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Advocate's Edge

Bumpy ride
Determining damages for securities fraud

Court weighs in on IRS challenges to S corporation valuations

The QDRO: An important tool for dividing retirement plans in a divorce

Nonphysical injuries damages
Decision could benefit employers *and* employees

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Determining damages for securities fraud

Calculating damages in class-action securities fraud cases is challenging. Securities laws don't sufficiently address the issue and there's little useful case law because most cases settle. Experts engaged for such cases confront several complicated issues, including aggregate damages and determining an accurate damages amount.

Theories of recovery

Securities fraud class actions typically are brought under Rule 10b-5 of the Securities Exchange Act of 1934. Generally, plaintiffs assert that the defendant disseminated misleading information or failed to disclose adverse information, causing its shares to trade at an inflated price. The complaint often invokes "fraud on the market," claiming that the plaintiffs relied on market efficiency and market price integrity when trading the defendant's stock.

Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA) to curb abuse of securities laws by plaintiffs, particularly in the form of securities fraud class actions. The statute limits a plaintiff's damages to the "difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price … during the 90-day period beginning on the date on which the information correcting the [misrepresentation] that is the basis for the action is disseminated to the market."

No single approach is accepted for proving out-of-pocket losses, but experts often employ models that rely on event studies.

Aggregate damages debate

It's difficult, if not impossible, to assess the damages sustained by every investor who bought or sold stock during the class period — especially because all of the plaintiffs may not have been identified at the time of trial. Plaintiffs, therefore, frequently try to make the case for aggregate, rather than individual, damages. Theoretically, aggregate damages represent a single amount covering all plaintiffs, to be distributed via an administrative claims process.

Defendants contend that aggregate damages aren't accurate because they don't reflect variations in individual damage amounts owed to each plaintiff — which could reduce the overall amount substantially. In seeking to exclude expert testimony regarding aggregate damages, a defendant might argue that the PSLRA bars aggregate damages, as the defendant successfully maintained in the Pennsylvania district court case *Bell v. Fore Systems*. The *Bell* court concluded that the PSLRA's damages limitation "cannot be imposed on the class as a whole, but must be applied to the circumstances of each plaintiff."

Other courts have disagreed with *Bell*. These courts dismissed concerns about overcompensation by arguing that the court-administered claims process ensures the legitimacy of claims amounts. Defendants might counter that, should they opt to settle their cases, no claims process would be involved.

A California district court in *In re Broadcom Corporation Securities Litigation* ruled that the issue of aggregate damages under PSLRA is for each court to decide: "The statute neither requires nor prohibits proof of aggregate damages [but rather] leaves it open for a court to select the most reliable method of damages proof that is available."

Establishing the damages amount

Existing case law generally restricts plaintiffs' recovery to out-of-pocket losses. It permits plaintiffs to recover only their economic losses, based on factors like the number of shares traded and the dates of transactions.

No single approach is accepted for proving out-of-pocket losses, but experts often employ models that rely on event studies. In an event study, an expert constructs a "value line" to depict a stock's "true value" if purchasers had known the undisclosed information on each day of the class period. The expert then can determine the individual loss for each class member by comparing the price that member actually paid with the true value.

The calculation must account for some difficulties. This includes traders who engage in multiple transactions within the class period and lengthy periods between the misrepresentation and the disclosure. (See the sidebar "Executing the event study.")

Alternatively, an expert may use trading models — such as the proportional trading model and two-trader model. But some courts have declined to admit trading model evidence on multiple *Daubert* grounds. Instead, they've favored allowing the jury to determine a per-share damages amount per day in the relevant period, with the court applying the claims process to ensure accurate total damages.

Executing the event study

An event study is used to estimate damages in securities fraud litigation. Usually, it comprises two stages:

1. The expert determines the point at which the disclosed information allegedly affected the stock price in a negative manner. Determination of the event "window" can be difficult because the window must incorporate the period within which the disclosed information becomes embedded in the stock price. The window could close well ahead of the formal disclosure of fraud; it also could open and close multiple times as news trickles out to the public.

2. The expert establishes a performance benchmark based on the performance of a comparable security during the class period, possibly with adjustments for risk. The benchmark reflects the rate of return that the subject stock would have experienced but for the fraud. By deducting the stock's actual performance from the benchmark for a given day, the expert calculates the day's "abnormal return."

The expert likely will look at the cumulative abnormal return over several days because information may not immediately affect stock price. A negative cumulative abnormal return can indicate that the stock reacted to negative information. But if the cumulative abnormal return is close to zero, the fraud event probably didn't affect the stock price.

Several courts have allowed trading model estimates of aggregate damages for settlement purposes, withholding their approval of the settlements until after claims data was submitted. With the data, a court can verify the per-share award.

Complex calculation

The issues associated with the calculation of securities fraud damages are complex and subject to a range of factors. It's essential to add financial experts to your litigation team as early as possible to develop a strong damages argument. ✧

Court weighs in on IRS challenges to S corporation valuations

In a decision that fuels a continued debate between taxpayers and the IRS, the U.S. Tax Court in *Dallas v. Commissioner* determined that an S corporation shouldn't be tax-affected. The court reasoned that the proportion of earnings distributed to shareholders was independent of the decision to tax-affect the stock. The court also considered several other important issues.

Facts of the case

In 1999 and 2000, Robert Dallas sold nonvoting shares (approximately 55%) of Dallas Group of America, Inc. (DGA) stock to separate trusts for the benefit of his two sons in exchange for cash and notes receivable. DGA is an S corporation that manufactures and distributes chemicals and holds nonoperating assets, including investments in a bank, land, an insurance company and split-dollar insurance receivables.

When Dallas transferred an equal number of nonvoting shares in DGA to each trust in 1999, all of the involved parties agreed to be bound by a third-party appraisal to determine the sale price. The third-party valuation tax-affected the S corporation income, increased reported income by reducing executive compensation to market rates and applied a 15% discount for lack of control as well as a 35% discount for lack of marketability.

The 2000 transfer was made without an updated professional valuation. The taxpayer estimated approximately 5% appreciation in stock for the exchange value, and the promissory notes didn't contain a self-canceling clause. During the IRS's audit of the 1999 transaction, the tax examiner pointed out that the 1999 notes contained a self-canceling clause. In mid-2001, the 1999 notes were re-executed without the clause.

The dispute

The IRS argued that the sales were bargain sales and, therefore, gifts. Accordingly, the IRS assessed total gift tax deficiencies of more than $2.5 million.

The taxpayer's first appraiser tax-affected the S corporation's earnings using a 40% tax rate. At trial, the taxpayer's second valuation expert opined that the share price was less than the amount the first appraiser assessed — primarily because executive compensation shouldn't have been adjusted and nonvoting stock should reflect an additional 5% discount for lack of voting rights.

The second appraiser agreed with the first appraiser that the earnings should be tax-affected, claiming that 1) he had always tax-affected S corporation earnings, 2) an informal poll taken at a conference of appraisers showed that 90% to 95% of attendees tax-affected S corporation earnings, 3) the American Society of Appraisers rejects certification unless applicants do so, and 4) in submitting employee

stock ownership plan valuations to the Department of Labor, his company had always tax-affected S corporation earnings.

The third-party valuation expert for the IRS at trial concluded on a *higher* share value than claimed in the IRS deficiency notice.

The decision

The court's decision follows earlier Tax Court cases *Gross*, *Heck* and *Delaware Open MRI Radiology Associates* in not imputing an income tax at the corporate level when valuing an S corporation. Its finding addressed several issues:

Tax-affecting. According to the court, the testimony of the taxpayer's appraiser was that they tax-affected under the assumption that DGA would lose its S corporation status after or as a result of the hypothetical sale of its stock. The court said there was no evidence that DGA expected to lose its S corporation status. DGA had a history of distributing sufficient cash for the shareholders to pay taxes on their share of S corporation earnings and there was no evidence this practice would change: "We conclude there is insufficient evidence to establish that a hypothetical buyer and seller would tax-affect DGA's earnings and that tax-affecting DGA's earnings is not appropriate."

Arm's-length price. The taxpayer argued that, by determining the sale price through a third-party valuation, the sale was an arm's-length transaction. The court determined that intrafamily transfers are presumed to be gifts unless the evidence can overcome that presumption. Both the 1999 and 2000 sales contained share adjustment clauses that showed the transactions were made for estate planning purposes. Additionally, the sons weren't represented by their own counsel. The court, therefore, concluded the sales weren't arm's-length transactions.

Executive compensation adjustments. In determining whether compensation paid to DGA's executives (the father and two sons) was reasonable, the court found the record insufficient to suggest that DGA was planning to change how it paid them and no basis to assume changes in DGA's executive compensation should be incorporated into the valuation analysis.

Discounts for lack of control and marketability. The Court rejected any additional discount for the nonvoting status of the minority stock transfers. It determined a 20% lack of marketability discount in accordance with the IRS's expert — largely because the parties didn't dispute the point.

Value of self-canceling notes. Other than their face value, the taxpayer provided no evidence about the value of the 1999 notes. The IRS claimed that the self-canceling feature reduced the fair market value. The taxpayer asked to reform the 1999 notes, arguing the self-canceling clauses were a drafting mistake. The court rejected this argument and found the notes were self-canceling and therefore worth less than face value.

Ongoing battle

Appraisers often tax-affect S corporation earnings, and there can be situations where this is appropriate. Proponents feel that tax-affecting is necessary because a hypothetical buyer would routinely consider income taxes in a purchase decision. Additionally, most purchases of small and midsize businesses are made via an asset sale in which the buyer wouldn't use the same entity as the seller. However, it's likely that the IRS will continue its challenges to this issue. ✧

The QDRO: An important tool for dividing retirement plans in a divorce

Retirement plan accounts often can make up a significant portion of a divorcing couple's marital assets. But if a division isn't planned carefully, divorcing spouses can be subject to accelerated taxes and, if under age $59^1/_2$, early withdrawal penalties.

A qualified domestic relations order (QDRO) can direct the division of a retirement plan — helping ensure that the participant's (payee's) ownership of the benefits is protected and that the nonparticipant (alternate payee) receives the benefits to which he or she is entitled. And it allows both spouses to continue to enjoy the benefits of tax-deferred growth and avoid any early withdrawal penalty.

Addressing tricky issues

Generally, all qualified plans subject to IRC Section 401(a) also are subject to QDRO rules. These include defined benefit, defined contribution, pension, profit sharing, 401(k) and employee stock ownership plans.

A QDRO typically addresses several important issues surrounding these plans. The value of defined benefit plan benefits, for example, can be difficult to estimate before the participant retires — making it challenging to divide the assets between divorcing spouses. A QDRO can address this issue using one of two approaches:

1. Separate-interest. This divides the pension benefit based on the alternate payee's longevity. It identifies a formula to divide the amount due, and then sets a date when monthly payments will begin.

2. Shared-interest. This divides the benefit based on the plan participant's longevity. It splits the benefit using a percentage or flat amount, and usually applies when the plan participant has already retired or when his or her retirement plan doesn't allow separate interests.

QDROs assist in dividing defined contribution plans. Quarterly statements make 401(k) and 403(b) plans easier to value and divide than defined-benefit plans. In fact, most QDROs don't divide defined contribution plans based on their value as of the divorce date, but as of the nearest "valuation date," when the plan is valued annually.

QDROs also can be used to specify survivor benefits. Without a survivor clause in the QDRO, the benefits an alternate payee receives could cease immediately when the participant dies. So QDROs should include a provision that benefits will continue whether the plan participant dies before or after reaching retirement age.

Tax implications

Because QDROs enable the distribution of tax-deferred benefits, tax consequences should be considered when drafting a divorce settlement. Any retirement benefit distributions in excess of a participant's after-tax contributions are subject to federal (and possibly state) income tax. The former spouse as alternate payee is taxed upon the receipt of benefits from a plan in the same manner as the participant, except that distributions pursuant to a QDRO aren't subject to the 10% penalty tax on early (before age $59^1/_2$) distributions.

If a distribution is made to a former spouse without a QDRO in place, the distribution is taxable to the participant, who is deemed to have received the distribution and then transferred it to a third party. If a distribution is made to the participant's former spouse pursuant to a QDRO, the distribution is taxed to that person in the year it's received.

However, with a QDRO, the income tax and early withdrawal penalty tax aren't applicable to distributions to the alternate payee as long as he or she rolls over the distribution to an IRA or other qualified plan within 60 days. The alternate payee is, however, responsible for paying taxes on subsequent distributions made from the IRA or other qualified plan.

If the alternate payee intends to roll over the funds but fails to elect a direct transfer to a qualified plan, the distributing plan must withhold federal income tax of 20% of the gross amount. This can be a problem for the plan's participant, who may be subject to immediate taxation if the entire distribution amount isn't rolled over. In this case, the participant may need to come up with the cash.

Drafting a QDRO

It's important to address all potential issues in a QDRO before a divorce is final and ensure that all requirements are met when drafting or reviewing the order. A retirement plan could lose its status as "qualified" if it fails to comply with any of the QDRO's terms. ✧

Nonphysical injuries damages

Decision could benefit employers *and* employees

In a surprising decision, a federal appellate court last year found it unconstitutional for the government to tax damages for emotional distress, loss of reputation and other nonphysical personal injuries. The three-judge panel in *Murphy v. IRS* subsequently vacated its judgment and scheduled a rehearing for this spring. If reinstated, the ruling could affect employment law cases dramatically.

Plaintiff's argument

The plaintiff brought suit to recover income taxes she paid on compensatory damages received for emotional distress and loss of reputation in an action against her former employee. (She received no damages for lost wages or diminished earning capacity.) She asserted that Internal Revenue Code Section 104(a)(2) is unconstitutional. The statute excludes from taxation damages received "on account of personal physical injuries or physical sickness."

The plaintiff cited the 16th Amendment, which provides that government may "lay and collect taxes on incomes, from whatever source derived," and a U.S. Supreme Court holding that Congress can tax "all gains" or "accessions to wealth." Based on the holding — issued after adoption of the amendment — the plaintiff argued that her award was neither a gain nor an accession to wealth.

Court's initial ruling

The D.C. circuit court focused on whether the award constituted "income." It first asked "in lieu

of what were the damages awarded?" The court found the damages weren't awarded in lieu of income but to make the plaintiff emotionally and reputationally whole. It observed that neither her emotional well-being nor her reputation was taxable.

The court also asked whether Congress would have considered compensatory damages for nonphysical injury "income" when crafting the 16th Amendment. It noted that emotional distress and loss of reputation were actionable in tort at the time Congress adopted the Amendment and concluded that Congress didn't regard compensation for nonphysical injuries as different from compensation for physical injuries. The court therefore found that Sec. 104(a)(2) is unconstitutional.

Future implications

If reinstated this spring, the appellate court's decision could benefit employers in addition to employees because plaintiffs may be more willing to settle for smaller, untaxable amounts. Regardless of the court's upcoming decision, plaintiffs' attorneys may well pursue *Murphy*'s arguments in other jurisdictions.