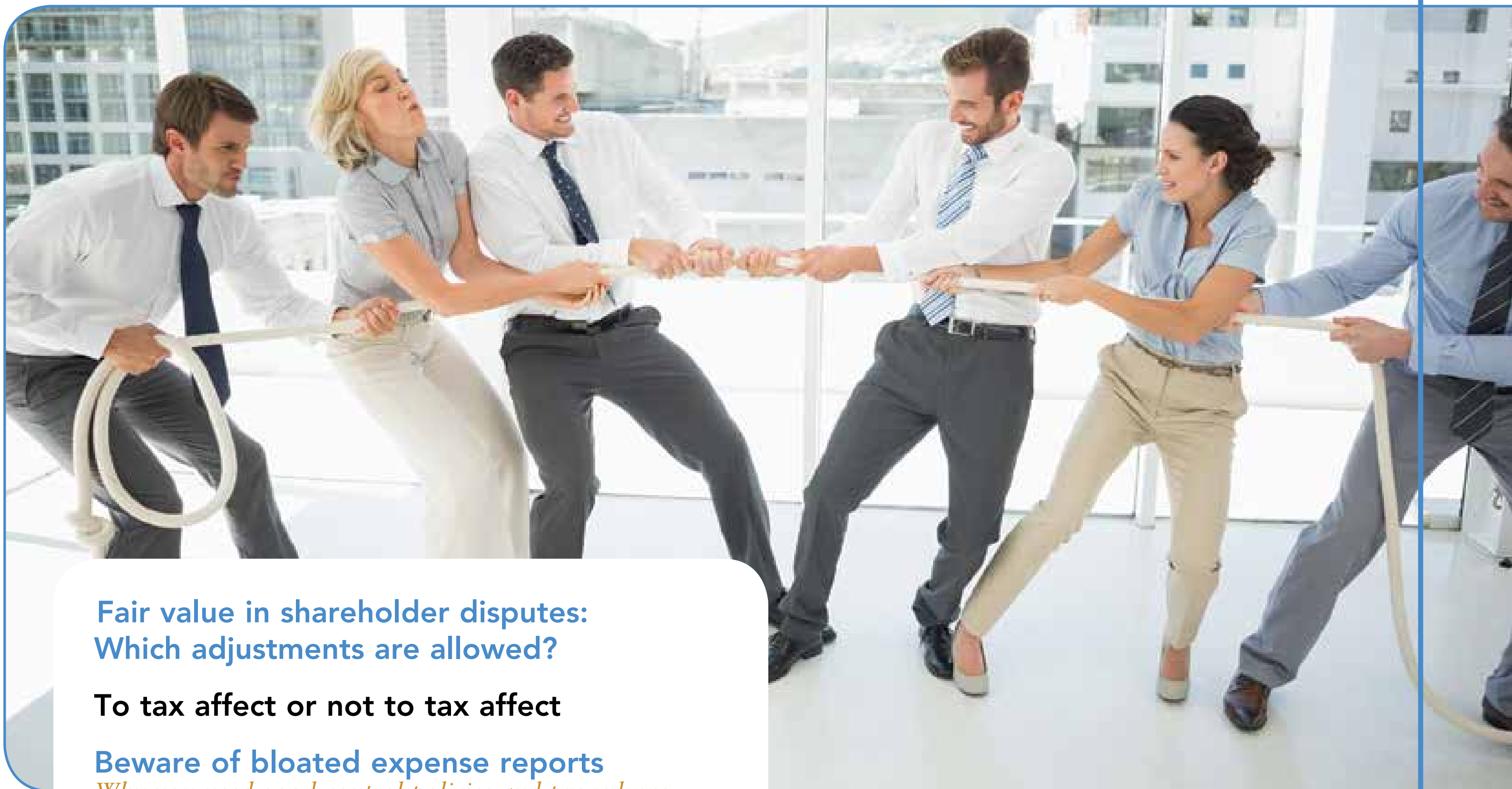
Advocate's EDGE



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Fair value in shareholder disputes: Which adjustments are allowed?

In disputes involving dissenting or oppressed minority shareholders, fair value is the sought-after standard of value. One of the most contentious issues when calculating fair value is: Which valuation adjustments apply? That question was up for debate in a recent case decided by the Utah Supreme Court. (Bear in mind that the fair value standard is defined by state law and court interpretations may vary from jurisdiction to jurisdiction.)

SHAREHOLDER DISPUTE LANDS IN COURT

The case arose when two minority shareholders in Utah Resources International (URI) objected to the company's June 2004 share consolidation transaction. Utah law provides that shareholders can dissent from certain corporate transactions and requires the corporation to pay the dissenting shareholders fair value for their shares.

Not surprisingly, URI and the dissenters disagreed on the fair value of the shares, so URI petitioned the court to determine their fair value. The trial court appointed an appraiser and concluded that the fair value was more than twice the amount proposed by URI. On appeal, the Utah Supreme Court considered whether the lower court had erred in disallowing the following four types of adjustments when determining the fair value of the shares.

1. TRANSACTION COSTS

The court-appointed appraiser reduced the gross value of URI's real estate for anticipated broker commissions and closing costs. The trial court rejected this discount. But the Utah Supreme Court upheld it because URI's undisputed business strategy as of the valuation date was holding and selling its real estate. It was reasonably foreseeable that URI would incur these costs when it sold the real estate, so the court ruled it was appropriate to consider reasonable transaction costs when determining the fair value of the minority interests.

2. BUILT-IN GAINS

The court-appointed appraiser also reduced the value of URI's real estate to account for "built-in" capital gains taxes. In rejecting this deduction, the trial court relied on case law that rejected use of a built-in gains deduction where the company had no plan to sell its assets prior to the triggering event.

The appellate court noted that URI's business plan before the share consolidation transaction included selling all of its real estate. Failing to account for the built-in capital gains taxes would give the dissenters a windfall because, even if the share consolidation transaction had never occurred, URI would have sold the real estate and paid the tax, thereby reducing the value of their shares. Moreover, the Utah Supreme Court found that it's a generally accepted financial technique to consider reasonably foreseeable taxes.

3. TAXES ON ROYALTY INTERESTS

The appellate court also held that the trial court had erred in rejecting a deduction for income taxes on URI's oil and gas royalty interests. It noted that the appraiser had valued the interests using an income approach and explained that "not only is it appropriate to consider tax rates in conducting an income approach valuation, it is necessary." According to the court, the appraiser should have either applied an after-tax discount to the after-tax revenue stream or applied a pretax discount rate to pretax revenues. The trial court, though, mistakenly required him to do neither and instead had him apply a posttax discount rate to a pretax revenue stream.

4. ASSET-LEVEL DISCOUNT FOR LACK OF CONTROL

Under the Utah dissenters' right statute, the fair value of a dissenter's shares is his or her proportionate share of the value of 100% of the company's equity. Therefore, shareholder-level discounts for lack of control and marketability are legally prohibited.

However, URI owned a minority interest in a separate company. This interest was a separate asset on URI's balance sheet. Nothing in the Utah dissenters' right statute prevents appraisers from taking a discount for lack of control at the *asset* level when determining fair value. The Utah Supreme Court found that URI's lack of control over this asset affected every shareholder — majority or minority — on a pro rata basis, so the asset-level discount wasn't inherently unfair.

A CASE-BY-CASE ANALYSIS

The Utah Supreme Court's ruling demonstrates that the appropriateness of certain adjustments frequently turns on the circumstances of a case. A qualified valuator can help ensure that proper discounts are applied and an accurate value calculated.

NEW YORK COURT REJECTS MANDATORY DLOM

A New York court recently weighed in on the issue of shareholder-level marketability discounts in shareholder disputes. The case was an appraisal proceeding where both sides agreed that a neutral appraiser's report would serve as a starting point for determining the fair value of the dissenting shareholder's shares. The appraiser applied a 30% discount for lack of marketability (DLOM), which became a matter of dispute.

The plaintiff claimed that state law required a DLOM. The court disagreed. It found that the rationale for applying a DLOM — that a frozen-out, minority shareholder should recover less to reflect that the company as a whole can be difficult to sell — didn't apply, because an actual sale of the company was "highly unlikely."

To tax affect or not to tax affect

When valuing an interest in an S corporation, tax affecting — reducing the business's projected future income for hypothetical corporate income taxes — has been a subject of debate for many years. The courts have sent mixed signals on whether tax affecting is appropriate for S corporations. But the IRS, as recently as last fall, has opposed the practice when valuing minority interests.

NOTABLE CASES

Until the U.S. Tax Court considered the issue in 1999 in *Gross v. Commissioner*, appraisers generally valued S corporations as having the same value as otherwise identical C corporations. To do so, a valuator would reduce an S corporation's earnings for corporate-level taxes as if it were a C corporation. In *Gross*, however, the court found that S corporations are more valuable because of their preferential pass-through tax treatment, rendering such tax affecting inappropriate. The Sixth Circuit Court of Appeals affirmed the Tax Court's ruling in 2001.

According to the IRS, tax affecting essentially — and inappropriately — eliminates from the buyer pool all types of buyers who can benefit from pass-through taxation.

In 2006, though, the Delaware Chancery Court took a different approach. In *Delaware Open MRI Radiology Associates v. Kessler*, the court found that treating an S corporation as a C corporation with a full tax affecting would materially undervalue the business. Nonetheless, it concluded that some degree of tax affecting was appropriate. The court took a hybrid approach designed to capture the tax benefit that S corporation owners receive because their dividends aren't subject to corporate taxes. It ultimately applied a "pre-dividend" corporate tax rate of 29.4% to the S corporation's earnings.

Six years later, the Massachusetts Appeals Court, in *Bernier v. Bernier*, explained that *Kessler* requires asking "if the S corporation … were a C corporation, at what hypothetical tax rate could it be taxed and still leave to shareholders the same amount … as they would have if they held shares in an S corporation?"

In *Bernier*, the court said, the answer was 0% because both the avoided dividend tax rate and the applicable personal income tax rate were 40%. It distinguished between failing to tax affect at all and using a 0% tax-affecting rate reached through application of all relevant rates.

THE IRS STANCE

In October 2014, the IRS issued a guide for its valuation analysts on valuing minority interests in S corporations. The guide posits that, if a mixed pool of potential buyers exists for such an interest, the buyer that would benefit from an S corporation's pass-through taxation will drive the ultimate transaction price, all other things being equal.

A rational seller wouldn't ignore this buyer in favor of one who couldn't take advantage of the tax savings and would therefore pay less. The guide says that a C corporation (or other buyer that wouldn't benefit from pass-through tax savings) would likely emerge as the highest bidder for a minority interest in an S corporation only in rare circumstances.

According to the IRS, tax affecting essentially — and inappropriately — eliminates from the buyer pool all types of buyers who can benefit from pass-through taxation. The guide concludes that no corporate tax should be applied when valuing a minority interest in an S corporation in the absence of a compelling demonstration that independent third parties dealing at arm's length would do so as part of a price negotiation.

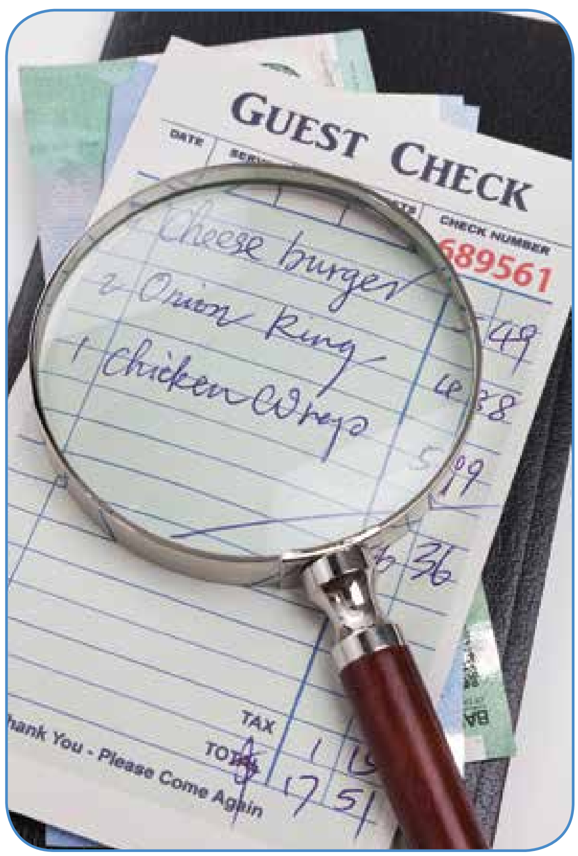
THE DEBATE CONTINUES

No definitive answer has yet been pronounced regarding the propriety of tax affecting an S corporation's earnings for valuation purposes. Until there is, valuators will need to make the determination on a case-by-case basis and explain any decisions to tax affect in detail.

Beware of bloated expense reports

Why you need good control policies and procedures

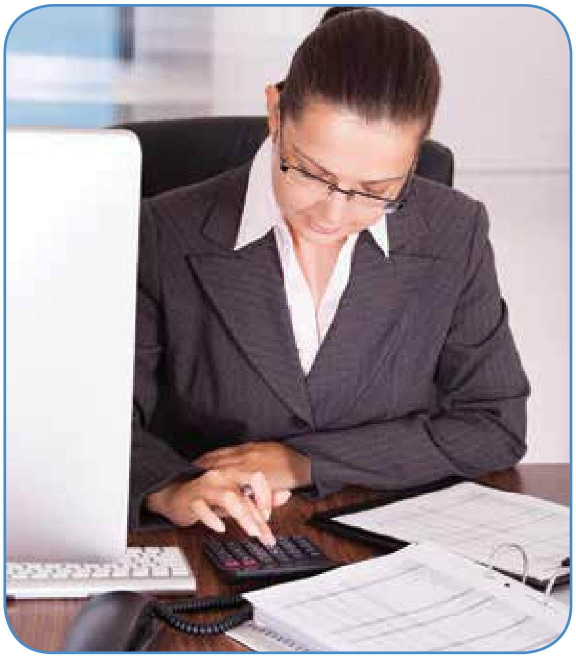
Expense account cheating is rampant in many businesses. Fortunately, there are ways to stop would-be thieves who overstate expenses, request multiple reimbursements, change numbers on a receipt and otherwise falsify their expense reports.



CATCHING A THIEF

There are as many ways to cheat on an expense account as there are employees willing to cheat. One of the most common methods is to mischaracterize expenses, using legitimate receipts for nonbusiness-related activities. If Robert treats his friend Todd to dinner, for example, that generates an actual receipt, but it shouldn't show up on Robert's expense account.

Requesting multiple reimbursements is riskier, but just as simple. If Robert wants his company to pay for Todd's dinner twice, he copies the receipt and turns it in on another expense report. Worse, he may attempt to be paid once for the bill, once for the receipt and once for the credit card statement.



Some employees simply overstate their expenses by doctoring supporting paperwork — for example, by changing a 3 to an 8 or a 1 to a 4 on a receipt. Then, there are cheats who invent expenses. For example, all David needs to do is ask a cab driver for an extra receipt, fill it out and turn it in for reimbursement.

These and other small expense account infractions can add up to outrageous sums. In one case, a top salesperson who traveled extensively for business was found to have defrauded his company of $30,000 over the course of three years by adopting a liberal definition of allowable business expenses.

IMPLEMENTING FRAUD POLICIES

In most cases, expense account fraud can be averted if companies implement fraud control policies and procedures and then *enforce* them. Too often, companies establish policies but fail to make sure they're followed correctly.

Once a company has an expense report policy in place, it should communicate it. Robert needs to know he can't take friends to dinner on the company dime, and David needs to understand that only business-related cab trips are reimbursable. This prevents misunderstandings and makes punishing infractions, when they occur, easier.

Also, managers should keep abreast of employee business travel plans and other activities that might trigger expense reports. If Jackie is based in Kansas City but submits a bill for a dinner in Chicago, her supervisor should have known about the trip before it happened. The supervisor should review every expense turned in and require original receipts for everything. If a photocopied receipt is necessary — and sometimes it is — the supervisor should inspect it carefully for signs of tampering.

While expense tracking software can't substitute for hands-on expense account reviews, it can help spot inconsistencies that develop over time. These programs make it easy to see if someone's expenses have soared in recent months or are noticeably higher than those of others in the same department.

A confidential fraud-reporting hotline is also a good idea. It encourages anonymous reports of misdoings and signals that the company is serious about eliminating fraud.

ANTIFRAUD POLICIES ARE KEY

At the same time, businesses need to take care that their antifraud policies are reasonable. If the official definition of reimbursable expenses is excessively narrow, some employees may be more inclined to lie on their expense accounts to make up for out-of-pocket expenditures.

Also, everyone in an organization must be held to the same standards. The owners/management can't be immune from scrutiny — especially because an owner/manager who cheats on an expense account may be perpetrating other forms of fraud, including falsifying financial records.

SYSTEMIC PROBLEMS

Unfortunately, fraud abounds in many business transactions. Although expense report fraud may *seem* trivial, perpetrators may use it to test the waters and then graduate to bigger and bolder scams. Forensic accounting experts can help companies unearth suspected expense reimbursement frauds and implement policies and procedures to keep fraud from recurring.

Computing trademark infringement damages

Trademark holders often turn to injunctive relief under the Lanham Act when their assets are infringed, asserting a likelihood of consumer confusion. But, if a trademark is infringed in a manner that causes *actual* consumer confusion, the holder could be entitled to both its own actual damages and the infringer's profits.

THE HOLDER'S LOST PROFITS

In the case of actual consumer confusion, the holder usually can recover its lost profits, including both past and anticipated future profits. Factors affecting the amount of recoverable profits include the presence and conduct of other competitors, general economic conditions and the holder's sales.

A court may award damages on an estimate of the sales the holder would have had "but for" the infringement, based on market share.

The holder's sales — before, during and after the infringement — are particularly critical. Lost profits might be based on a comparison of the actual sales after the infringement to its projections for that period. A court may also award damages on an estimate of the sales the holder would have had "but for" the infringement, based on market share. For future profits, the holder must have reliable sales projections prepared during the ordinary course of business, not for litigation.

Of course, courts will offset profits on lost sales with certain expenses that the holder avoided by not making those sales. Examples of these expenses include materials, parts and sales commissions.

THE INFRINGER'S PROFITS

A holder may be awarded the infringer's profits based on three theories — unjust enrichment, deterrence or substitution for the holder's damages. The last option typically applies when the holder can't provide sufficient evidence to calculate its lost sales. Regardless of the theory, the Lanham Act requires the holder to prove only the infringer's *sales*.

It's up to the infringer to provide evidence of any costs or deductions. With appropriate evidence, a court can apportion the infringer's profits so it isn't liable for profits that may not have been due to the infringement. Courts will also be on the lookout for "double-dipping" that occurs when the holder recovers damages for lost profits on diverted sales as well as the profits the infringer generated on such sales.

BEYOND DAMAGES AND PROFITS

Notably, the Lanham Act allows a court to increase the damages award above actual damages — up to three times the amount of actual damages — and to adjust an award of infringer profits if those profits are inadequate or excessive. The trademark holder can also recover its court costs. And attorneys' fees may be awarded in "exceptional cases."

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