Advocate's Edge

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Duped investors seek payback from brokers

Many investors whose portfolios took dramatic hits as a result of alleged mishandling are striking back, looking to recoup their losses from securities brokers. Suitability and churning claims picked up shortly after the Enron and WorldCom debacles and continue to gain steam. Investors can pursue these claims under the fraud provisions of SEC Rule 10b-5 or as violations of the broker's fiduciary duty.

Suitability: Does the investment fit the investor?

Suitability claims are based on the selection of investment vehicles that are inappropriate for an investor's objectives, resources, time horizon and risk tolerance. The riskiest investments generally should be limited to sophisticated investors who can afford to lose money and are willing to do so in anticipation of eventually gaining greater returns. They're not for investors concerned primarily with preserving capital.

The National Association of Securities Dealers (NASD) Securities Manual specifically addresses suitability. It requires NASD members to have a reasonable basis for believing that an investment is suitable for an investor. In making this assessment, the broker must consider the investor's risk tolerance, other security holdings, financial situation (income and net worth), financial needs and investment objectives.

Several questions are pertinent to suitability liability:

- ☑ Did the broker inquire about the client's assets, liabilities and other investments?
- ☑ Did the broker discuss and understand the client's income statement, including monthly income and expenses?
- ☑ Did the broker consider the client's age, marital status, number and ages of dependents, employment, investment horizon and needs such as health care and education?
- ☑ Did the broker and client discuss various investment objectives and their associated risks?

Relevant evidence might include account application forms, broker-investor correspondence, broker research, monthly account statements, other broker clients who made the same investment and evidence of the investor's first steps upon initial suspicion of unsuitability. A financial expert familiar with securities matters can help you identify and analyze relevant documents and data.

Churning: Are the trades excessive?

Churning involves excessive trading — with or without the investor's knowledge — designed to generate commissions and fees. And high commissions aren't the only potential problem for churning victims. The broker's actions might also create short-term capital

gains, taxable at the investor's marginal income tax rate rather than the more favorable long-term capital gains rate.

Red flags for churning include disproportionate turnover, frequent in-and-out trading and large commissions. But proving churning requires more than account turnover or market losses. The investor must have suffered an actual, compensable loss. The loss, though, can be unrealized, as where the investor has yet to sell the weak stock now in his or her portfolio.

Courts have identified a variety of factors that bear on churning claims, including:

- ☑ The number and frequency of trades,
- ☑ The amount of in-and-out trading,
- ☑ The amount of commissions generated by the trading, both in dollar terms and as a percentage of the broker's salary,
- ☑ The investor's objectives and level of business sophistication, and
- ☑ The degree of control exercised by the broker over the account.

As far as control over the account, the NASD and Securities and Exchange Commission require the trading to be conducted in a discretionary account in which the broker can trade without the client's prior approval. Courts have been less stringent, finding the control element satisfied if the investor routinely followed the broker's advice.

Watch for the warning signs

Suitability and churning violations share some red flags, such as high-turnover trading, high-volume trading in low-priced stocks, options trading and selling mutual funds more frequently than once a year. Any of these characteristics could signal inappropriate trading and may warrant investigation. ✧

Valuation by the numbers — QMDM focuses on quantitative factors

When valuing a minority interest in a closely held business, valuators typically apply a discount for lack of marketability. Many valuators agree, based on qualitative benchmark analysis of restricted stock studies, that an appropriate discount is in the neighborhood of 35%.

Some valuators, however, are turning to quantitative approaches, which, they say, can produce more accurate results. One such approach is the quantitative marketability discount model (QMDM), which calculates the discount based on a business interest's expected future dividends, holding period and return requirements. Some courts have accepted QMDM, but it's not without its critics.

Quantities, not qualities

QMDM proponents argue that the qualitative approach fails to incorporate the wide variation of investment characteristics in closely held businesses. They believe QMDM produces more accurate marketability discounts by considering the subject's quantifiable economic characteristics.

QMDM rests on several basic assumptions:

Expected growth in value. QMDM assumes that value eventually will be realized at the marketable minority level, so an investor would want an estimate of the value that will be attained. Low growth would increase the amount of the discount.

Expected dividends or distributions. The model recognizes that a minority interest that's expected to make regular distributions is worth more than one that's not. QMDM quantifies the value of expected distributions over the expected holding period, considering each distribution on an after-corporate-tax basis. It quantifies the impact of distributions based on the facts and circumstances. An interest with few or no expected distributions justifies a higher discount.

Expected growth in dividends or distributions. This component usually has a minimal impact in the absence of lengthy holding periods and significant distributions. Again, low growth should mean an increased marketability discount.

Expected holding period for the investment. QMDM assumes that investors in minority interests estimate how long they will need to hold the interest before realizing liquidity. Proponents concede that the holding period can't be estimated with certainty, but they maintain that it's an important exercise nonetheless. A long or uncertain holding period supports a higher discount.

Required return. The required return, or discount rate, used in the model should reflect the risk, among other things, that the company won't distribute cash flows or that the interest won't become transferable. The QMDM works from the base equity discount rate and adds an investor-specific premium for relevant risks. The higher the required return, the more a minority interest's value must be discounted.

Do facts lead to better figures?

While the average marketability discount for an illiquid minority interest might approach 35%, QMDM proponents maintain that individual fact patterns can yield a wide spectrum of results. QMDM, by considering an interest's quantifiable economic characteristics, has a certain logical appeal.

But some critics question the model's accuracy. They argue, for example, that QMDM measures other factors besides the marketability discount. They also point to the difficulty of accurately estimating the holding period. Keeping in mind the controversy over QMDM, it may be worth a look in some cases, particularly in jurisdictions whose courts have accepted the method. ✧

Tax Court applies "independent investor" test to compensation

The reasonableness of owner compensation is a critical issue for both business valuation and tax purposes. When valuing a closely held business using income-based methods, for example, compensation levels can have a significant impact on earnings or cash flows. In a tax context, the IRS may argue that excessive compensation represents profit distributions rather than deductible salary.

In *Miller & Sons Drywall, Inc. v. Comm'r* (T.C. Memo. 2005-114), the U.S. Tax Court applied the "independent investor" test in determining that the taxpayer's compensation was reasonable.

Keeping it in the family

Darle Miller started a drywall business with his father in the mid-1970s, eventually taking over as sole proprietor. In 1980, he and his brother Dean incorporated the business, and their brother Rocky bought an interest two years later. The ownership interests were divided as follows: Darle (CEO and president), 51.8%; Dean (secretary/treasurer and job-site supervisor), 24.1%; and Rocky (vice president and job-site supervisor), 24.1%.

Darle worked an average of 55 hours per week, regularly bringing work home to estimate the cost of completing jobs. Dean and Rocky worked 55 to 60 hours per week. For the three years in question, Darle's salary ranged from $282,501 to $440,000; Dean's and Rocky's salaries were between $150,000 and $250,000.

Being "reasonable"

As the Tax Court observed, the majority of federal appellate courts apply the multifactor test to determine whether compensation is reasonable.

Here, though, the court opted for the independent investor test, although the relevant circuit court (the Eighth Circuit) has never applied the test. Under the independent investor test, a court weighs whether an inactive, independent investor would have been willing to pay the amount of disputed compensation under the facts of the particular case.

Note that the multifactor and independent investor tests analyze many of the same factors. The difference is that in the latter test those factors are viewed through the lens of an independent investor. A key inquiry is whether, after paying the compensation in question, the company would provide shareholders with a fair return on their investment.

In *Miller*, the Tax Court focused its investor lens on nine factors:

1. **Employee qualifications.** The brothers' knowledge and experience supported their compensation.
2. **Nature, extent, and scope of the work.** Darle's 20 years of experience was irreplaceable, and his brothers' skills, dedication and efforts were in part responsible for the company's sales and profits.
3. **Size and complexity of the business.** Given the size and complexity of the company's operations, and the competitive nature of the industry, the brothers' business methods and techniques directly influenced the company's success. Also, the company's lean management required each brother to wear several hats.
4. **General economic conditions.** Favorable economic conditions during the period in question had "at most a minimal impact" on the company's success. Rather, the level of success depended on how well the brothers performed their jobs.
5. **Comparison of salary with distributions and retained earnings.** The lack of distributions from available profits supported the inference that some of the compensation actually represented taxable dividends. But the average return on equity of 15% for the period was close to the 15.8% assumed rate of return that an investor would find acceptable, favoring the taxpayer.
6. **Comparison to gross and net income.** This factor favored the IRS position because the brothers' compensation constituted a substantial percentage of the company's gross and net income, even surpassing net income one year.
7. **Comparison to salaries paid by similar companies for similar services.** This factor was neutral because no persuasive data was presented.
8. **Company's salary policy as to all employees.** The brothers received more generous and more frequent bonuses than the company's other employees, favoring the IRS position.
9. **Company's pretax profit margin.** The company's "exceptional" pretax profit margin indicated that the brothers deserved their high compensation. On the other hand, compensation substantially depleted earnings, so margins after compensation were no longer exceptional. However, this factor was neutral because, even after compensation, profit margins were near the industry average.

The future of reasonable compensation

In *Miller*, the court concluded, based on its application of the independent investor test, that the taxpayers' compensation was reasonable and fully deductible. Taxpayers from the Eighth Circuit who find themselves in Tax Court should expect to confront the independent investor test, unless the Eighth Circuit adopts a contrary test. And taxpayers in other circuits that have yet to definitively adopt a reasonable compensation test should be aware the Tax Court may take the initiative and impose the independent investor test. ✧

Closing the document generation gap

Organizations today generate enormous amounts of data in digital form, so electronic evidence is becoming a key part of the discovery process. In many cases, forensic experts are finding a gap between organizations' document management practices and their legal needs.

Common obstacles

Inadequate document management can make it difficult to identify and retrieve relevant electronic evidence. By learning about the parties' document management policies and practices you can anticipate discovery problems and smooth the evidence-gathering process.

Several obstacles seem to crop up again and again:

Lack of a central repository. Information is stored across multiple servers, backup tapes and individual employees' archives, some of which may not even be known to management.

Lack of a document retention policy. Employees save every document they create, with no organizational standards or guidance on what to retain, how long to keep it and how to categorize documents by importance or privileged status.

Mixed use of computers. Employees use their work computers for both business and personal reasons, resulting in intermingled data.

Failure to distinguish backups from archives. Information is saved longer than necessary under the theory it will satisfy both disaster recovery and business archive purposes.

Obsolete formats. Hardware and software are updated regularly, but backups remain in outmoded formats.

Multiple media types. Data is spread across desktops, laptops, PDAs, servers, hard drives, shared files, CD-ROMs, floppy disks and employees' home computers.

Sources of hidden evidence

To conduct effective electronic discovery, it's important to understand and target the more obscure sources of electronic evidence. These include:

Incomplete deletion. Data thought to be deleted may still exist in some form. When a document is deleted, it's not immediately purged; instead, the document is marked to be overwritten. Forensic experts can recover portions of a document until it's completely overwritten by new data.

Latent data. Electronic documents carry embedded data that's invisible to the naked eye. This data can reveal the document's author, indicate documents that were attached to an e-mail, and track revisions, among other things.

Miscellaneous data. You may be able to uncover miscellaneous caches of data that an organization can't identify. Often, these sources yield relevant evidence.

Using financial experts to smooth purchase price adjustments

Businesses put a great deal of time and effort into structuring acquisitions, but the most critical juncture can come after the deal has closed. With the input of a qualified financial expert, you can draft purchase price adjustment (PPA) provisions that minimize the likelihood of a dispute. And, in the event of a dispute, the expert can pave the way to a satisfactory resolution.

Understanding PPAs

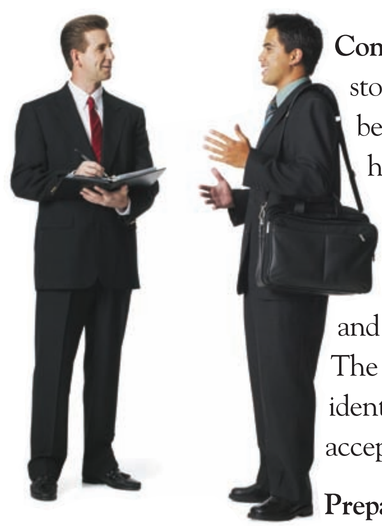
Most acquisitions are negotiated and finalized before closing-date financial figures are available. The parties must rely on previously issued "reference financials" to fill the gap. When the closing-date financials become available, a PPA is made to reconcile any disparities between the two.

Bearing PPAs in mind, buyers often approach a transaction by offering a higher purchase price, under the assumption that funds from the PPA will partially offset that price. The seller's goal is to minimize the amount of the purchase price it must return.

Drafting issues

The technical terms that lace a PPA provision in a purchase agreement can lead to different interpretations when the time for adjustments rolls around. Several of the provision's components demand close attention:

Materiality. Financial information is defined as material if it would influence the user's decision. Generally accepted accounting principles (GAAP) allow the exclusion of immaterial items from a balance sheet, but a buyer might not agree that excluded items were truly immaterial. The PPA provision, therefore, should establish a materiality standard for calculating the price adjustment. The provision might specify a dollar amount or certain factors that could be used to determine materiality.



Consistency. It's commonly understood that, when there's a conflict between GAAP and a seller's historical accounting practices, GAAP prevails. But that could result in closing financials that comply with GAAP and reference financials that don't. The PPA provision can explicitly identify areas where the parties will accept deviations from GAAP.

Preparation of balance sheets. The seller usually prepares the estimated closing balance sheet; the buyer prepares the actual closing balance sheet. Some purchase agreements require the seller to prepare both, but this can prove difficult, especially if the buyer, who controls the postclosing books, fails to cooperate.

Bases for the adjustment. PPA provisions often hinge on working capital adjustments or balance sheet elements, but other formulas are available. PPAs may turn on earnings, cash flow, tangible net worth or total net worth. Net worth adjustments, however, consider noncash items that rarely relate to the PPA's goal.

Valuation reserves. Buyers sometimes attempt to boost the purchase price by increasing reserve levels in the closing balance sheet. To avoid disputes, the PPA provision should exclude valuation reserves and should treat accounts receivable and inventory on a gross basis for purposes of determining the working capital target. Ideally, the provision will lock in reserve levels, thereby preempting the exercise of discretion or judgment.

More than an afterthought

By drafting the PPA provision carefully, you can save your client time and resources in the postclosing phase, and, in the event of a dispute, qualified experts can expedite the process. Without nagging PPA issues dangling overhead, your clients can focus on integrating their new businesses. ✧

Dealing with postclosing disputes

Financial experts can play a valuable role in the event of a dispute, serving as a consultant, testifying expert, or both.

Initially, an expert can translate the financial language and explain the accounting, financial, economic, tax, valuation and related issues. An expert can also:

- ☑ Evaluate whether GAAP has been applied consistently,
- ☑ Resolve earnout issues,
- ☑ Analyze reference and closing-date financials,
- ☑ Calculate the PPA,
- ☑ Scrutinize the other party's calculations for flaws,
- ☑ Negotiate a reasonable settlement range, and
- ☑ Allocate the purchase price for tax purposes.

Should the dispute proceed to trial or alternative dispute resolution, a financial expert can decipher the financial language for the fact finder, explain the client's position regarding an appropriate adjustment, and rebut the opposing party's position.