Advocate's EDGE

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Costly business

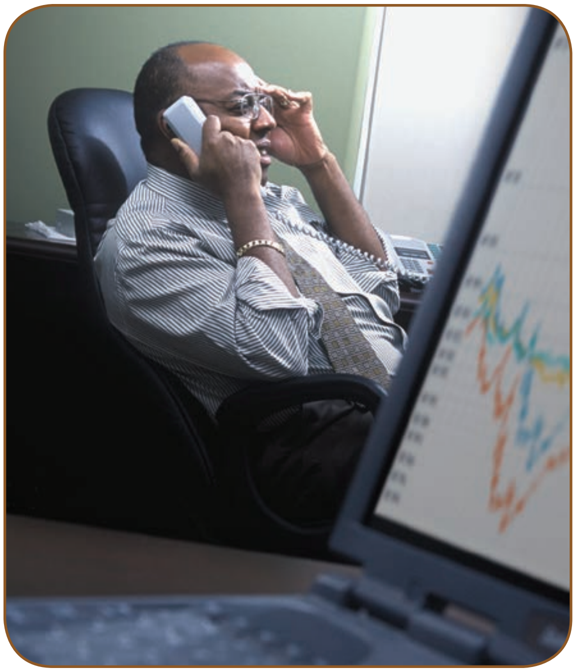
Shareholder damages in securities litigation

Securities litigation can prove costly to public companies, particularly when shareholders band together in class actions to accuse companies and their boards of directors of inflating their stock prices through material misrepresentations or omissions. The calculation of damages in securities fraud cases can be complicated and vulnerable to attack by opposing parties.

EVALUATE THE OPTIONS

The Securities Exchange Act of 1934 doesn't directly address the issue of calculating damages. Case law, however, has established that shareholders generally can recover the least of:

Out-of-pocket damages: the difference between any price inflation when the share was purchased and any price inflation that remained when the share was sold. "Price inflation" is defined as the difference between the actual stock price and its "true value," or the price it would have sold absent the alleged misrepresentation or omission.



Financial experts generally use three approaches to determine price inflation: 1) constant dollar, 2) constant percentage, and 3) constant index methods.

Losses caused by the misrepresentation or omission: the actual decline in the price of shares purchased after an alleged misrepresentation or omission, resulting from corrective disclosure of the information previously misrepresented or omitted.

Statutory limit: The Private Securities Litigation Reform Act of 1995 specifically limits a plaintiff's damages. Awards can't exceed the "difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price … during the 90-day period beginning on the date on which the information correcting the [misrepresentation] that is the basis for the action is disseminated to the market."

ESTABLISH CAUSATION

Regardless of the damages theory employed, a financial expert must establish loss causation. As the U.S. Supreme Court explained in *Dura Pharmaceuticals, Inc. v. Broudo*, an inflated purchase price alone normally doesn't constitute or approximate the relevant economic loss. After all, if the purchaser sells the shares quickly, before the relevant truth begins to leak out, the alleged misrepresentation or omission won't have led to any loss.

According to the Court, a loss can occur only after a corrective disclosure. Even then, the lower price could reflect not only the earlier misrepresentation or omission but also changed economic circumstances, investor expectations or other events. A plaintiff, therefore, must show that revelation of the truth caused the loss. In other words, recoverable damages are limited to the part of the price inflation that disappears after the corrective disclosure.

MEASURE PRICE INFLATION

Financial experts generally use three approaches to determine price inflation: 1) constant dollar, 2) constant percentage, and 3) constant index methods. All assume the price after corrective disclosure represents the true value.

Under the constant dollar method, the expert uses the change in stock price after the corrective disclosure to calculate the price inflation for each day prior to the disclosure. This method is well suited for short damages periods with little expected fluctuation in the overall securities market.

With the constant percentage method, the expert uses the percentage change in stock price after the corrective disclosure as a percentage measure of the price inflation for each day prior to the disclosure. This method has been criticized after the *Dura Pharmaceuticals* decision for allowing damages for in-and-out traders who bought shares during the relevant period but sold before the disclosure, as well as for allowing different damages for shareholders with the same losses. Critics also point out that this method allows shareholders who sold after disclosure to recover for inflation that occurred before the disclosure.

The index method assumes that the true value from the time of the misrepresentation or omission through the corrective disclosure would have moved in the same proportion as a selected market index (for example, the S&P 500). This method has been subject to similar criticisms as the constant percentage method.

BENCHMARKING AGAINST COMPARABLE STOCKS: THE ROLE OF EVENT STUDIES

When computing shareholder damages in securities litigation, financial experts often use models that rely on event studies. An event study examines stock price movements at the time of the misrepresentation or omission, at the time of the corrective disclosures, or both.

The expert typically determines the point at which the misrepresentation or omission allegedly affected the stock price. He or she then establishes a performance benchmark based on the performance of a comparable security during the relevant period. The benchmark reflects the rate of return that the stock would have experienced but for the misrepresentation or omission. By comparing the stock's performance with the benchmark for a given day, the expert can estimate the stock's price inflation.

Further analysis is needed, though. The expert must isolate price movements caused by the misrepresentation from those caused by other influences, such as other additional negative news released at the time of the misrepresentation.

ARM YOURSELF

Not surprisingly, loss causation and stock price inflation are usually the targets of heated debate — and they aren't the only contentious damages issue in securities litigation. In class actions, for example, you could also face thorny questions related to the estimation of aggregate damages. Your advisor can help you navigate these and other complexities related to shareholder damages.

A strategic undervaluation can come back to bite you

Reusing discounted financial projections prepared for transfer tax purposes can quickly backfire in a shareholder dispute. A recent opinion from the Delaware Court of Chancery, *Fox v. CDX Holdings, Inc.*, shows the importance of allowing valuators to arrive at their own independent conclusions.

OPTION HOLDERS CHALLENGE VALUATION

Caris Life Sciences (now known as CDX) was a privately held Delaware corporation. Through subsidiaries, it operated three business units — Caris Diagnostics, TargetNow and Carisome. Only Caris Diagnostics was profitable. To achieve the dual goals of securing financing for the other companies and generating a return for stockholders, the holding company sold Caris Diagnostics to Miraca Holdings using a "spin" merge structure to minimize taxes.

The court noted that previous Delaware decisions have criticized erroneous or seemingly motivated analyses by financial advisors. But the accounting firm's second opinion "reached a new low."

It first transferred ownership of TargetNow and Carisome to a new subsidiary and then spun off that subsidiary to its stockholders. At that point, owning only Caris Diagnostics, Caris merged with a wholly owned subsidiary of Miraca.

The merger canceled stock options that represented about 2.9% of CDX's stock. The option holders were entitled to receive for each share the amount by which the fair market value (FMV) of the share exceeded the exercise price. A class of option holders sued CDX, alleging that management had undervalued the spun-off entity that held TargetNow and Carisome.

COURT REJECTS TRANSFER TAX VALUATION

The court found that CDX's management had selected a value for the spun-off entity that wasn't a "good faith determination" of FMV. Rather, the figure was generated by the company's tax advisor using an intercompany tax transfer analysis designed to ensure the spinoff would result in zero corporate-level tax. The court found management provided "falsely low numbers" to support the transfer tax valuation, which was *not* a fair market valuation.

According to the court, the tax advisor's conclusion that the entity had a value of $65 million conflicted with the stockholder's subjective belief from earlier in the year that TargetNow alone was worth $150 million to $350 million. It also conflicted with views held by the company's founder, the private equity fund that held about 25% of Caris shares and the company's financial advisor. And it contrasted with higher values that an accounting firm had generated for the same businesses in a series of valuation reports prepared for other purposes in the same year as the merger.

Moreover, at the time of the merger, Miraca questioned the tax advisor's valuation and insisted on a second opinion from the accounting firm that had previously valued the company for other purposes. The tax advisor and stockholder met with the accounting firm before it began work. It proceeded to prepare a valuation that largely (and admittedly) copied the tax advisor's analysis. Therefore, the second opinion was slightly lower than the transfer tax valuation.

The court noted that previous Delaware decisions have criticized erroneous or seemingly motivated analyses by financial advisors. But the accounting firm's second opinion "reached a new low." The court observed, "The copy job was so blatant that the output matched [the tax advisor's], even when the inputs differed." The accounting firm also abandoned its previous valuation methodologies. And, when it didn't copy directly from the tax advisor's original report, the valuator made significant errors.

CREDIBILITY COUNTS

The management of CDX tried to distance itself from the second opinion by conceding it was flawed and arguing that no one relied on it. But the court found that the report reflected on the integrity of the option valuation process, and it awarded approximately $16.3 million in damages. To avoid such costly mistakes, remind your clients about the importance of expert witness independence — both in reaching accurate figures and maintaining the client's credibility with the court.

Hunting for misplaced "goods"

Fraud experts can help recover lost items

One of the most difficult administrative tasks for retailers, manufacturers and contractors is keeping tabs on inventory. New items are purchased from suppliers, items are sold to customers, obsolete and damaged items are written off, and markdowns periodically occur. Tracking work-in-progress inventory, if applicable, only adds to the complexity. If the numbers didn't seem to add up during your year-end physical inventory count, it may be time to bring in a fraud expert to uncover the source of the discrepancy.

MONITORING INVENTORY

Before assuming theft, a fraud expert determines whether the items were really stolen or were simply misplaced. In many cases, employees keep sloppy records or fail to follow proper procedures, resulting in "missing" inventory. For example, a company without a location assignment for each item, an effective method of keeping tabs on overflow stock and a well-run returns system is likely to misplace inventory.

If there's no innocent explanation for missing inventory, the expert looks for signs that the environment is conducive to fraud. For example, a company with poor controls over purchasing, receiving and cash disbursement is at high risk of inventory theft. In addition, one person performing multiple duties can easily commit and conceal fraud.

If the expert believes inventory could have been stolen, he or she combs the records for clues. Anything that doesn't follow established inventory procedures could be a red flag — such as odd journal entries posted to inventory, large gross margin decreases or sudden problems with out-of-stock inventory.

EXPOSING IRREGULARITIES

Next, the expert works to prove the fraud. Inventory fraud may leave a paper (or electronic) trail, so forensic accountants typically review journal entries for unusual patterns. An entry recording a physical count adjustment made during a period when no count was taken obviously warrants investigation. The expert follows up by tracing unusual entries to supporting documents.

Whether employees or inventory specialists perform the job, a fraud expert carefully observes warehouse activity once employees realize a count is imminent.

Vendor lists also may show suspicious patterns, such as post office box addresses substituting for street addresses, vendors with several addresses, and names closely resembling those of known vendors. Even if they've found no evidence of nonexistent vendors, fraud experts look at vendor invoices and purchase orders for anomalies such as unusually large invoices or alleged purchases that don't involve delivery of goods.

Discrepancies between the amounts due per invoice, the purchase order and the amount actually paid warrant investigation. Finally, experts familiarize themselves with the cost, timing and purpose of routine purchases and flag any that deviate from the norm.

CATCHING THE THIEF

It's important to confirm physical inventory as well. Although a count performed by employees may disrupt normal business routines, it's an effective way to learn exactly what merchandise may be missing — and could lead directly to the thief (unless the thief is involved in the physical inventory count!). Fraud experts sometimes recommend hiring an outside inventory firm to perform the count and value the inventory.

Whether employees or inventory specialists perform the job, a fraud expert carefully observes warehouse activity once employees realize a count is imminent. Thieves may attempt to shift inventory from another location to substitute for missing items they know will be discovered.

Inventory at remote locations also can disappear, so fraud experts often will confirm quantities with the storage facility or go with the client to inspect them personally. Whenever possible, it's best to perform a count in person rather than delegate the job to someone who may not be trustworthy.

BRINGING IN THE CAVALRY

Unfortunately, there will always be crooks in businesses that involve inventory. Whether the heist is small or large, it can still damage the company's reputation and bottom line. Fortunately, by bringing in a reputable valuator and fraud expert, such instances of inventory theft will dwindle and eventually cease.

BIG time

Calculating the discount for imbedded capital gains on C corporations

In recent years, courts have increasingly allowed experts to apply a discount for the tax liability related to built-in gains (BIGs) when determining a C corporation's value for tax purposes. In the notable 2014 *Estate of Richmond* case, the U.S. Tax Court conceded that this tax liability can't be ignored in valuation. Yet some dispute remains regarding how to properly calculate the BIG discount.

DOLLAR-FOR-DOLLAR VS. PRESENT VALUE

The BIG discount recognizes that a hypothetical willing buyer of a business would likely pay less for the shares of a C corporation because of the tax liability for BIGs embedded in its appreciated assets. However, both the Fifth and Eleventh Circuit Courts of Appeals have reversed Tax Court decisions to adopt dollar-for-dollar offsets for the capital gains tax that would be realized upon the sale of appreciated assets held by a C corporation.

In *Estate of Richmond*, the Tax Court also rejected a dollar-for-dollar discount, opting instead for a discount equal to the present value of the future capital gains taxes. The court may not simply reject the dollar-for-dollar approach out of hand in every case. Rather, its position seems to depend on the particular circumstances.

For example, in *Richmond*, the Tax Court rejected the estate's dollar-for-dollar adjustment for built-in capital gains tax, because a sale of the C corporation's assets wasn't imminent. The court decided that a willing buyer and seller clearly wouldn't agree to a discount that treats a potential liability susceptible to indefinite postponement as if it were an accrued liability due immediately.

On the other hand, in the 2010 *Estate of Jensen* case, the IRS applied a discount determined by comparing shares in the corporation to closed-end funds, which are commonly subject to BIG discounts. The court rejected the IRS approach and ultimately accepted the estate's dollar-for-dollar approach, noting that this discount was in the same range as its own present value calculations.

Typically, federal court of appeals cases that allow dollar-for-dollar offsets for BIG liabilities involve scenarios where there's an assumption of an immediate sale that would trigger the taxes. Courts applying the present value approach generally assume that the underlying asset won't be sold immediately.

A SMART CHOICE

You can't assume that the courts will always apply one BIG approach over another in every situation. A qualified valuator can help you determine the approach most likely to be accepted by the court.

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