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The valuation of shares in shareholder litigation has been the subject of much debate — particularly over the selection and application of an appropriate standard of value. A recent Eleventh Circuit court decision, *Cox Enterprises, Inc. v. News-Journal Corp.*, demonstrates some of the key questions that can arise, as well as their potential resolution.

DISAGREEMENT OVER VALUE ARISES

News-Journal Corporation (NJC) is the publisher of a daily newspaper and several local shopping guides. Over the years, the closely held Florida corporation has established and financially supported several nonprofit arts organizations. When NJC's annual giving began to exceed the amount it was allowed to deduct as charitable donations, it started reporting the contributions as corporate promotion costs so it could deduct them as business expenses.



In 2004, Cox, a newspaper publisher holding a 47.5% interest in NJC, became aware of NJC's purchase of naming rights on a performing arts center for \$13 million and filed suit. The privately held corporation alleged various acts of fraud, waste and mismanagement. In response, NJC elected — under a Florida statute — to purchase Cox's shares at their fair value. According to Florida courts, "fair

value" under the statute is what a willing buyer in an arm's-length transaction would offer for an interest in the business. Cox and NJC couldn't agree on the amount, however.

At trial, Cox's expert determined that the fair value of Cox's shares was about \$145 million. NJC's expert determined that it was only about \$29 million. Leaning heavily on Cox's expert's valuation, the district court found that the fair value was about \$129 million.

FAIR VALUE VS. FMV

One of the issues the Eleventh Circuit looked at on appeal was fair value vs. fair market value (FMV). The district court had used FMV in calculating fair value, and NJC challenged this use.

The Eleventh Circuit found that, although fair value and FMV aren't synonymous, the terms aren't mutually exclusive, either. So, as long as potentially distorting corporate actions (such as impending mergers) aren't at issue, it can be appropriate for a court to use FMV to estimate fair value.

The Eleventh Circuit noted that Florida courts have recognized that valuation proceedings necessarily present a variety of evidence and methods related to determining the price of minority interests. It cited a Florida state court case for the notion that a court "should consider proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court," including market price.

In Cox, the district court had decided that Cox's expert's FMV/comparable sales valuation method was appropriate. Because there was no distorting corporate action and the lower court based its decision on the circumstances and offered solid reasons for it, the Eleventh Circuit found the lower court hadn't abused its discretion.

"GOING CONCERN" DEFINITION

The Eleventh Circuit also considered the meaning of "going concern" and whether "normalization" of NJC's operating margin was appropriate. Both Cox's

and NJC's experts had valued the company as a going concern, but the NJC expert's opinion was influenced by NJC's general counsel's "suggestion that valuing a company as a going concern rests on the assumption that a company will operate in the future exactly as it has in the past."

The Eleventh Circuit explained that the term "going concern" generally means a commercial enterprise actively engaging in business with the expectation of continuing indefinitely. According to the court, "In the valuation context, it is generally used in contradistinction to a business that will be liquidated."

The district court's (and Cox's expert's) valuation assumed that, as a going concern, NJC would be managed in a reasonably prudent manner going forward — even though it hadn't been in the past. The Eleventh Circuit found this assumption to be appropriate. It noted that applying a going concern definition that requires a valuation based on any previous mismanagement or waste could incent majority shareholders and directors to violate their fiduciary duties and manage the business in such a way as to undermine minority shares' value.

In applying the "market approach" in his valuation, Cox's expert performed an analysis that compared NJC's value with the purchase prices of similar newspaper publishers. For example, he compared NJC's earnings before interest, taxes, depreciation and amortization (EBITDA) margin to the average EBITDA or operating margin of 11 publicly traded newspapers. He found that the 11 papers had an average operating margin of 28.3%, vs. NJC's margin of 9.3%. The expert, therefore, "normalized" (or adjusted for the company's specific circumstances) NJC's margin to 28.3%. (For more about normalization, see "What's normal? How valuers adjust earnings to reflect market value" on page 5.)

NJC argued that it was wrong to assume NJC was capable of achieving the same level of financial return as other similarly situated newspapers. But the Eleventh Circuit found that the district court hadn't abused its discretion by normalizing NJC's margin.

CREDENTIALS MATTER

Because the circuit court opinion in *Cox Enterprises, Inc. v. News-Journal Corp.* contrasted the two experts' qualifications, the difference in their qualifications is worth examining.

The Cox expert was a partner in a firm specializing in the valuation of newspapers. The firm has valued more than \$10 billion worth of transactions in its history and more than 50% of the daily newspaper transactions in the United States over the past decade. The expert had previously worked in the newspaper business and was once general manager/business manager and part owner of a daily newspaper. The district court characterized him as "plainly qualified" to testify on News-Journal Corporation's fair value.

NJC's expert was a CPA and partner in his firm, as well as an accredited senior appraiser. But he had little experience in valuing newspapers. In fact, 90% of his practice involved gift taxation and complex divorces. The district court described him as "appreciably less" qualified than Cox's expert.

The lesson is clear: Courts take note of expert qualifications. They may, as a consequence, give more weight to one expert over the other.

The district court had reasoned that normalizing "the financial data of a poorly operated corporation before determining what that corporation would sell for in an arm's-length transaction" better approximates the corporation's value as a reasonably prudently managed business.

NJC wasn't the only party that questioned the district court's valuation. Even though the court's valuation generally favored Cox's expert's, Cox appealed the court's refusal to adjust its fair value calculation to compensate for past misconduct by NJC's management.

The Eleventh Circuit agreed that fair value should consider the impact of any waste or other harm resulting from mismanagement. But it found that the district court's normalization of the operating margin addressed such impact.

ACCOUNTING FOR REALITY

As the *Cox* case shows, the role FMV can play in shareholder litigation — even when a statute calls for fair value — is significant. Regardless of the standard of value, to hold up in court a valuation must take into account all the appropriate factors and relevant court decisions. ▀

Show me the money

Tracing hidden business assets

Distrust is typically part and parcel of divorce litigation — especially when it comes to financial matters. To secure a fair and equitable resolution, attorneys may need to trace assets and income that a business owner spouse has hidden to reduce child support, alimony liability or the final settlement amount. Forensic accountants can help by deploying the same asset-tracing techniques they use to detect occupational fraud.

TRACING SUSPICIOUS PAYMENTS

Experts typically start by looking for suspicious payments that could indicate a business is stashing assets for its owner. These payments ostensibly represent business expenses but could actually represent money transferred into the owner's pocket and away from disclosed bank accounts. To find these payments, the expert collects various financial documents from the business, including:

- ▶ Bank account statements,
- ▶ Purchase orders,
- ▶ Invoices,
- ▶ Receipts, and
- ▶ Records of payments from bank accounts, check registers and ledgers.

Checks associated with the suspect payments are studied particularly closely. A check to a vendor that was cashed — rather than deposited — may indicate a nonexistent vendor. Or a vendor might appear to have endorsed a check, but it was subsequently endorsed by an individual for cash or deposit to an undisclosed personal account. Even when a check has been deposited in a business account, the forensic specialist may seek to confirm the accountholder's legitimacy.

Experts check payments against the company's documentation as well. Discrepancies from normal practices, missing documentation, photocopies, and unnumbered or sequentially numbered invoices all raise red flags and may merit further investigation.

DETECTING FRAUD SCHEMES

Forensic accountants on the hunt for hidden assets frequently search for on-book fraud schemes, such



as payments to nonexistent vendors or “ghost” employees. A business owner also might recruit third parties to assist in asset-hiding schemes. For example, the company could issue a check to a vendor in an amount greater than actually owed, with the vendor returning the excess as cash.

To detect payments to fictitious vendors, experts look for unusual activity in the business's cash receipt and disbursement journals, ledger accounts, purchase orders, and invoices. Vendor accounts with no tangible deliverables — for consultants, commissions and advertising, for example — receive special attention, as do multiple vendors with the same address. Another potential red flag is when cash has been deposited into a company account, but not recorded on the company's books.

To uncover potential ghost employees, experts review payroll lists, current and former employee lists, personnel files, and employment applications. The accountant also checks withholding forms and authorized deductions because ghost employee records typically omit the appropriate deductions and exemptions.

A suspected overbilling scheme with a third party may exist if there are invoice notations for “extra” or “special charges” without additional explanation or corresponding goods or services. Other warning signs: discrepancies between the invoice and actual payment, and unusually high charges.

UNCOVERING HIDDEN INCOME

Spouses attempting to hide assets may also fraudulently drive down their business’s income to reduce the company’s net income — and value as a marital asset. For example, a business owner might purchase personal assets such as cars and real estate or cover expenses like cell phone bills and insurance premiums with business funds.

To find hidden income, an expert scrutinizes the business’s actual expenses and expected sales associated with that level of expenses, accounts receivable and journal entry writeoffs. He or she also examines the business’s internal controls and the spouse’s ability to override them, the company’s markup structure, and the associated expected profitability. Large or unusual

A check to a vendor that was cashed — rather than deposited — may indicate a nonexistent vendor.

accounts receivable credits or sales returns usually merit further investigation.

SHINING A LIGHT

During divorce litigation, your client must shine a light on every financial corner — particularly when that spouse has had limited access to the couple’s financial information during the marriage. Uncovering hidden income and assets is likely to help your clients receive the settlement and support they deserve. ▸

What’s normal?

How valuers adjust earnings to reflect market value

Your clients may need a business valuation for a variety of reasons — for example, a sale, marital dissolution or buy-sell agreement. So it’s important to understand how professional appraisers determine value. Although valuers scrutinize their subjects’ balance sheets, they also recognize that those numbers only reflect a business’s “book value” at a point in time. To arrive at the most accurate market value, these professionals must adjust or “normalize” a company’s earnings.

BOOK VS. FAIR MARKET

The discrepancy between balance sheet value, or book value, and fair market value (FMV) can usually be attributed to a business’s accounting practices. Many businesses — especially small and midsize ones — record their assets at their historical cost. For example, production machinery purchased for \$200,000 is



recorded at that amount for the duration of its life, regardless of its current market value.

Even accounting for depreciation over time, an asset's book value probably won't equal market value because depreciation methods are usually selected based on tax considerations, instead of economic value. Thus, assets are recorded at an amount far below market value. And if they have depreciated fully, they aren't recorded at all despite remaining in use and having value.



Businesses that use cash basis — rather than accrual — accounting also distort their value on balance sheets. Cash basis accounting records income as it's collected and expenses as they're paid, as opposed to when they're earned or incurred. The balance sheet, therefore, doesn't show accounts receivable (A/R) or payable.

TARGET AREAS

For these reasons, a balance sheet typically requires normalization adjustments before a valuator can reach an accurate FMV. Valuators usually make adjustments in several areas, including:

Accounts receivable. A/R is recorded at face value, with a deduction for estimated uncollectible accounts.

And unbilled A/R, with adjustments for collectibility, is recorded.

Inventory. Valuators record inventory at current replacement cost value by reducing or writing down obsolete or aging inventory. Inventory that was purchased as assets is recorded, and phantom inventory that doesn't actually exist is eliminated from financial records.

Property, plant and equipment. Real estate is generally reported at FMV for valuation purposes, although it is sometimes dealt with separately from the overall business value. In that case, the valuator also removes real estate-related income items from other financial statements and records reasonable rent expenses.

Furniture and equipment are recorded at used replacement value — current replacement value less a depreciation adjustment for the length of time the asset has already been in service. Leased equipment is recorded as assets (with the remaining balance listed as a liability) if the lease is fairly characterized as a purchase agreement.

Leasehold improvements. If the improvements increase the business's value, valuators record them as assets even though they remain with the landlord when the lease expires.

Taxes. Overpayments of taxes are recorded as assets.

Prepaid expenses. If a business prepays expenses like insurance, valuators make an adjustment to the extent of the prepayment, thereby erasing future liability and increasing the business's value.

Unrecorded obligations. The business's obligations to pay for goods and services it has received but not yet paid for are recorded. These include lease payments, accrued sick and vacation pay, unfunded pension liabilities, unpaid payroll, and payroll taxes.

Contingent liabilities. Valuators estimate contingent liabilities such as potential lawsuits, and record them as debt.

AN ESSENTIAL STEP

In addition to normalizing earnings, valuators may also make corresponding adjustments to a business's income statement. Your client should understand that these steps are essential to the valuation process and are likely to result in a business value that's different — anywhere from slightly to dramatically — from the book value they currently know. ▀

Employment discrimination claims

What's in it for the claimant

The number of employment discrimination charges filed climbed 9% from 2006 to 2007, according to the Equal Employment Opportunity Commission. That's the biggest jump since 1993. With the economy in a recession and unemployment on the rise, the number of claims is likely to continue to increase. So now may be a good time to review the remedies available to claimants in these cases.

GENERAL REMEDIES

Certain remedies are available to successful employment discrimination claimants regardless of whether the discrimination was caused by intentional acts. They also are available to successful claims under Title VII (which prohibits discrimination based on race, color, religion, sex or national origin), the Age Discrimination in Employment Act (ADEA), the Equal Pay Act and the Americans with Disabilities Act (ADA).

Under most federal laws, compensatory and punitive damages are available in cases of intentional discrimination.

Courts may grant relief in the form of back pay, promotion, reinstatement, front pay, reasonable accommodation or other actions that would make the claimant whole. A claimant can also recover attorneys' fees, expert witness fees and court costs. Under most federal employment discrimination laws, compensatory and punitive damages are available in cases of intentional discrimination.

DETERMINING DAMAGES

Compensatory damages include actual monetary losses, future monetary losses, inconvenience, emotional distress and other nonpecuniary losses. Courts require

evidence of actual harm to recover emotional distress damages. Although the U.S. Supreme Court hasn't specifically addressed the type of evidence necessary, evidence often involves testimony from the employee, co-workers, family members and medical experts.

If the complaining party demonstrates that the respondent engaged in a discriminatory practice with malice or reckless indifference to the federally protected rights of an aggrieved individual, a court can award punitive damages. An employee seeking punitive damages may introduce evidence of:

- ▶ The employer's net worth and monthly net income,
- ▶ The employer's malicious acts,
- ▶ The role of top officials in the wrongful conduct, and
- ▶ Any patterns of discrimination.

Note that, in *Kolstad v. American Dental Association*, the Supreme Court ruled that plaintiffs seeking punitive damages in employment discrimination cases aren't required to show an egregious act separate from the defendant's culpable mind. The *Kolstad* court also ruled that an employer can't be held vicariously liable for managers' employment decisions if those decisions are contrary to the employer's good faith efforts to comply with Title VII.

Under 42 U.S.C. Section 1981a(b), total compensatory and punitive damages are capped. The cap is based on the number of employees the employer had in each of 20 or more calendar weeks in the current or preceding calendar year, and it tops out at \$300,000 for employers with more than 500 employees. Caps don't apply, however, to discrimination claims based on race or national origin.

CRUNCHING THE NUMBERS

Because there are many variables involved in employment discrimination damage awards, work with a qualified financial expert to determine a reasonable settlement amount before trial. If the complaint does go to trial, your expert can provide critical testimony in court supporting your position. ▶