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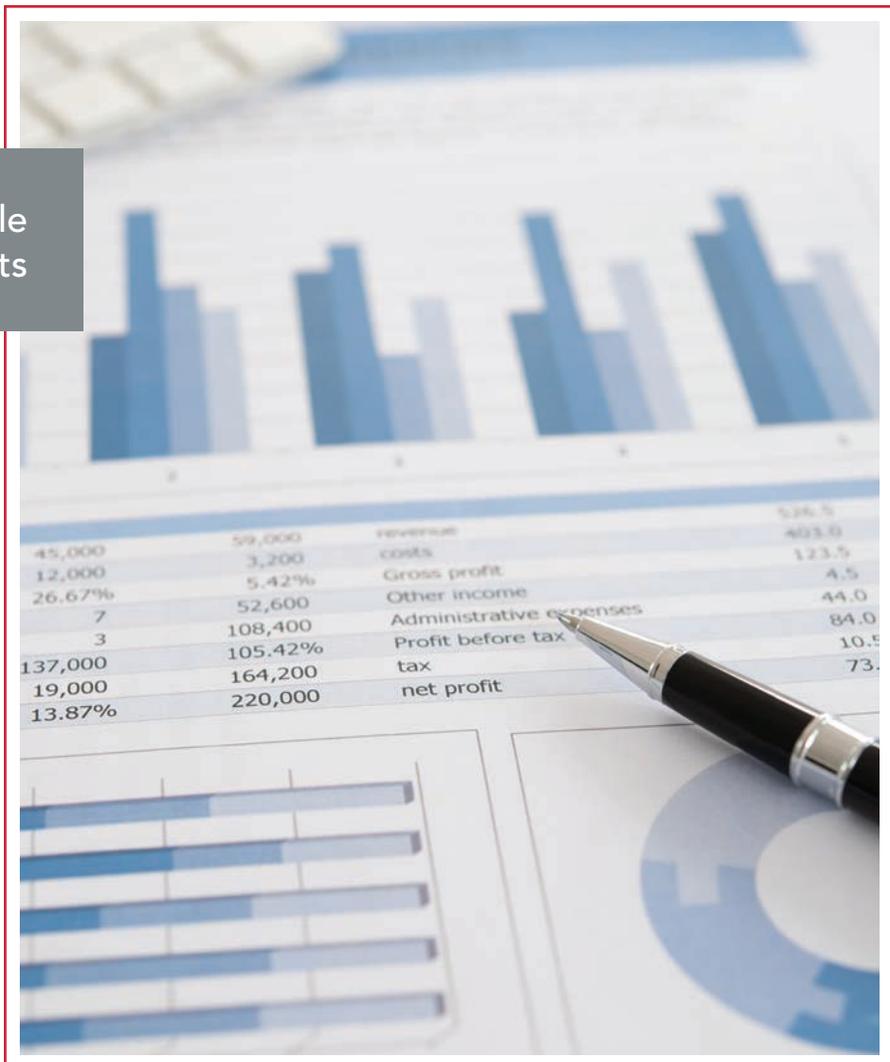
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Shareholder buyout: Battle of the valuation experts

In a recent New York buyout case — *Sergio Magarik v. Kraus USA, Inc.* — the sole issue before the court was the fair value of the petitioner’s interest in the respondent corporation. The outcome turned on the credibility of opposing valuation experts and the soundness of their methods.

Case facts

The case involved a privately held corporation and internet-based seller of imported plumbing fixtures that was formed in 2007. The petitioner was a minority shareholder who held 24% of the company’s shares. The company enjoyed rapid growth. Though its sales grew from \$21 million in 2012 to \$36 million by 2015, the company was saddled with negative cash flow and significant debt.

On September 21, 2015, the minority shareholder petitioned for dissolution of the corporation and sought damages from the other owners on grounds of shareholder oppression. The respondent shareholders elected to exercise their statutory right to buy the petitioner’s interest for fair value. As a result, all other claims and counterclaims were dropped, and the sole issue for the court was the fair value of the petitioner’s interest.

Valuation approaches

Both experts used a combination of the income and market approaches to value the company. The petitioner’s expert valued the company at \$21.9 million under the discounted cash flow (DCF) method (income approach) and \$38.8 million under the guideline public company method (market approach). He averaged the two to arrive at a value of roughly \$30 million.

The respondents’ expert computed preliminary values under the income approach using the

capitalization of earnings method (\$6.16 million) and DCF method (\$6.1 million and \$5.9 million). His market approach valuation, based on the “merged and acquired company method,” produced values ranging from \$5.26 million to \$6.1 million. Assigning greater weight to the income approach, the expert valued the company at \$6.05 million.

Court ruling

In its post-trial decision, the court highlighted several flaws in the methods used by the petitioner’s expert:

- ◆ His income projections were unrealistic. He relied heavily on projected earnings prepared by the company’s controller in connection with a loan application. These projections were “ambitious, and, in fact, were overstated.” The company never realized these projections.
- ◆ His valuation failed to sufficiently account for the competitive nature of the company’s internet business and its lack of cash flow.
- ◆ The valuation overestimated the value of the company’s brand, which the company didn’t even own.
- ◆ His application of the market approach relied on “incorrect comparables” that were publicly traded and not reasonably comparable to the subject company in terms of size, ownership or marketability.



Court faced with monumental valuation challenge

In *William Richard Kruse v. Synapse Wireless, Inc.*, the sole issue was the fair value of a dissenting shareholder's interest in the company before its 2016 merger. The Delaware Chancery Court attempted to arrive at a reasonable valuation, even though it was provided with unreliable estimates from both sides.

The experts' cases reached "monumentally different" conclusions: The dissenting shareholder's expert opined that the company was worth \$4.1876 per share at the time of the 2016 merger. The company's expert provided a range of values from \$0.06 to \$0.11 per share.

Both experts relied on these three valuation techniques:

1. Prior purchases of the company's stock,
2. Comparable transactions, and
3. Discounted cash flow (DCF) models.

The court rejected the experts' market-based analyses. It determined that previous prices didn't result from a competitive sales process and their comparable transactions analyses had significant flaws.

The court also criticized management's projections, which both experts relied on in their DCF analyses. It found that these analyses were "difficult to reconcile with [the company's] operative reality."

The court noted that, in a typical litigation context, absent reliable evidence, a fact finder might conclude that neither party is entitled to a verdict. However, that's not an option in statutory appraisal cases.

Under these circumstances, a court is free to wholly or partially adopt the more credible valuation. In this case, the court accepted the DCF valuation prepared by the company's expert, with minor adjustments. It explained that the expert "credibly made the best of less than perfect data to reach a proportionately reliable conclusion." Based on this approach, the court set the fair value at \$0.228 per share.

The court concluded that the vast disparity between the income and market valuations underscored "mistaken premises and assumptions." In contrast, the court explained that the methodology used by the respondents' expert provided "a realistic assessment" of the company's fair value.

The court applied a discount for lack of marketability of 5%, rather than the 25% discount suggested by the respondents' expert. As a result, the court

concluded that the fair value of the petitioner's interest was \$1,379,400 (24% × \$6.05 million, less a 5% discount for lack of marketability).

Valuable lesson

In this case, the court's fair value calculation was only one-fifth of the amount sought by the petitioner. This case illustrates the profound impact of a credible valuation based on sound assumptions and methods. ■

How to calculate damages in fraud cases

When courts order restitution from fraud, it may be difficult to determine how much the company has actually lost.

Forensic accounting experts can help fraud victims calculate damages in accordance with state laws and prepare presentations that convince judges to accept their conclusions.

Evaluating case specifics

Calculating restitution seems easy, right? If an employee steals inventory worth \$20,000, he or she should repay that amount, perhaps with interest. However, the calculations get more complicated when a business's profits are lost because of the fraud.

The calculation varies from state to state, and even from case to case, but forensic accountants typically determine damages using either:

1. The "benefit of the bargain" method, or
2. The "out of pocket" method.

What's appropriate depends to some degree on the location and nature of the fraud. For example, a hypothetical company decides to buy and race a thoroughbred horse for promotional purposes. A horse dealer locates a suitable animal valued at \$950,000, but offered at \$800,000 because the current owner is retiring.

Many victims seek both civil judgments and criminal convictions against fraud perpetrators.

In truth, however, the owner is selling the horse because it hasn't lived up to expectations. The horse is actually worth only about \$700,000 — information the dealer has known for several weeks. Putting aside the buyer's failure to perform proper due diligence, how much should it be able to expect in restitution?



Under the out-of-pocket method, the company would be awarded \$150,000 in damages, or the difference between the horse's real value and the amount paid for it. Using the benefit-of-the-bargain method, damages would be calculated at \$250,000 — the difference between the dealer's misrepresented value and the animal's true worth.

Applying the benefit-of-the-bargain method

Fraud victims usually prefer the benefit-of-the-bargain method. It allows them to recover not only their actual losses and fraud-related expenses, but also the lost profits on their investments.

There are several approaches accountants may use to calculate lost profits when the benefit-of-the-bargain rule applies, including:

Yardstick approach. Here, the company's profits are compared to those of a similar company that wasn't defrauded.

Hypothetical approach. After gathering marketing evidence that demonstrates potential lost sales, the expert subtracts costs that would have been associated with the lost sales to arrive at lost profits.

Before-and-after approach. Under this method, damages are based on the difference between 1) the company's profits before and after the fraud,

and 2) the company's profits while the fraud was being committed.

The appropriate method for calculating damages will vary according to the specifics of each case. Experts must work with attorneys to determine what's appropriate.

Beware: Net income rarely is the basis for assessing lost profits. Lost-profit awards are taxable, which means they're calculated on a *pretax* basis, making net income invalid for computational purposes.

Pursuing civil remedies

Establishing damages for restitution is one thing. Collecting them may be more difficult. In many criminal cases, perpetrators aren't required to begin paying restitution until they're released from prison. In addition, victims who aren't named in indictments handed up against the fraudster aren't eligible to receive restitution. And, in many cases,

the perpetrator already has spent the proceeds of the fraud — or hidden them in other people's names or offshore bank accounts or trusts.

For these and other reasons, many victims seek both civil judgments and criminal convictions against fraud perpetrators. Civil actions can force crooks to sell or forfeit assets to help pay restitution. Also, while criminal orders affect only property of the defendant, civil forfeitures can include assets taken by family members or friends of the perpetrator. Filing a civil action has no effect on criminal proceedings, and victims may receive restitution orders from either or both.

Getting it right

Companies that have been struck by fraud understandably want to receive the highest restitution award available. A fraud expert can help evaluate the facts of the cases and select the most appropriate method to calculate damages. ■

Researching the effect of COVID-19 on the DLOM

Business valuation experts often apply a discount for lack of marketability (DLOM) when valuing a private business interest. This adjustment reflects the relative difficulty of converting the interest into cash, quickly and at minimal cost, compared to publicly traded stocks. The discount is typically stated as a percentage of the interest's value.

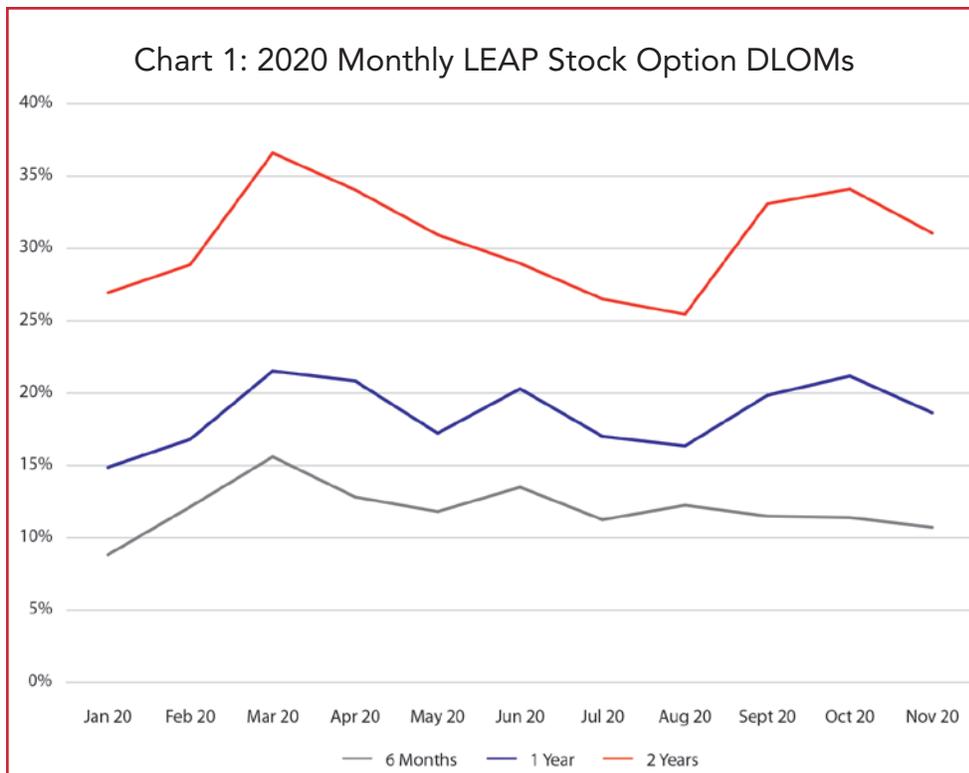
The DLOM is derived from various empirical studies and then it's adjusted based on the characteristics of the subject company, the size of the business interest and current market conditions. During the COVID-19 pandemic, market conditions changed swiftly and dramatically. Here's an overview of how the DLOM has been affected.

Empirical discount studies

Common sources of empirical data used to quantify a DLOM include:

Restricted stock studies. Restricted stock is identical to freely traded stock, except that it's subject to a minimum one-year holding period. A restricted stock study compares restricted stock prices to freely traded stock prices on the same day to estimate the discount for lack of marketability.

Pre-initial public offering (pre-IPO) studies. The Securities and Exchange Commission requires companies to disclose all stock transactions (including stock options and convertible preferred stock) within three years of going public. A pre-IPO study



compares these private transactions to the company's IPO price.

Stock option studies. These studies derive discounts from puts and/or calls on publicly traded stock options known as long-term equity anticipation securities (LEAPs). *Put* options give the holders the right to *sell* the stock at a certain price in the future; they are typically issued at or below the current market value. *Call* options give the holders the right to *buy* the stocks at a certain price in the future; they allow the holders to "call" away shares at a higher price in the future.

A discount based on LEAP puts and calls reflects what the universe of buyers and sellers have agreed upon as a price that they would relinquish or acquire shares for in the future compared to the current stock price. Discounts also reflect factors such as time, volatility and dividend yield.

2020 trends

COVID-19 has had adverse effects on many sectors of the economy. It has caused significant market

volatility and uncertainty since the economy was temporarily shut down in March 2020. Has the pandemic affected the marketability of business interests?

LEAP stock option discount data released by MergerShark, a proprietary source of M&A and business valuation data, may provide an answer. The 2020 data indicates that the COVID-19 pandemic has increased discounts, which means companies are *less* marketable. The database

includes LEAP put and call options from a sample group of 30 large publicly traded U.S. companies, such as Nike, Starbucks and Microsoft. This diverse sample group provides a reliable, market-based proxy for valuation discounts.

Chart 1 shows a large spike in discounts from January to March across the 6-, 12- and 24-month periods, reflecting the stock market's significant decline as well as the uncertainty surrounding the future. Although the stock option-based discounts remained elevated in November from the start of the year, discounts have fallen due to the market's apprehension as reflected in the March stock market lows. The MergerShark 2020 averages are roughly 15% *higher* than the historic averages for such monthly discounts over the past five years.

Custom approach

When quantifying a DLOM for a privately held business, it's important to factor in current market conditions, including the effects of the COVID-19 crisis. Each company is unique. Contact a valuation advisor to understand what's right for the case at hand. ■

Are retained business earnings marital property?

The Court of Appeals of Michigan recently addressed whether a business's retained earnings should be included in a marital estate, if the business is one of the spouse's separate property. In this issue of first impression in the state, the appellate court declined to adopt a bright-line rule. Instead, it found that trial courts should make this determination on a case-by-case basis.

Competing valuations

In *Jensen*, the husband had significant premarital assets, including a commercial truck customizing business. Each spouse presented expert testimony at trial on the business's value.

Both experts used the income approach, calculating the company's earnings before interest, tax, depreciation and amortization (EBITDA) margin. They arrived at comparable values at the beginning of the marriage (\$2.29 million by the wife's expert and \$2.46 million by the husband's expert).

However, there was a substantial difference in their opinions of value at the time of separation. The wife's expert valued the business at \$4.33 million. And the husband's expert valued it at \$2.86 million.

The trial court found the value set forth by the husband's expert to be more credible, noting that it "involved seeing the site, interviewing the owner of the business, [and] understanding the business in more detail." The appellate court upheld that conclusion.

Treatment of retained earnings

On appeal, the wife's attorney argued that the trial court should have awarded her a portion of the company's retained earnings generated during

marriage, at least to the extent that the company's value hadn't increased by an amount that was equal to or greater than those retained earnings. However, under Michigan law, the treatment of earnings retained by a separately owned business wasn't clear.

The appellate court ruled that retained earnings are generally presumed to be separate property, unless the nonowner spouse demonstrates that some or all of those earnings should be included in the marital estate. Factors to consider include:

- ◆ The owner-spouse's authority to distribute earnings,
- ◆ The business's historical operations and need for operating capital,
- ◆ Whether the owner-spouse was reasonably compensated, and
- ◆ Whether the owner-spouse deliberately caused the business to retain earnings "to deprive the marital unit of income."

Based on a review of these factors, the appellate court found that it wasn't improper for the trial court to treat retained earnings as separate property in this case.

Lessons learned

Legal precedent related to business valuations and the use of expert witnesses in divorce tends to vary from state to state. It's important to review emerging trends in other states, especially if you encounter a case that involves a financial issue that hasn't been addressed by courts in your jurisdiction. ■



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