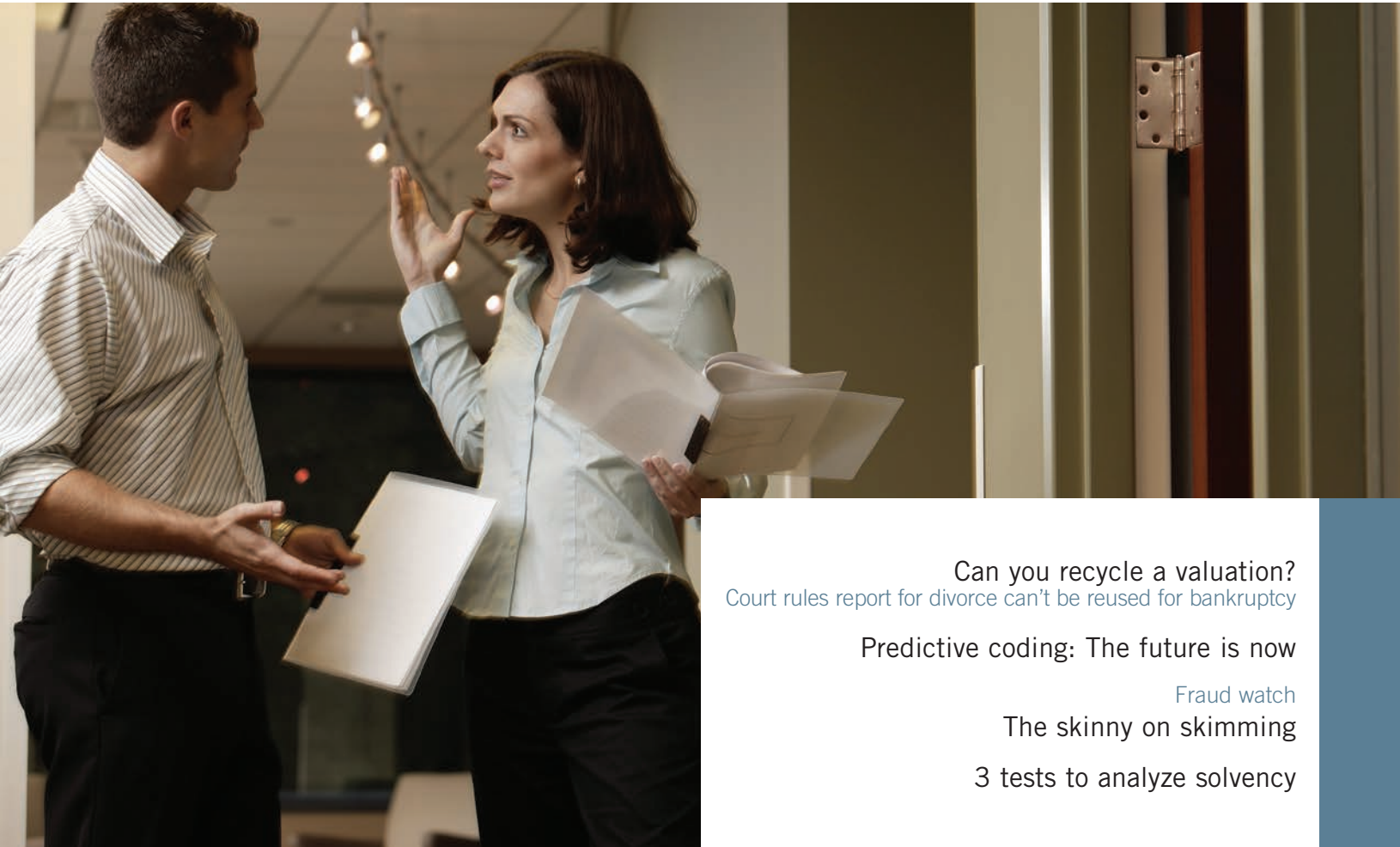


# ADVOCATE'S EDGE



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Court rules report for divorce can't be reused for bankruptcy

Predictive coding: The future is now

Fraud watch

The skinny on skimming

3 tests to analyze solvency



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# Can you recycle a valuation?

Court rules report for divorce can't be reused for bankruptcy

All valuation reports are *not* created equal. In fact, every valuation report is unique, created as of a specific date and for a specific purpose, which may affect the standard of value the valuation expert uses. That's why a single valuation report can't necessarily be recycled for multiple purposes without an expert's express written consent. For example, a business valuation report prepared for a divorce case shouldn't also be used in subsequent bankruptcy proceedings, as the recent case *In re Cole* illustrates.

## One valuation can't serve two purposes

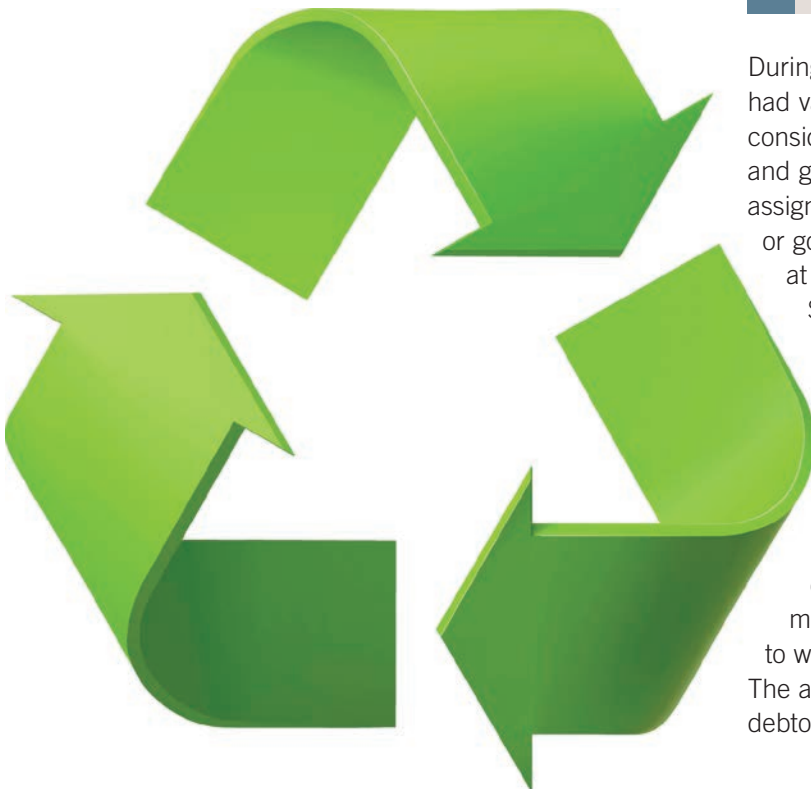
This bankruptcy case involved a divorced dentist who owned a 25% interest in a dental practice. For purposes of equitable distribution of assets in the

divorce proceedings, the trial court was required to determine the value of the husband's interest in his dental practice. The divorce court noted that the relevant standard of value was the "intrinsic value" of the business interest "to these parties."

There was nothing in the practice's shareholder agreement or any other evidence that suggested the husband (or a Chapter 7 trustee stepping into his shoes) had the ability to force a sale of the practice in order to maximize his 25% interest in the proceeds.

During the divorce proceedings, the wife's expert had valued the interest at \$212,000, assigning considerable value to ongoing patient relationships and goodwill. The husband's expert declined to assign any value to the practice's patient records or goodwill and valued the husband's interest at \$15,782. The divorce court adopted the \$212,000 value.

The husband then filed for Chapter 13 bankruptcy and sought confirmation of his repayment plan. The bankruptcy court had to determine whether the repayment plan would meet the liquidation test under the Bankruptcy Code. The code requires a court to ask: Would the creditors receive payments with a present value that's at least equal to what they would receive in a Chapter 7 case? The answer depended primarily on the value of the debtor's interest in the dental practice.



### Set value with shareholder agreement's buyout formula

The debtor in the *In re Cole* bankruptcy case claimed that his interest in a dental practice had no value, based on the testimony of an experienced Chapter 7 trustee. The trustee testified that, if he were administering the debtor's estate, he would abandon the interest because he didn't think anyone would pay anything for it in the open market.

The court, however, found that the practice's shareholder agreement suggested the interest would have significant value in a Chapter 7 liquidation. Under the agreement, the debtor (or trustee) could compel the other shareholders to buy out his interest for a price determined by a formula in the agreement. The court ruled that the price would be \$161,268, according to the buyout formula. Therefore, the bankruptcy court valued the interest at that amount and, as a result, denied confirmation to the debtor's plan.

The dentist's ex-wife was the primary unsecured creditor. She opposed the plan and argued that collateral estoppel barred her ex-husband from relitigating the value of his interest in the dental practice and required the bankruptcy court to value the interest at \$212,000.

### One size doesn't fit all

Echoing the divorce court, the bankruptcy court defined value for equitable distribution purposes as "that value which represents the property's intrinsic worth" to the parties. The court added that intrinsic value is "a very subjective concept that looks to the worth of the property to the parties." In divorce court, the value set forth by the wife's expert, therefore, established the value of the husband's interest in the practice to those two spouses, not necessarily hypothetical buyers and sellers.

By contrast, in a Chapter 13 bankruptcy proceeding, the court must determine the value of the interest in the context of a hypothetical Chapter 7 liquidation. The Bankruptcy Code requires a Chapter 7 trustee "to reduce to money" the property of the bankruptcy estate. According to the court, this requirement clearly contemplates a sale or other disposition of the property, which is different from determining the intrinsic value for a divorce proceeding.

During divorce proceedings, the court said the amount that a Chapter 7 trustee would receive by liquidating the debtor's interest in the practice was *not* the basis for establishing its value. In other words, the issue decided by the divorce court wasn't the same as the issue before the bankruptcy court, and collateral estoppel didn't apply.

The court also rejected the wife's alternative argument — that her expert's value should be applied because his "going concern" value was the appropriate standard for valuing a business interest. The court pointed out that this value represented 25% of the going-concern value of the practice as a whole. Moreover, there was nothing in the practice's shareholder agreement or any other evidence that suggested the husband (or a Chapter 7 trustee stepping into his shoes) had the ability to force a sale of the practice to maximize his 25% interest in the proceeds.

### Different standards call for different valuations

In uncertain economic times, you can't blame a client for wanting to leverage a valuation report for multiple purposes. Unfortunately, valuations are valid only for the specific purpose (or purposes) that they're originally developed for. ■

# Predictive coding: The future is now

**P**redictive coding has been around for a while. But the legal community has lagged other industries in adopting it. Increasingly, courts are approving the use of predictive coding, especially in cases involving mountains of electronically stored information (ESI). Attorneys need to understand what predictive coding is and how it can be used in litigation, including its advantages and disadvantages.

## Technology at work

Predictive coding is also known as technology-assisted review (TAR). The term generally refers to the use of software to identify relevant ESI, including the types of information your expert witnesses will need to contribute during discovery and at trial. It uses an iterative “machine learning” process and various algorithms.

It's easy to see how predictive coding can save significant time and money on document review in discovery.

With input from expert witnesses, attorneys can train the software by identifying a set of documents (known as the seed set) as relevant or nonrelevant. The documents may also be identified for privilege or confidentiality. The software applies algorithms to the seed set to identify relevant documents, and those results are compared with the attorneys' coded documents.

The software incorporates feedback from the seed set into its next round of document review. Using an iterative process with additional sets of documents and comparisons between the software's and the attorney's conclusions, the



software continually improves its ability to properly identify documents. Once the software agrees with the attorneys' findings at the desired rate (for example, on 95% of the documents), it can apply its coding to the remaining document population, ranking the documents according to their likelihood of relevance.

It's easy to see how predictive coding can save significant time and money on document review in discovery. Attorneys could also use the technology for early case assessment, deposition preparation and similar tasks.

## Pros and cons

Predictive coding comes with both advantages and disadvantages. For example, it facilitates the early identification of important discovery documents that can shape litigation or settlement strategies before extensive document review has even occurred. It also can eliminate the need for manual review conducted by contract attorneys — or at least reduce the number of documents to be manually reviewed — and ensure greater consistency than is generally possible with human reviewers.

Predictive coding evens the playing field for smaller firms going up against larger firms with more resources. And it undermines allegations of deliberate nonproduction of responsive documents, as

software-produced results are more defensible than those produced by humans.

On the other hand, the current lack of standards for predictive coding makes it unclear how courts and opposing counsel will react to the proposed use of this technology. Opposing counsel could potentially insist on being involved in the software training, which could give them access to irrelevant but nonetheless damaging documents. The training also requires extensive involvement by experienced attorneys, which increases the cost. Moreover, predictive coding doesn't work well for spreadsheets

or other documents without searchable text, image and video files, and short text as in texts or instant messages.

### A supplement, not a replacement

Needless to say, predictive coding can never completely replace manual reviews by attorneys and paralegals. For the coding to be effective, litigators must use their professional judgment in matters, including software training; collection, review and production of identified documents; and negotiations with opposing counsel. ■

## Fraud watch

# The skinny on skimming

Cash is an obvious target for dishonest employees bent on fraud. In the latest *Report to the Nations on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners (ACFE) draws a line between thefts of cash on hand and thefts of cash receipts, such as skimming. To help protect against this common scheme, your clients need to understand how skimming works.

### Understand the basics

Skimming occurs when an incoming payment is stolen *before* it's recorded on the books. In the most basic skimming scheme, an employee sells goods or services to a customer, collects payment and pockets the money without recording the sale. If the customer receives goods but no sale is recorded, skimming will cause a discrepancy between physical inventory counts and what's reported in the company's inventory ledger.

Perpetrators can also skim receivables. This generally is harder to pull off, because overdue accounts appear on the accounts receivable aging schedule.



Employees may try to cover their thefts by “lapping,” or borrowing money from one account to make up for a shortage in another.

### Detect theft early

Skimming can be difficult to detect. Potential red flags include:

- Infrequent bank deposits,
- Frequent shortages of cash on hand, and
- Consistent fluctuations in bank balances.

If skimming is suspected, consider hiring a fraud investigator to perform physical inventory counts to check if inventory levels match up with recorded sales. This expert may also review journal entries for false credits to inventory; write-offs of lost, stolen or obsolete inventory; write-offs of receivables; and irregular entries to cash accounts. Lapping can be uncovered by comparing the dates of customers' payments with the dates the payments were posted.

### Prevent skimming in the first place

A critical step toward prevention is segregation of duties. An employee should never be responsible for collecting, recording, reconciling and depositing cash receipts — split up those duties among multiple employees. In addition, employers might consider monitoring spaces where employees handle cash

with visible video cameras and regularly reconciling inventory records to look for shrinkage.

Other preventive measures include: 1) requiring daily bank deposits, 2) investigating no-sale and voided transactions, 3) reconciling cash deposits to all cash and checks received, and 4) providing an anonymous tip hotline for employees, customers and vendors who'd like to report suspected misconduct. These practices may deter dishonest employees who might be tempted to skim or engage in other fraudulent activity.

### Help clients help themselves

No business is ever completely immune to occupational fraud. With your help and the help of trained fraud investigators, your clients can reduce the likelihood and severity of skimming and other schemes. ■

## 3 tests to analyze solvency

**S**olvency is generally defined as a business's or individual's ability, at a specific point in time, to meet its long-term interest and repayment obligations. To determine whether a business is solvent, both the federal Bankruptcy Code and the Uniform Fraudulent Transfer Act look at the fair value of a debtor's assets.

The company (or debtor) is determined to be solvent when the fair value of assets is greater than its debts. This may seem straightforward, but sometimes the waters get muddy. For example, some companies may be legally solvent but nonetheless unable to pay their debts because the fair value of assets might include nonliquid assets. Here's a closer look at what factors into a solvency opinion.

### Independent analysis

A company's solvency may come into play in fraudulent conveyance, bankruptcy alter ego and due



diligence actions. When questions arise about solvency, the parties often call on a business valuation expert to prepare a solvency opinion. A solvency opinion is an independent professional analysis that questions management's assumptions and projections. Obtaining an accurate, authoritative solvency opinion is essential because transactions made during an insolvency period can be voided by a court.

Experts consider several key issues to determine solvency:

- Does the company have positive equity (that is, do assets exceed liabilities)?
- Is the company able to pay off debts as they come due?
- Does the company possess adequate capital to operate?

With these questions in mind, the expert then applies three tests to analyze solvency.

### Balance sheet test

The first test determines whether, at the time of the transaction at issue, the debtor's asset value exceeded its liability value. Assets are generally valued at fair market value, rather than at book value. The latter is typically based on historic cost, and fixed assets (such as vehicles and equipment) may be reduced by annual depreciation expense.

The balance sheet is just a starting point for this test. Book value is an accounting concept, and — under the principle of conservatism — the value of some assets may be understated on a balance sheet prepared under U.S. Generally Accepted Accounting Principles (GAAP). So, adjustments may be needed to amounts shown on the balance sheet to more accurately reflect the fair market value of assets.

In addition to business valuation experts, other appraisal specialists may sometimes be hired to determine the fair market value of such assets as real estate, equipment and intellectual property. Adjustments also may be required for unrecorded contingent assets and liabilities.

### Cash flow test

The second test examines whether the debtor incurred debts that were beyond its ability to pay as they matured. It involves analysis of a series of projections of future financial performance. Such projections are developed by varying some key operating characteristics of the business, such as revenue growth.



In his or her analysis, an expert considers a range of scenarios. These include management's growth expectations, lower-than-expected growth, and no growth — as well as past performance, current economic conditions and future prospects.

Experts also look at various financial metrics when applying the cash flow test. Examples include the debt-to-equity, current and quick ratios.

### Adequate capital test

This final test determines whether a company is likely to survive in the normal course of business, bearing in mind reasonable fluctuations in the future. In addition to looking at the value of net equity and cash flow, experts consider other relevant factors, such as asset volatility, debt repayment schedules and available credit.

When assessing how much capital is reasonable, an expert may consider the company's historic performance (before its solvency came into question) and industry norms. The capital adequacy test is passed if the debtor corporation is expected to have sufficient cash on hand to pay its 1) operating expenses, 2) capital expenditures, and 3) debt repayment obligations.

### All or nothing

A company must pass all three of these tests to be considered solvent. Courts usually will presume that a company (or debtor) is insolvent, unless it can prove otherwise. A comprehensive solvency analysis performed by a credentialed valuation expert can provide objective support for managerial decisions based on forward-looking financial statements. ■



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