitalization rate or projected cash flows to reflect key person risks. Alternatively, an expert who uses the market approach might adjust the pricing multiples to reflect this risk.

When are key person risks relevant?

Owning a small business isn't enough to justify a key person discount. These adjustments are typically reserved for situations in which an individual has:

- Management or leadership skills that can't be replaced at a comparable cost,
- Close relationships with stakeholders (such as suppliers, customers, investors and lenders) that allow the company to get more favorable deals than it otherwise would,
- Rare technical knowledge or skills that help the company stay at the forefront of the industry, or
- Unusual employee loyalty such that his or her departure could trigger a mass exodus of important staff.

Though key person discounts are typically associated with professional practices, they have also been applied to manufacturing and retail companies. Also note that courts appear most likely to accept a key person discount for going-concern businesses where the key person is free to leave and compete with the company. So, the existence of valid employment or noncompete agreements may offset the key person discount.

A common pitfall

Dependence on a key person can be a costly gamble if he or she unexpectedly leaves. Valuation professionals and attorneys must take care, though, to ensure that the risk isn't double counted. If the discount has already been incorporated in the expert's methodology, a separate key person discount at the entity level shouldn't also be applied. ■