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Defensible Business Valuations™

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New Opportunities for Using Expert Business Appraisers Arise in Bankruptcy Arena

Attorneys frequently test the law in new ways, and they're currently pushing the boundaries in the area of fraudulent transfers—sometimes ensnaring innocent third parties such as purchasers or shareholders. Recent cases demonstrate how expert business appraisers can help attorneys push the parameters of the law—or protect their clients from becoming subject to the more aggressive legal tactics.

Unsuspecting third parties become ensnared

The recent *In re Hennings Feed & Crop Care* bankruptcy case [365 B.R. 868 (Bankr. C.D. Ill., 2007)] serves as one example. Hennings was an agricultural chemicals dealer who sold to a number of end-users, including other dealers, at a discount price. The transactions were otherwise "arms-length," but because the third-party dealers paid a price that was less than Henning's cost, as calculated by the trustee's expert, the trustee claimed they were fraudulent transfers.

In Illinois, the "look-back" period is four years (the time during which a trustee may "look back" to recover actual and constructive fraudulent transfers). Thus the Hennings trustee sought to recover the difference between what the dealers paid and the debtor's cost, for purchases over the four years preceding the bankruptcy. Based on the expert evidence, the court found for the trustee, and the unsuspecting dealers were liable for millions of dollars of below-cost purchases that occurred over the four years. Had the trustee been able to prove that an actual rather than constructive fraudulent transfer took place, the dealers might have been required to pay the total value of all purchases during the four years.

Shareholders can also be caught

When an over-leveraged buyer acquires a business, the selling shareholders may be exposed to claims of fraudulent transfer. For a certain number of years after the sale—depending on the "look-back" period in any state—if and when the business becomes insolvent, an aggressive bankruptcy trustee could force the shareholders to disgorge the proceeds of the sale. This could happen even though, at the time of the sale, the business was prof table, there was no debt on the balance sheet, and the owners sold it in good faith to an unrelated party in an arms-length deal.

Thus it may be wise for the seller to engage a business valuation expert to render a solvency opinion at the time of the transaction, or later, at the time of any bankruptcy f ling. A solvency opinion essentially states that the business is solvent; that it should have suff cient cash f ow to meet its obligations; and that the sale will not leave it with insuff cient capital.

As the boundaries of bankruptcy law continue to change, accredited business valuation experts can continue to assist attorneys by identifying and compiling evidence for fraudulent transfer claims and/ or trying to predict where the other side might f nd grounds for the same.

This issue includes...

This issue of Shannon Pratt Valuations' *Defensible Business Valuations™* includes articles on using business appraisers and solvency opinions to bring or defend against fraudulent transfer claims in bankruptcy; the SEC's new Rule 2290, which requires increased disclosure of information related to fairness opinions; a discussion of multiple business valuation standards and credentials; a summary of a study f nding that Daubert evidentiary challenges of f nancial experts are increasing rapidly; and an abstract of a case that rejected an absolute prohibition on using discounts for lack of marketability in marital dissolution cases.

New SEC Rule 2290 Raises the Bar on Fairness Opinions

The SEC recently approved amendments to Rule 2290, which addresses the disclosures and procedures related to the issuance of "independent" fairness opinions. Originally proposed by NASD (the National Association of Securities Dealers, which has since reincorporated as FINRA, the Financial Industry Regulatory Authority), the stated objective of the new rule is to provide greater clarity to investors and simplify compliance. Factors such as Sarbanes-Oxley, shareholder lawsuits, and state investigations helped encourage SEC approval, and the new rule has put fairness opinions under heightened scrutiny.

Days of 'rubber-stamped' opinions may be over

Boards of directors and corporate executives often seek fairness opinions during sales and/or acquisitions to provide a legal "safe harbor" for the f nancial aspects of the transactions. The opinion provides a public statement that the consideration in the proposed transaction is fair from the shareholders' perspective. Too often, however, critics and the courts have complained that fairness opinions are nothing but rubber-stamped endorsements of corporate deals rendered by the investment bankers, who could have a conf ict of interest. With the advent of Rule 2290, those days may be ending.

Notably, the new Rule recognizes that the real issue with fairness opinions was not their f awed analysis so much as their procedural limitations. For instance, a provider may have had too little time to make the proper analysis or received wrong information. Because fairness opinions are subject to public disclosure, third parties can sometimes use them in unintended ways or to draw incorrect conclusions. A fairness opinion is some evidence of fair dealing and f duciary compliance—but it is never an attestation of the "best price" or a substitute for good business judgment.

The new disclosure requirements in Rule 2290 should help shareholders as well as boards of directors to make better-informed decisions. In addition to disclosing the parties' additional roles in the transaction, opinions must now disclose any material relationships during the two years prior and any contingent compensation. Management-supplied information must receive independent verif cation, and a fairness committee must approve the overall opinion.

New procedural requirements relate largely to the selection and qualif cation of the fairness committee members and the process by which they will conduct a balanced, independent review. This includes the selection of appropriate valuation methods, because while a fairness opinion is not a formal valuation, it should include at its core a credible valuation. Opinion providers should start documenting their analysis right from the start of the engagement and be prepared for disclosure in every deal.

In a World of Diverse BV Standards, Credentials and Competency are Critical

The lack of unif ed standards has become one of the most controversial—and critical—topics for the business valuation profession. As a result, BV litigation experts may be more susceptible to intense examination regarding compliance with the appropriate professional standard(s), an area they (and their attorneys) should be prepared to expect—and use to their advantage, when cross-examining an opponent's expert.

Standards from diverse sources

Many believe that professional standards for business valuation "began" with IRS Revenue Ruling 59-60. Issued in 1959 and applicable by law to federal estate and gift tax valuations, Rev. Ruling 59-60 still remains the seminal guidance on valuation of ownership interests in closely held businesses. Its inf uence carried over into the BV standards that began to appear in the 1980s and 1990s: f rst, with The Appraisal Foundation's issuance of the Unif ed Standards of Professional Appraisal Practice (USPAP) in 1987, followed by standards from the American Society of Appraisers (1992), the Institute of Business Appraisers (1993), and the National Association of Certif ed Valuation Analysts (1993).

More recently, this past summer the American Institute of Certif ed Public Accountants (AICPA) issued its Statement on Standards for Valuation Services No. 1 (SSVS 1). As a result, BV professional standards are currently dispersed among f ve different organizations, plus continued federal guidance. The U.S. Tax Court has recognized USPAP and so has Congress, in legislation such as the Financial Institution Reform, Recovery and Enforcement Act (1989) and the 2006 Pension Protection Act. In 2006, the IRS issued Notice 2006-96, which cited USPAP as a generally accepted appraisal standard.

Multiple standards feed multiple questions

The pressure to adhere to these emerging standards is currently impacting all BV professionals, irrespective of their accrediting organizations. Beginning in January 2008, for example, when SSVS 1 became effective, many of the AICPA's approximately 300,000 members became bound by the standards when they perform valuation-related engagements.

In the litigation arena, appraisers who hold multiple credentials can expect to hear questions such as: "Which standards are best?" and "Do they ever conflict?" To maintain their credibility, experts should be prepared to answer these questions as they relate to their credentials and also their competency—that is, whether the opinions set forth in their reports comply with the appropriate standards. By the same token, accredited BV experts can help guide attorneys in developing the same questions for cross-examining their opponent's expert, identifying areas where credentials or compliance may be lacking.

New Study Finds Daubert Challenges up By Two Hundred Percent

The U.S. Supreme Court's *Kumho Tire* decision in 1999 extended the *Daubert* admissibility criteria to non-scientific expert testimony—and since then, *Daubert* challenges to all types of expert witnesses have increased almost 200%, according to the latest study by PricewaterhouseCoopers (PwC). The 2000-2006 Financial Expert Witness *Daubert* Challenge Study examines nearly 3,000 federal and state court opinions and finds the following trends:

- The number of *Daubert* challenges to all expert witnesses increased by more than one third between 2005 and 2006—the second consecutive annual increase exceeding 30%.
- Despite increases in the number of challenges—and exclusions—in the past seven years, the percentage of expert exclusions is remaining fairly consistent, at around 47%.
- Approximately 519 *Daubert* challenges targeted financial experts; of these, 106 took place in 2006—an increase of 14% over 2005.
- Of the 519 challenges to financial experts, 30% were completely excluded, 18% were partially excluded, and 49% were admitted.
- Five federal circuits (2nd, 3rd, 5th, 6th, and 7th) together heard 60% of all financial expert challenges. In the 9th Circuit, 68% of expert testimony was excluded in whole or in part, compared to only 24% in the 1st Circuit.
- Although plaintiffs' experts are the most frequent targets, once defendants' experts are challenged, exclusions are in equal proportion (47% plaintiffs vs. 48% defendants).
- Economists, accountants, and statisticians comprise 50% of all challenges—but they also survive Daubert attacks more successfully than other financial experts.

The most common cause of a financial expert's exclusion was a lack of reliability, followed by a finding of lack of relevance and an expert's lack of qualifications, according to the study. Further, flaws in a financial expert's methodology or misuse of accepted financial or economic methods also frequently lead to exclusion. Less common was a "maverick" use of novel or untested methods. In the business valuation arena, failure to consider a discounted cash flow (DCF) analysis was the basis for expert exclusion in three notable cases, most recently in *In re Med Diversified*, 2006 Bankr. LEXIS 1677 (Bankr. E.D.N.Y. 2006) and *Celebrity Cruise Inc. v. Essef Corp.*, 2007 U.S. Dist. LEXIS 3653 (N.Y.S.D. 2007).

To access the free *Daubert* study from the PwC website, go to: http://www.pwc.com/extweb/pwcpublications.nsf/docid/b5b7c01ed69db8598525732f0075615b.

Florida Court Considers Prohibiting Marketability Discounts in Divorce

Erp v. Erp, 2007 Fla. App. LEXIS 18726 (November 28, 2007)

In this case, the Florida Court of Appeals considered whether, as a matter of law, a discount for lack of marketability (DLOM) should not be applied when valuing a business for divorce purposes.

During the marriage the couple purchased an RV dealership, formed as a Subchapter S corporation, which they grew to a business that earned more than $1 million annually. Each spouse owned a 40% interest while their two children held the remaining shares equally. Prior to trial, the parties agreed that one of them should be awarded the entire 80% interest while the other spouse would receive an equalizing payment of one-half the fair market value of that interest.

Demonstrative exhibit makes impact

At trial, both parties' experts generally used an income-based approach to value the business. The wife's expert valued the business at $12.5 million and $5 million for her 40% share. By contrast, the

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husband's expert valued the business at $4.56 million and the wife's one-half share at only $720,000.

However, the husband's expert presented a "demonstrative exhibit" to the trial court, which presumed to detail the differences between the two appraisals. Of particular note was the expert's application of a 25% discount for lack of marketability (DLOM).

The trial court awarded the 80% interest in the business to the husband, with an equitable distribution to the wife. The court used parts of each expert's appraisal, and ultimately valued the business at $6.2 million. Further, it valued the wife's one-half interest at $2.48 million (or 40% of the total value of the corporation).

The trial court explained its determination by reference to the demonstrative exhibit, and applied the marketability discount, but at a reduced level of 10%. Among other issues, the wife appealed the application of a marketability discount.

Should DLOMs be precluded in divorce?

The wife argued that a marketability discount should be prohibited as a matter of law in a divorce valuation. She analogized the divorce context to that of an oppressed and/or dissenting shareholder. Because a court orders judicial "buyout" in those cases (as it does in divorce), and because local (Florida) law does not permit DLOM in the oppression context, the wife argued that the court should not be permitted to apply a marketability discount in this case.

The appellate court was not persuaded. Dissenting shareholder cases arise in the context of an "involuntary change in the fundamental corporate structure," it said. The appraisal remedy protects minority shareholders who are cashed out of their investment by precluding further reduction of their interests through marketability discounts. This situation is not present in the divorce context. "What is appropriate in the oppressed shareholder or minority appraisal rights cases may not necessarily be desirable in a judicial dissolution of a corporation or in an action for dissolution of marriage involving equitable distribution."

In this case, the wife was not the victim of majority shareholder oppression. The more proper analogy, the court reasoned, is to a judicial dissolution of the business based on shareholder deadlock, where a court has discretion to determine whether a marketability discount is appropriately applied to a closely held corporation.

Accordingly, the court declined to prohibit marketability discounts as a matter of law in divorce cases. Finding no abuse of discretion, it aff rmed the trial court's application of a 10% DLOM.

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