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ADVOCATE'S EDGE

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Qualifications matter

Don't cut corners on business valuation experts

When selecting a business valuation expert, you may find that the least expensive candidate isn't necessarily the most qualified one. A recent California Court of Appeals case highlights how hiring an inexpensive or inexperienced expert can backfire, even if the opposing side fails to present expert testimony. Notably, this case involved a failed start-up software business with no revenue or earnings history — and no viable products.

Start-up shuts down

Prescription Diversion Solutions (PDS) was formed in June 2012. Two of the start-up's founders had developed a prototype of a software application intended to help doctors manage patient medications and prevent fraud and prescription abuse. The developers invited the plaintiff to join their business venture as its third founding member because he had relevant experience: He was a doctor who claimed to have computer programming experience.

Within 14 months of forming PDS, the software developers discontinued working with the plaintiff. They claimed the doctor had misrepresented his programming ability and contributed little to the business. After dissolving PDS, the developers started a new company (ScriptGuard), which purchased some of PDS's assets (primarily, the prototype software code).

> Beyond his lack of experience, the expert's opinion was based on inaccurate information.

The doctor sued, and the trial court found one of the defendants had breached his fiduciary duty as a PDS board member by participating as an interested director in the sale of PDS's assets to his new company. However, the Superior Court of Orange County awarded no damages because the plaintiff's expert wasn't credible. On appeal, this decision was affirmed.

Expert testimony criticized

The plaintiff hired an expert to value his 30% interest in PDS. The expert testified at trial that the value of PDS ranged from \$1.5 million to \$8 million. He noted "many historical instances where nonrevenue generating companies, especially web-based companies, have sold for millions and millions of dollars on the expectation that they would begin to generate revenue and net profits related to the business." However, the expert had never previously valued a technology or software company, start-up or otherwise.

Beyond his lack of experience, the expert based his opinion on inaccurate information. He believed ScriptGuard had run a pilot program to test its software in a large medical group with three offices, 12 physicians and two physician assistants, "responsible for more than 35,000 covered lives." According to the expert, there were testimonials as to how well the product worked. In fact, no pilot tests had ever occurred, and PDS had never demonstrated any ability to interact with third-party prescription databases to guard against fraud and drug abuse.

The expert's "misapprehension of basic facts" was one of several grounds supporting the trial court's finding that the expert lacked credibility. The trial court also faulted the expert for relying on "speculation and wishful thinking on the part of [both] the plaintiff and the defendants" in their self-interested assessments of PDS's value at different times.

California's Fourth District Court of Appeals acknowledged that anticipated profits dependent on future events generally are objectionable because they're speculative. Nonetheless, the court said, prospective profits are allowed where their nature and occurrence can be shown by reasonably reliable evidence. (See "The challenges of valuing start-ups" at right.)

Alternate arguments fail

In addition, the court rejected the plaintiff's argument that, when the defendants dissolved PDS, they offered the plaintiff $110,000 to cover his $35,000 investment in the company and his 30% business interest, along with $15,000 in compensation. The plaintiff characterized this offer as the defendants' admission that his interest in PDS was worth at least $110,000. The appeals court agreed with the trial court that it was, instead, an amount offered to the plaintiff by the defendants to "make him go away."

The court also dismissed the plaintiff's claim that the agreements the defendants entered into to raise $220,000 for ScriptGuard provided the best evidence of the company's value. Those agreements, the court concluded, reflected investors making bets on the business's success and said nothing about PDS's intrinsic value.

Qualifications add value

This case demonstrates that unqualified experts can leave plaintiffs with valid claims holding an empty bag after a court rules in their favor. So, it's important to vet the credentials of potential valuation experts before you hire them. ■

The challenges of valuing start-ups

The *Zaffarkhan* case (see main article) shows how valuing a new business — or one that never launched a real product — is challenging. But, for purposes of establishing lost profits damages, it's not impossible, if your assumptions are reasonable and your sources of evidence are credible.

Much of the difficulty in valuing a start-up stems from the lack of historical financial data, which forces experts to turn to other types of evidence. The *Zaffarkhan* court faulted the plaintiff for making little use of the so-called "yardsticks" commonly used to value new or speculative businesses.

Under the Restatement (Second) of Contracts, a plaintiff can establish prospective profits damages for such businesses using such sources as:

- Expert testimony,
- Economic data,
- Market surveys and analyses, and
- Business records of similar enterprises.

Likewise, the Restatement (Second) of Torts provides that, where the defendant has specifically prevented the launch of a new business, a court should consider the factors relevant to the would-be business's likelihood of success. Examples include general business conditions and the degree of success of comparable enterprises.

Critical tax issues for business owners in divorce

The Tax Cuts and Jobs Act (TCJA) made sweeping changes to the tax law that must be considered when business owners file for divorce. Here's an overview of how you may need to modify your mindset during settlement talks.

Lower taxes, higher earnings

In general, tax reform legislation enacted under the Trump administration has been favorable for business owners. Starting in 2018, the TCJA lowers the corporate rate to a flat 21% for C corporations and personal service corporations. It also:

- Lowers the tax rates for owners of pass-through entities (including sole proprietorships, partnerships, S corporations and limited liability companies),
- Introduces a deduction for owners of pass-through entities of up to 20% of qualified business income,
- Repeals the corporate alternative minimum tax (AMT),
- Reduces the number of pass-through business owners subject to individual AMT,
- Expands first-year Section 179 and bonus depreciation deductions for qualified asset purchases, and
- Provides incentives to repatriate foreign income and operate in the United States.

These provisions (along with many other pro-business changes) are expected to lower business tax obligations. In turn, lower taxes mean higher future earnings and business values.

However, some TCJA provisions are unfavorable to businesses. For example, there are new limits on business interest deductions and net operating losses (NOLs). The law also eliminates the domestic production activities deduction (DPAD) and certain business expense deductions. When valuing a business, it's

important to have a comprehensive understanding of both the positive and negative effects of the TCJA on future earnings.

It's all relative

Which marital assets are most desirable under current tax law? Various provisions of the TCJA may cause divorcing spouses to see private business interests in a more favorable light than under prior law.

For example, under the TCJA, tangible personal property held for business or investment purposes — such as vehicles or equipment used for business — are permanently ineligible for Sec. 1031 like-kind exchanges. Eliminating like-kind exchanges of tangible personal property could make these assets less appealing than under prior law, because owners can no longer defer any built-in tax obligations.

Real estate also might have less appeal under the TCJA. Although Sec. 1031 like-kind exchanges are still allowed for real estate held for business or investment purposes, the TCJA limits itemized deductions from owning a primary residence or vacation home. Plus, fewer taxpayers are expected to itemize deductions under the TCJA. These changes reduce the tax benefits of owning a home and may affect asset allocations.

However, when divvying up assets, it's important to consider *future* tax obligations. For example, business interests typically incur capital gains tax when they're sold. Capital gains happen when an asset's value exceeds its tax basis. By comparison, a spouse's personal residence is subject to a home sale gain exclusion of $250,000 (or $500,000 for a married couple who files a joint tax return).

New treatment for alimony

Another critical issue to consider in divorce settlements is alimony. For divorce agreements signed after December 31, 2018, the recipient is no longer required to include alimony payments as income, and the payer can no longer deduct the payments. That's a major change that will likely cause the parties to pay more taxes overall (assuming the payer has a higher marginal effective tax rate than the recipient does) than under prior law.

Also, be aware when calculating alimony payments that courts in some states don't allow "double-dipping" — that is, allowing a spouse to benefit twice from a former spouse's future earnings. In these jurisdictions, spouses who receive alimony payments shouldn't in theory be credited for half of the business's personal goodwill (if applicable).

Need help?

If you're drafting or revising a divorce agreement, a business valuation expert can be a valuable resource. When hiring an expert, be sure to ask how the TCJA is likely to affect your specific case. ■

3 steps to investigate fraud

Theft sometimes happens from *inside* an organization. When a business owner suspects that an employee is stealing assets or manipulating financial results, it's time to call an outside expert to help investigate matters. Here are three steps forensic accounting experts follow to build a fraud case that can stand up in court.

Conducting interviews

Skilled interviewers trained in fraud detection know how to spot fraud warning signs, detect deception and pin down suspicions by talking with suspects and their co-workers. The specific information an expert asks employees depends, in part, on the circumstances and individuals involved.

Experts generally ask members of management direct questions about such issues as:

- Possible fraud ploys (or allegations of fraud),
- The company's fraud risks, and
- Programs and controls that have been implemented to mitigate specific fraud risks or to otherwise help prevent, deter and detect fraud.

An expert may interview not only a company's management and audit committee, but also anyone who can provide information helpful in identifying risks of financial fraud. Thus, interviewees might include employees at all levels who are involved in initiating, recording or processing complex or unusual transactions, as well as operating personnel not directly involved in the financial reporting process.

The interview process usually starts with introductions and rapport-building. The expert may explain the purpose of the interview and ask questions to which the answers are already known, so he or she can observe the subject's demeanor and degree of candor.

Then the expert transitions to more specific questions. He or she encourages the interviewee to do most of the talking — and may even use silence as a tool, as people being interviewed frequently try to fill conversation gaps. The employee may disclose information unintentionally, provide clues or suggest an unplanned, but fertile, line of questioning.

Before ending the interview, the expert will confirm the information elicited. He or she also will ask open-ended questions about other individuals to interview and areas to explore.

Gathering evidence

Another key task experts perform during a fraud investigation is collecting evidence from the company's internal sources. Examples include personnel files, phone and email records, security camera recordings, and physical and IT system access records.

Locating this evidence may require the expert to perform computer forensic examinations. For example, experts may access the accounting system to search for suspicious journal entries, credits and reversals, and overridden controls. They may also consider external sources of evidence, such as public records, customer and vendor information, media reports, and private detective reports.

Analyzing the facts

Forensic accounting specialists have been trained on how to review and categorize internal and external evidence, conduct computer-assisted data analysis, and test various hypotheses. Rather than rely on gut instinct, your expert will formally document every step in the investigation and follow formal procedures to ensure a comprehensive investigation.

When the expert is finished conducting interviews and gathering evidence, he or she will report any findings. You may determine the appropriate format for the report and how distribution will be affected by the need to protect legal privileges and avoid defamation.

To catch a thief

Proving fraud can sometimes be like finding a needle in a haystack, especially if the thief did a good job hiding his or her electronic or paper trail. Botched investigations may prevent the victim-organization from recouping losses and prosecuting the perpetrator. So, it's important to hire an experienced forensic accounting expert to build a solid case. ■

ACP Master, Ltd. v. Sprint Corp.

Herculean projections can defeat a valuation

It's common for courts to reject testimony from business valuation experts who rely on unrealistic assumptions or data. To illustrate this point, here's a recent Delaware Chancery Court decision to disregard an opinion based on "implausible" projections. The decision was affirmed by the state's Supreme Court.

Statutory appraisal rights claim

In July 2013, Sprint Nextel completed a merger with Clearwire. Sprint already held the controlling interest in Clearwire. It paid $5 per share to fully acquire the smaller company, which owned a large block of 2.5 gigahertz wireless spectrum.

After the merger, minority shareholders contested the adequacy of the deal's price. Delaware's appraisal statute required the court to determine the fair value of the shares, assessing Clearwire as a going concern based on the "operative reality" of the company at the time of the merger. Delaware's Chancery Court ultimately accepted Sprint's expert's estimated value of $2.13 per share over the shareholders' expert's value of $16.08 per share.

> Most of the difference between the experts' values came down to the projections they used when applying the discounted cash flow (DCF) method.

Faulty foundation

Most of the difference between the experts' values came down to the projections they used when applying the discounted cash flow (DCF) method. Sprint's expert used projections — referred to as the "single customer case" — that were prepared by Clearwire's management in the ordinary course of business.

Conversely, the shareholders' expert relied on more aggressive "full build" projections. These projections weren't prepared in the ordinary course of business. Rather, Sprint's management created them to convince a Japanese telecommunications company poised to acquire Sprint to top a competing offer for Clearwire. The projections show how Sprint's business would have looked if the merger had failed and Sprint was, instead, required to pay wholesale prices to use Clearwire's spectrum.

The court held that the full build projections didn't reflect the company's operative reality if the merger didn't close. It cited several reasons. For example, the projections assumed Sprint would use the same amount of spectrum, paying by the gigabyte, as if it owned the spectrum. But evidence at trial showed the company would use less spectrum if it didn't own Clearwire because paying per gigabyte from a third party had a much higher marginal cost.

The full build projections also assumed that Sprint would pay Clearwire "a staggering amount of money" that would reduce Sprint's operating income by as much as $12.5 billion. The court found Sprint could have found other, less expensive options.

Lesson learned

Valuations based on "herculean assumptions" like those behind the full build projections are unlikely to pass muster. Make sure your business valuation experts build estimates that are reasonable and reflect relevant business realities. ■

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