BCC Advisers Litigation & Valuation Report

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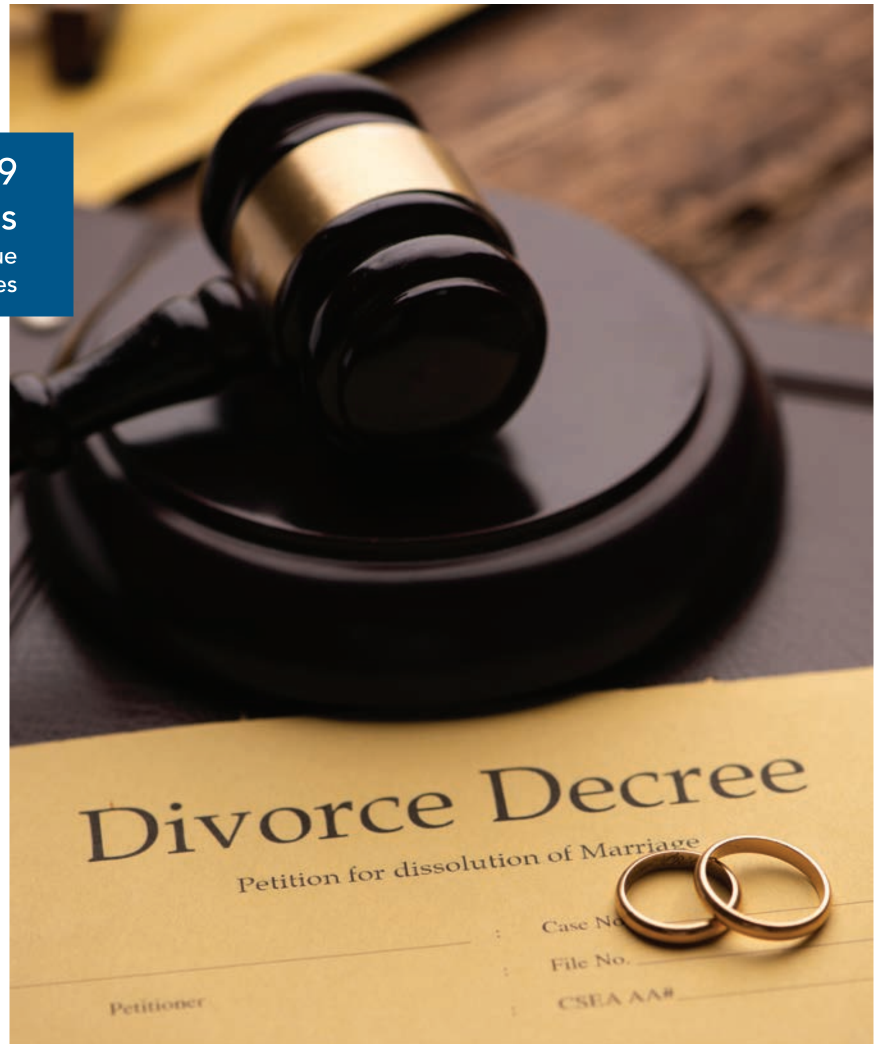
Pandemic creates unique business valuation challenges



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How COVID-19 affects divorce cases

Pandemic creates unique business valuation challenges

The COVID-19 pandemic has had a devastating impact on the economy and created significant uncertainty. For couples involved in divorce proceedings, the current environment presents unique challenges as the parties strive to reach an equitable property division agreement.

Matter of fairness

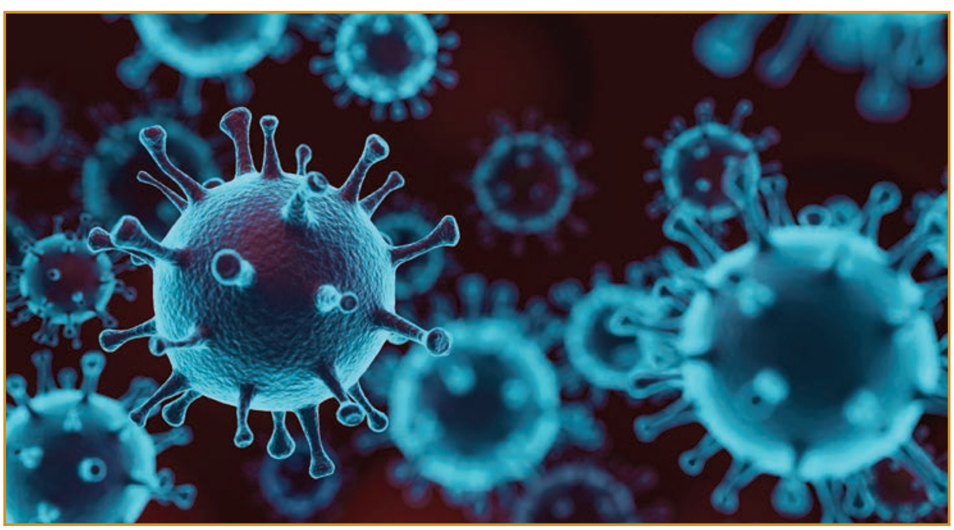
In both equitable distribution and community property states, fairness is a primary concern. Rarely is ownership of a business, real estate, retirement accounts or another marital asset simply split 50-50 between the spouses. Rather, courts are more likely to award a business to the spouse who's active in operating it and a home to the spouse who continues to reside there. To achieve fairness, the parties will work out an agreement to compensate the other spouse by 1) paying him or her a percentage of the asset's value, or 2) awarding him or her another marital asset of comparable value.

Achieving a fair property division can be challenging in volatile economic times. For example, Mr. and Mrs. Smith reached a property division agreement on January 1, 2020. Under the agreement, Mrs. Smith would keep the family home, and Mr. Smith would retain his closely held tool-and-die shop. Both assets were valued at $1 million as of January 1.

After multiple COVID-19-related postponements, the couple's property division hearing will be held on September 1, 2020. As of the new trial date, however, the value of the business is only $700,000, while the home's value is still $1 million. Is the original agreement still fair? Should the parties return to the negotiating table?

Known vs. knowable

Often, the valuation date is the date of separation or the date the divorce complaint was filed. But what happens if divorce proceedings are initiated in late 2019 or early 2020, and the value of a business has declined dramatically as a result of the pandemic? A business's value is generally based on facts that were "known or reasonably knowable" on the valuation date. Subsequent events that affect value — but fail to meet this standard — are usually disregarded. However, professional standards generally require valuators to disclose subsequent events in their reports and explain how those events affect value.



For valuation dates that are later in the year, the pandemic's impact may be clearer. But uncertainty over the future still creates business valuation challenges. Will the business recover? If so, how long will it take? Will it bounce back quickly once the pandemic ends, or has it suffered more lasting damage? Different types of businesses have been

To double-dip or not to double-dip?

In a divorce context, more than half the states prohibit double-dipping. This refers to using the same future business income stream to determine 1) the business's value as a marital asset, and 2) the business owner-spouse's ability to pay spousal support. Double-dipping is generally viewed as unfair, but courts may sometimes permit it under certain circumstances.

For example, in a recent case — *Kim v. Kim* — the Court of Appeals of Ohio, Ninth District, upheld the trial court's use of the same income stream to value the husband's business and determine income available for spousal support. The appellate court found that Ohio statutory law precludes an outright prohibition of double-dipping, because it requires courts "to consider all sources of income, including income derived from a marital asset divided in the property distribution, in determining spousal support." At the same time, the impact of double-dipping should be considered, with an eye toward avoiding unfairness.

In *Kim*, the trial court concluded that, based on case facts, equity didn't require a "double-dipping offset." Among the facts the trial court cited were:

- The "huge disparity" in the parties' income,
- The wife's lost income capacity as a result of her homemaking and child care responsibilities, and
- The fact that the husband's salary and distributions from the business were entirely within his discretion and control.

In particular, Mr. Kim's average income was more than half a million dollars, while Mrs. Kim earned only $45,000 per year. The appellate court agreed with the trial court's interpretation of the facts at hand, noting that some circumstances, including disparity in income between the parties, may "override the unfairness in double-dipping."

affected by COVID-19 differently — and some have even flourished during the pandemic.

During this volatile time, valuation experts are likely to emphasize income-based valuation techniques, such as the discounted cash flow and capitalization of earnings methods. These techniques can be adjusted to reflect current business disruptions while capturing a projected return to a "normal" level of profitability. Predicting if, and when, that will happen is no easy task, however.

Flexibility is key

Today, divorcing couples need to keep their options open. They might consider waiting to see how the recovery goes before finalizing their divorce settlements — or at least reserve the right to adjust those settlements to reflect future developments. And, for existing agreements, your clients might consider asking the court to change the valuation date or otherwise modify their agreements in the interest of fairness. ■

Factor current risks into the cost of capital

Estimating discount rates is a complex task — even in the best of times. But today's uncertain economy has forced valuation experts to re-evaluate traditional methods of quantifying discount rates. Discount rates take into account the time value of money. These rates may be used when valuing a business under the income approach or as a "hurdle" rate when evaluating capital budgeting decisions.

Equity vs. WACC

Equity investors and lenders require a certain "return" to compensate them for letting borrowers use their money. The level of return depends on the perceived risk of the investment. In general, a high-risk investment requires a *high* return, which equates with a *low* price.

In today's volatile marketplace, what return do equity investors and creditors expect? Business valuation experts ask this question when they quantify the discount rate (also known as the cost of capital). The discount rate may be based on either:

- The cost of equity, or
- The blended cost of debt and equity capital, sometimes known as the weighted average cost of capital (WACC).

Experts may use the cost of equity as a discount rate or as a key component of the WACC, depending on the income stream being discounted (equity or invested capital).

Sources of empirical data

Building up the cost of equity usually starts with estimating the risk-free rate. Long-term Treasury bond rates — which are commonly used to estimate this rate — have dropped significantly compared to historic rates.

Equity risk premiums are another key component of the cost of equity. When estimating the cost of equity, valuation experts can refer to several data sources, including Duff & Phelps and Morningstar. Moreover, they can refine the data — by size and industry code, for example — to obtain a more comparable sample. In today's markets, public stock prices have fallen because the perceived risk has increased, and investors are demanding higher returns. Some experts advocate using current rates of return over historic long-term rates.

Another component of the WACC is the cost of debt. Though the costs of business loans are currently near historical lows, there are generally fewer tax breaks for using debt financing. In prior years, experts factored a "tax shield" into their cost of debt to reflect the deductibility of business interest expense. However, current tax law limits deductions for business interest expense for larger businesses. Plus, distressed companies generally don't generate taxable income, so there's little if any current tax benefit to paying interest.

Furthermore, in today's distressed economic conditions, a company's access to capital may be limited. This may affect its capital structure in the future.

When sources of borrowing are limited, shareholders may be asked to contribute additional funds or forgo distributions to help keep the business afloat. To the extent that a company relies more on equity financing and less on debt financing, its weighted average cost of capital will increase.

Word of caution

Valuation is said to be a "prophecy" of the future. While no one can predict the future with 100% accuracy, detailed market and industry research can help support discount rates. The COVID-19 crisis has had a material negative effect on many businesses. This being the case, historic performance may not always be a reliable predictor of future performance.

A company's historic cost of capital may need to be adjusted to reflect current market conditions. When factoring financial distress into the valuation equation, it's important to avoid double-counting risk factors when quantifying the discount rate and elsewhere in their calculations (such as when they quantify earnings streams and marketability discounts). An experienced valuation professional can estimate a discount rate that's based on detailed market and industry research. ■

Grieve v. Commissioner

Subsequent events: Tax Court rejects speculative assumption

In *Grieve v. Commissioner*, the taxpayer transferred a nonvoting stake in a limited liability company (LLC) to a grantor retained annuity trust (GRAT). The LLC held roughly $9.1 million of cash and publicly traded stock, and the taxpayer's valuation expert applied a 35% combined discount for lack of control and marketability to the value of the gift.

The IRS issued a $4.3 million deficiency notice, plus accuracy-related penalties for a substantial gift tax valuation understatement. Here's how the taxpayer prevailed in the U.S. Tax Court.

Background

The LLC had two types of ownership interests:

- 20 voting class A units (0.2% of the total units), and
- 9,980 nonvoting class B units (99.8% of the total units).

All class A units were owned by the taxpayer's daughter. Owners of class B units couldn't vote on or participate in any proceedings in which the entity or its members took action. The LLC agreement also contained various provisions that restricted transfers of membership units, including full consent of all owners of class A units for transfers to nonfamily members.

> *The Tax Court can consider subsequent events only if they're "fairly shown to be reasonably probable."*

The taxpayer hired a valuation expert to value the transfer of the class B units to the GRAT on November 1, 2013. The expert valued the gift at only $5.9 million on a minority, nonmarketable basis, using the adjusted net asset method. The value included a 13.4% discount for lack of control and a 25% discount for lack of marketability. Valuation discounts are multiplicative, not additive. So, the effective combined discount was 35%.

The IRS disputed the fair market value of the gift. The IRS's expert assumed that a hypothetical seller of the class B units would first look to acquire control of the 0.2% interest held by the class A unit holder to avoid the large discounts that a willing buyer would seek for buying the class B units. He valued the Class B units at $9 million.

Taxpayer victory

The value set forth by the IRS's expert was contingent on an additional action from a hypothetical buyer: the purchase of the class A voting units. The IRS's expert testified that a buyer would pay a 5% premium to acquire control. However, the sole owner of these units, the taxpayer's daughter, testified that she had no intention of selling the units. (As of the date of the court opinion, no sales or offers had occurred.)

Additionally, the taxpayer's daughter told the court that she'd demand a substantial premium if she ever decided to sell the units. Plus, if a sale were made to someone outside of her family, she'd also expect to receive a management fee.

Citing *Olson v. United States*, the Tax Court said it could consider subsequent events only if they're "fairly shown to be reasonably probable." Conversely, considering *improbable* subsequent events would "allow mere speculation and conjecture to become a guide for the ascertainment of value."

The taxpayer's expert supported his valuation discounts with empirical studies and tied them to facts of the case at hand. The IRS's expert didn't provide any detailed analysis related to these discounts. So, the court agreed with the $5.9 million valuation set forth by the taxpayer's expert.

Building a solid foundation

Speculative assumptions that aren't reasonably probable on the valuation date won't stand up in Tax Court. A comprehensive written valuation report from a credentialed valuation expert can help the court understand the assumptions underlying a federal gift or estate tax return. ■

Estimating lost profits using the before-and-after method

In *Memorial Hermann Health System v. Gomez*, the Court of Appeals of Texas, First District, upheld an award of $6 million in compensatory and punitive damages to a cardiovascular surgeon. His employer raised several issues on appeal, including an argument that evidence of lost profits was legally insufficient. The appellate court disagreed.

What happened?

A surgeon sued his former employer, Memorial Hermann Health System (MHHS), for defamation and business disparagement. The doctor alleged that MHHS had used misleading mortality rate data and a whisper campaign to defame him and disparage his practice.

The doctor hired a forensic accountant to estimate lost profits. The expert compared his cardiothoracic surgical activity before and after the alleged defamation. However, she disregarded the doctor's vein practice, largely a side business involving cosmetic procedures that a physician's assistant or nurse practitioner could perform.

> ***The expert's conclusions were persuasive, because she'd presented a range of projections and ruled out other plausible causes for lost business.***

How were damages estimated?

The doctor's expert examined data from before the alleged defamation and extrapolated what his practice would have looked like — and the amount of profits he would have earned — but for the defendant's alleged wrongful conduct. The expert determined that he could have performed 258 surgeries per year. She subtracted his actual profits from this amount to arrive at his lost profits.

The expert saw no evidence that the practice had begun to recover. In fact, it had continued to decline. She provided the jury with a range of damages estimates, from $2 million to $5.6 million, based on various growth scenarios.

The expert also considered other potential causes of lost profits — including general market conditions and the doctor's own actions — but found none. She noted that other MHHS surgeons had experienced increases in their practices during the same time period. MHHS had pointed out that the doctor was making more money at the time of trial than he was before the defamation. But the expert testified that, but for the defamation, he would also have enjoyed income from a thriving cardiovascular surgery practice. She further testified that, if those surgeries had been available, his vein practice wouldn't have cut into his surgical practice, because he could have turned the vein procedures over to a nurse practitioner.

How did the court decide?

The court concluded that the evidence was sufficient to support the damages award. It found that the expert's methodologies and supporting data were reliable. Her conclusions were also persuasive because she'd presented a range of projections and ruled out other plausible causes for lost business.

This case underscores the importance of hiring a credentialed expert to estimate lost profits. Courts favor comprehensive analyses that consider multiple factors — including some that may not support the client's financial interests.