JANUARY/FEBRUARY 2021

ADVOCATE'S EDGE

Disputed stock sale survives "entire fairness" review

Vishing: Beware of callers with malicious intent

Looking to sell?
Exercise caution when entering the M&A market during the COVID-19 crisis

Linde v. Linde
Court rejects asset valuation approach in appraisal case

990 Stewart Avenue
Garden City, New York 11530

t: 516.288.7400
f: 516.288.7410
e: info@garibaldicpas.com

GARIBALDI GROUP
Certified Public Accountants
Financial and Management Consultants

www.garibaldicpas.com

Disputed stock sale survives "entire fairness" review

When Delaware courts review corporate director decision making, the toughest standard of scrutiny is known as "entire fairness." The Delaware Chancery Court recently applied this standard in *Coster v. UIP Companies, Inc.* This case involves a dispute over the control and ownership of a company after the sale of unissued stock to an executive in the business. The court's opinion illustrates how the standard works — in this case, in the directors' favor.

Consolidated case

The company at issue was owned equally by two of its founders. The plaintiff (Coster) was married to one of the founders and inherited his 50% interest. When she and the remaining founder (Schwat) couldn't agree on nominees to fill vacant board seats, she filed a lawsuit seeking the appointment of a custodian to break the deadlock.

Schwat responded by causing the company to sell one-third of its outstanding but unissued voting shares to an employee to whom equity had long been promised. To invalidate this sale of stock, Coster filed another lawsuit, which was consolidated with her first claim.

Court analysis

Under Delaware law, there are three tiers of review for evaluating director decision making:

1. The business judgment rule,
2. Enhanced scrutiny, and
3. Entire fairness.

The Chancery Court explained that a plaintiff can negate the presumption of the less stringent business judgment rule and shift the burden of proving entire fairness to the defendant. To achieve this, the plaintiff needs to show that the action in question wasn't taken by a board majority comprising "disinterested and independent directors." In this case, the plaintiff showed that the board that unanimously approved the stock sale consisted of Schwat, the employee who bought the stock and a third individual.

That meant the defendants needed to establish that the stock sale was the product of both fair dealing and fair price. The fair dealing inquiry considers:

- When the transaction was timed,
- How it was initiated, structured, negotiated and disclosed to the directors, and
- How the approvals of the directors and the stockholders were obtained.

The court noted, though, that price may be the preponderant consideration — outweighing other

Fiduciary breach: How to calculate lost profits

When asset managers, trustees and others breach a fiduciary duty owed to beneficiaries, financial experts typically turn to the following methods for computing lost profits:

Before and after method. Under this technique, the expert generally compares the profits from the damages period to the actual profits *before or after* that period. For example, in the case of investment mismanagement, an expert might compare the returns during the two periods. This approach sometimes proves difficult, however, because the requisite data isn't always easily available.

Projection method. This method essentially compares the profits from the damages period to the *projected* profits if not for the alleged breach. With an investment mismanagement case, an expert might compare the ending value of the portfolio with the ending value of a hypothetical portfolio that wasn't mismanaged. The data underlying this method is often readily available.

Yardstick method. Here, an expert compares the subject's performance to the performance of a qualitatively and quantitatively similar *benchmark*. For example, a stock's or portfolio's performance might be compared to the performance of a market index or investment peer group. Or performance could be compared to the returns that had been targeted but weren't reached because of the wrongful conduct.

Experts also will consider other factors (besides the alleged breach) that could have affected performance. Examples of these unrelated factors include adverse market conditions, the introduction of new competitors in the marketplace or the loss of a key person.

features — in a nonfraudulent transaction. The court acknowledged that the procedural process in this case was "by no means optimal." For example, no official board meeting was held to consider the stock sale. But it found that Coster's fair dealing arguments alone didn't prove that the stock price was unfair.

Fairness of price

When evaluating the fairness of the price, the court said that a corporation's value isn't a single point but a *range* of reasonable values. Relevant factors include assets, market value, historical and projected earnings, and other elements that affect the intrinsic or inherent value of a company's stock. This evaluation generally requires an estimate of the company's "fair value."

The plaintiff's expert didn't conduct a formal valuation. Rather, he found flaws in the opposing expert's valuation. The court characterized some of these attacks as "a theoretical dart throwing exercise that seemed untethered to any real world considerations, including the practical effect of these criticisms on the fairness of the price."

The court ultimately concluded that the value conclusion set forth by the defendants' expert was the most reliable indicator of the company's fair value on the date of the stock sale, because it fell within a range of reasonable values. As a result, the defendants successfully established that the stock sale satisfied the entire fairness standard. The court concluded that the defendants didn't breach a fiduciary duty.

Valuation to the rescue

Applying the strictest form of scrutiny of board decisions isn't insurmountable. The defendants in this case were able to prevail largely because they had obtained an independent valuation *before* selling their stock. Advise your clients to engage similar support before moving ahead with potentially controversial actions. ■

Vishing: Beware of callers with malicious intent

As if adapting to remote working arrangements during the COVID-19 crisis hasn't been difficult enough, now businesses must safeguard against opportunistic hackers who attempt to infiltrate remote employees' less-secure home networks. One new ploy — known as "vishing" — uses a new twist on phishing scams to gain access to business networks. Here are the details.

Vhishing vs. vishing

Vhishing is a type of social engineering fraud that involves email or text messages designed to trick someone into revealing sensitive information. These scams may target private individuals to gain access to their passwords, account numbers and other sensitive personal data. Or they may target employees to gain access to sensitive information about workers and customers, as well as valuable intellectual property, stored on their employers' networks.

The difference in voice vhishing (or vishing) scams is that the perpetrator uses the phone — rather than email or text — to contact an individual. These scams are often more aggressive, elaborate and personalized than traditional phishing scams. Therefore, they may be harder to detect.

How it works

The Federal Trade Commission recently filed lawsuits against two telemarketing firms in Florida and a company claiming to sell extended automobile warranties. The companies were accused of violating the Do Not Call registry and committing fraud by selling bogus warranties. Since 2007, they allegedly made roughly a billion calls — using spoofed caller ID numbers to hide their identities from law enforcement — and stole more than $10 billion from unsuspecting consumers.

During the COVID-19 pandemic, vishing scams have evolved to target remote workers. In a typical scenario, a "visher" creates a dossier for key employees he wants to target, using public information obtained from searching the Internet and social media. Armed with information such as the employee's name, home address, position and duration of employment, the perpetrator is able to convince his targets that he's a member of their employer's IT department who needs to install security updates on their laptops.

Believing they're giving remote access to a trustworthy co-worker, the employees unwittingly click on a virtual private network (VPN) link set up by the perpetrator and enter their network login information, including any two-factor authentication or one-time passwords. The employees' honest mistake gives the visher real-time access to the company's actual VPN — and all of the company's proprietary information.

How to prevent it

In August 2020, the Cybersecurity and Infrastructure Security Agency and Federal Bureau of Investigation issued a joint advisory, warning employers about a rise in vishing scams targeting remote workers. Most of these scams exploit weaknesses in companies' VPNs, which are widely used as a secure way for remote employees to log into their employer's network from home.

The advisory outlines several steps for companies to take, including:

- Restricting VPN connections to managed devices only, using such mechanisms as hardware checks or installed certificates,
- Limiting VPN access hours, if possible, to mitigate after-hours access,
- Using domain monitoring to track the creation of, or changes to, the company's domains,
- Actively scanning and monitoring Web applications for unauthorized access and modification, and
- Employing the principle of least privilege (where users can access only those privileges needed to perform essential job functions; access to other privileges is blocked) and implementing software restriction policies or other controls.

Businesses should consider implementing a formalized authentication process for employee-to-employee phone communications — for example, requiring a second factor to authenticate the phone call before discussing sensitive information. Employee training can also be a powerful tool to help workers identify and report suspicious activity.

Fraud experts offer peace of mind

The last thing businesses need during these challenging times is to be hit with a vishing scam. A security breach can result in ransom costs, forensic fees and expenses, employee and customer notice obligations, liability for security breaches, and reputational damage. A forensic accounting specialist can help your business clients implement effective safeguards against these kinds of attacks and train employees to recognize potential red flags. ■

Looking to sell?

Exercise caution when entering the M&A market during the COVID-19 crisis

The COVID-19 pandemic has devastated some businesses, while others are thriving. As the crisis gradually subsides, business sellers will need to walk a fine line between pouncing on what may appear to be a good offer and hanging back to mull over the options.

Refresh and renew

Some business owners had spent years preparing to sell and were ready to find a buyer when markets seized up during COVID-19–related shutdowns last spring. As the economy recovers, many won't be able to return where they left off. Most U.S. companies have become less profitable during the economic downturn, so their current financial profile may not look as rosy as it once did. Businesses in some hard-hit sectors — including full-service restaurants, salons, private gyms, hotels, entertainment venues and cruise lines — may even be showing signs of financial distress.

In 2021, business buyers will almost certainly be more risk-averse than they were before the COVID-19 crisis began. What they might have overlooked in early 2020, such as a moderate debt load or underused capacity, won't pass muster now. Before sellers put their businesses on the market, they should hire a valuation expert to review the financials and operations and suggest ways to improve marketability — and, potentially, the selling price.

Depending on the state of the business, fixes could be as simple as cleaning up facilities and organizing financial and legal documents. Or they could be as challenging as reducing expenses, restructuring debt and selling off major assets. These projects could take substantial time to complete.

Watch out for bargain hunters

As the economy recovers, some buyers are likely to be hunting for bargains, particularly companies

that have taken a beating during the COVID-19 crisis and those with owners anxious to retire. Private equity funds, for example, may be looking for higher-growth companies that can be bought cheaply and resold at a profit after several years.

> In 2021, business buyers will almost certainly be more risk-averse than they were before the COVID-19 crisis began.

Sellers may be able to get a good deal from these buyers, but it's smart to shop around before accepting an offer. Financial buyers focused on shorter-term gains may be faster out of the gate than strategic buyers and initially make lucrative offers. However, they're also likely to play hardball at the negotiation table, where that original offer could turn into something less satisfactory.

On the other hand, opportunistic buyers can enhance a company's selling price. Competition typically drives up bids from corporate buyers that have been eyeing the business for years. It's an incentive for strategic buyers, including supply chain partners and competitors, to get off the sidelines and make an offer.

Weigh the options

Although caution can be a virtue when wading back into the M&A market, it can also lead to missed opportunities. Once a serious suitor is found and the offer price seems fair, the seller should move quickly to close the deal.

Flexibility and openness to creative terms can help keep a transaction from unraveling. For example, sellers should at least consider partial seller financing, earnouts or a deal structure that provides the buyer with tax benefits.

Seek outside expertise

Many factors will affect a seller's ability to get a fair price this year, including the company's industry, financial health and preparedness for sale. Valuation professionals can help sellers understand their company's value in the current market and evaluate ways to structure the deal to maximize their return on investment. ■

Linde v. Linde

Court rejects asset valuation approach in appraisal case

The asset-based (or cost) approach is one of three techniques that are commonly used to value private businesses. It's based on the adjusted book value of the company's assets less any outstanding liabilities. In *Linde*, a Pennsylvania Court of Appeals found that this approach wasn't appropriate under the circumstances — and a valuation that relied on it wasn't credible.

Battle leads to buyout

Two siblings — Barbara and Scott Linde — formed a construction business in 2006. Barbara and Scott owned 25% and 75% of the issued shares, respectively. After their relationship soured, Scott offered to buy out his sister's minority interest at book value upon her termination as an employee. He also proposed eliminating cumulative voting. She rejected his offer.

Several years later, Barbara was terminated from the company. She sued Scott, the company and its other directors for breach of fiduciary duty and civil conspiracy. She also requested removal of Scott from his positions with the business and the appointment of a custodian to oversee the company.

The trial court ruled in Barbara's favor, but it denied the appointment of a custodian. It also declined to remove Scott, instead ordering the buyout of Barbara's shares at "fair value." The court subsequently held an evidentiary hearing on the valuation issue and awarded Barbara almost $5.4 million, including about $1 million in prejudgment interest.

Courts dismiss asset-based approach

Barbara's expert applied the income and market approaches to determine value. Scott's expert used only the asset-based approach. In determining fair value, the lower court relied entirely on the valuation of Barbara's expert. The defendants appealed.

The Court of Appeals affirmed the trial court's decision. The lower court had cited multiple problems with the defense expert's valuation. Moreover, it found that the asset-based approach is "simply an improper method of valuation" when value should be determined on a going-concern basis.

The appellate court agreed with the lower court's reasoning: The asset-based approach is primarily used for holding companies, start-up or troubled companies, or small businesses not easy to get into or out of. The construction business didn't fall into any of those categories, so the asset-based approach couldn't "properly inform" the court regarding the stock's value.

Lesson learned

The asset-based approach does have its place — but it's not appropriate for every valuation. A qualified business valuation professional will consider the relevant circumstances and apply the most appropriate approach based on the facts and circumstances. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2020

Certified Public Accountants
Financial and Management Consultants

990 Stewart Avenue | Garden City, New York 11530

PRSRT STD
U.S. POSTAGE
PAID
CHICAGO, IL
PERMIT NO. 4269

garibaldicpas.com

GARIBALDI GROUP

The **Garibaldi Group** takes accounting and financial management to a new level of responsiveness.

- Accounting, auditing and consulting for small to mid-sized closely held businesses and professional practices
- Business and professional practice valuations
- Forensic accounting, fraud engagements and expert witness testimony
- Tax planning and compliance
- Private wealth management
- Business, financial and estate planning

Because at The Garibaldi Group,
it's our business to know your business.

Now that's accounting done right!

Certified Public Accountants
Financial and Management Consultants

990 Stewart Avenue Garden City, New York 11530
Tel: 516.288.7400 • Fax: 516.288.7410 • garibaldicpas.com