Advocate'sEDGE

Weak buy-sell agreement leads to lengthy litigation

Have faith
Trusting fraud experts with your fidelity insurance claims

Valuing a professional practice
Court prefers excess earnings method in divorce case

***Daubert* challenges: Is your financial expert vulnerable?**

May/June 2014

McGOVERN & GREENE LLP

CPAs & Forensic Accountants

Weak buy-sell agreement leads to lengthy litigation

Closely held businesses often rely on buy-sell agreements to ensure a smooth transition when an owner exits the company. But as a New York appellate case, *Sullivan v. Troser Management, Inc.*, demonstrates, it's not enough to have the agreement. The agreement also needs to provide a clear method for valuing the shares for repurchase — and the best method usually is an independent appraisal. Without it, lengthy litigation can ensue.

THE AGREEMENT AT ISSUE

In 1986, Troser Management entered into an agreement with its director of sales for a ski resort. The agreement provided that the director would be granted an 18% equity interest in the corporation if he remained with the business until 1991.

A contemporaneous buy-sell agreement provided that the corporation could repurchase the stock if, among other things, the director ceased to be employed by it. The agreement also provided that the purchase price of a stock share "shall be an amount agreed upon annually by the Stockholders as set forth on the attached Schedule A." If there was no agreed-upon value within the two preceding years, the price would be the last agreed-upon value, increased or decreased by reference to the company's book value. No Schedule A was attached.

PARTIES DISPUTE PURCHASE PRICE

The director sued to obtain the 18% interest, and the trial court directed Troser to issue him the stock. Over the course of several more rounds of litigation, though, it was determined that the stock's purchase price couldn't be settled by the buy-sell agreement, because the stockholders had never agreed upon a value for the shares. Rather, the price should be based on the director's percentage interest in Troser's assets.

On the most recent appeal (*Sullivan IV*), Troser argued that the buy-sell agreement dictated that

THE PROBLEM WITH VALUATION FORMULAS

While the circumstances in *Sullivan v. Troser Management, Inc.* (see main article) were somewhat unusual, it's not uncommon for a buy-sell agreement to specify a valuation formula to be used to determine a sale price when the agreement is triggered. Such formulas may seem straightforward and less costly than obtaining an independent appraisal, but they can be problematic.

Valuation formulas typically rely largely on objective elements like multiples of earnings, book value and adjusted book value. They don't account for subjective elements such as the company's risk premium and growth rate or objective elements such as general economic conditions, regulatory changes or industry developments. But such elements can have a significant effect on a company's value and so are critical to reaching an accurate price that reflects all relevant conditions.

Because formulas rarely account for the many variables that make up a business's value, there's no good substitute for a professional appraisal. Clients that wish to "save money" by not hiring a valuation expert may be penny wise but generally are pound foolish.

the shares be valued based on book value. The appellate court disagreed, noting that the agreement provided only that book value should be used to *adjust* the agreed-upon value if the stockholders hadn't agreed on the value for a period of two years. The court concluded that book value didn't come into play because the stockholders had never agreed on the value of the shares, and, thus, there was nothing to adjust.

The appellate court also noted that the net asset valuation approach wasn't mandated, stating that "there is no uniform rule for valuing stock in closely held corporations." It was, therefore, up to the court to determine the appropriate method for valuing the director's interest based on the evidence at trial.

INDEPENDENT APPRAISALS TO THE RESCUE

The parties in this case might have avoided their decade-plus of litigation if they had stated in the buy-sell agreement that the purchase price would be based on an independent appraisal. Appraisals conducted at the time a buy-sell agreement is triggered generally are preferable to other pricing methods, including fixed price (as attempted in this case) and valuation formulas. (See "The problem with valuation formulas" on page 2.)

Moreover, in cases involving the death of a shareholder, the IRS might be more likely to accept an independent appraisal value than a buy-sell agreement with a formula or fixed price. Often, the IRS interprets fixed values as being intended to accomplish estate planning goals.

AVOID HASSLE AND COSTS

The appellate court's latest decision sent the case back to the trial court for yet another round on the value of the shares. Don't let this happen to your clients. Draft their buy-sell agreements to provide for independent appraisals.

Have faith

Trusting fraud experts with your fidelity insurance claims

When businesses pursue civil actions against occupational fraud perpetrators, they generally settle the case or receive favorable verdicts. However, companies rarely recover the full amounts of their losses. Fidelity insurance is designed to help bridge that gap.

Unfortunately, proving larceny or embezzlement losses to an insurer can be challenging. Claimants must follow strict procedures, and claims frequently are contested. That's where a forensic accountant comes in.

TIME FOR A SPECIALIST

Fidelity policies typically impose strict deadlines for providing notice to the insurer and submitting claims. If the deadlines aren't met, a claimant could forfeit its coverage. But few organizations employ people with the necessary experience to properly investigate occupational fraud incidents and provide insurers with the right information on time.

Hiring an expert can increase the odds of satisfying insurer deadlines and maximizing recovery under a policy. Fidelity coverage usually includes reimbursement of investigation and claim preparation costs — which makes the decision to hire an expert practically risk-free.

DOCUMENTING LOSSES

Fidelity insurance claimants that fail to follow proof-of-loss documentation rules to the letter could delay or even preclude recovery. A company's policy will detail the specific data it must provide.

> *Hiring an expert can increase the odds of satisfying insurer deadlines and maximizing recovery under a policy.*

But proof of loss typically requires, at a minimum, detailed accounts that include the names of the alleged perpetrators, their positions in the company, their dates of employment and whether they've been terminated. If the claimant knows of fraudulent or dishonest acts previously committed by the alleged perpetrators, it should be reported. Additional details that bolster a claim are information about the events surrounding the loss — including transactions, amounts, dates, names, addresses and phone numbers, as well as how and by whom the loss was discovered.

A THOROUGH INVESTIGATION

A fraud expert ensures that proper documentation is submitted by conducting a thorough investigation into the loss incident. First, an expert will closely review a company's fidelity insurance policy. Familiarity with a policy's requirements enables experts to align an investigation and resulting documentation with an insurer's requirements.

Once those parameters are established, a fraud expert works with the claimant's own investigation team to collect and analyze data. The expert also will conduct interviews with anyone who might have relevant information or insights.

Next, the expert quantifies the company's loss and prepares documentation to submit to the insurance company. Such documentation can take the form of a formal report, spreadsheets, timelines or flowcharts. The insurer will use this information to evaluate the company's claim, and the documents may also be used in subsequent legal proceedings — whether they involve the insurer or the perpetrator.

While preparing documentation, a fraud expert also can identify any potential weak points in a claim and explain to the insurer why the weaknesses aren't as significant as they might initially seem. Finally, the expert might review reports from the insurer's experts and draft responses to those reports, if appropriate.

CLEANING HOUSE

Maximizing recovery from a fidelity insurance policy shouldn't be your client's only concern. Defrauded companies also need to consider why the losses occurred and whether they need to implement better fraud-prevention measures.

Occupational fraud often occurs in organizations that have failed to make and formalize internal controls — or that have become lax in enforcing them. For example, when members of management override controls for anything other than an urgent or unusual reason, they tacitly communicate to rank-and-file employees that the rules are made to be broken. A fraud expert can evaluate your client's existing policies and procedures and the "tone at the top" and suggest improvements to minimize the likelihood that employees will find fraud opportunities.

DIY NOT ADVISED

When occupational fraud occurs, companies often try to prepare and submit fidelity insurance claims on their own. This is a mistake. If your client hopes to recover the full amount claimed, this complicated process is best handled by an experienced forensic accountant.

Valuing a professional practice

Court prefers excess earnings method in divorce case

Experts on opposing sides commonly rely on different methods when valuing a business. But that doesn't mean all methods are equally valid.

As the parties in divorce case *A.C. v. J.O.* recently learned, the particular circumstances — including the type of litigation and kind of business — may dictate that one method is preferable to the other. In that case, the court found that the excess earnings method was superior to the price-to-revenue method.

DUELING DENTAL PRACTICE VALUATIONS

The wife in the case owned a dental practice. After her dentist-father retired, she purchased part of his client list for an amount based on an independent appraisal of the goodwill of his practice.

At trial, her husband presented an expert's preliminary report on the value of the practice. The expert used the price-to-revenue method to value the practice at $455,000. The price-to-revenue method (also known as the multiple-of-revenue method) applies a multiplier to the business's revenue to reach a value. The multiplier is initially based on the company's revenues and is then often adjusted for other factors, such as the subject's profitability, financial condition and life stage.

At the request of the wife, the expert also performed an alternate calculation using the excess

earnings method. This method is a hybrid income approach based on IRS Revenue Ruling 68-609 and involves the determination of net tangible assets and goodwill. Goodwill is determined by calculating normalized excess earnings after allowing for a reasonable return on net tangible assets and then applying an appropriate multiple to those earnings. Reasonable compensation for the services performed by the business owner must be deducted in arriving at the normalized earnings.

In this case, the excess earnings method valued the dental practice at $316,000, attributable to the practice's goodwill.

A BETTER METHOD?

The trial court found that, while there's no uniform method for fixing the value of an ongoing business for equitable distribution purposes, the excess earnings method is more appropriate for valuing an interest in a professional partnership than the price-to-revenue method is.

As the court pointed out, the excess earnings method took into account the absence of tangible assets (the wife rented part of a dental office and the equipment in it) and factored in goodwill, based on three generations of dentists in her family. The price-to-revenue method, the court said, used comparable sales figures from national reports to develop a multiplier. Those figures didn't adequately address the fact that the wife didn't own an office, an office lease or any equipment — all of which would be part of the ordinary sale of a dental practice in most of the country.

The court also observed that there were no unusual circumstances for it to consider. For example:

- The wife's income and client base were stable,
- No evidence was presented of new laws that could affect the practice, and
- No disasters had affected gross receipts.

Finally, she was the only shareholder in the practice and had no inventory to value.

Although the price-to-revenue approach wasn't appropriate for this case, appraisers have successfully used the method to achieve a reasonable result. They may, however, need to adjust the multiple for various differences between the subject company and industry comparables.

The trial court found that the excess earnings method is more appropriate for valuing an interest in a professional partnership.

METHOD MATTERS

The success of a valuation in court, whether in a divorce or other matter, turns largely on the selection of the right method for the business and type of case. And when it comes to valuing professional practices and small businesses for purposes of marital dissolution, the excess earnings method is one of the most widely used. In many cases, it may prove more appropriate than the price-to-revenue or other methods.

Daubert challenges: Is your financial expert vulnerable?

The U.S. Supreme Court's 1999 opinion in *Kumho Tire Co. v. Carmichael* made clear that the *Daubert* criteria for admissibility of expert testimony applies to all types of experts — including financial witnesses. In the years since *Kumho*, PricewaterhouseCoopers (PwC) has regularly examined written opinions that address *Daubert* challenges. The latest report provides valuable data that can help you choose expert witnesses.

SURVIVAL RATES

PwC's report looks at 1,400 challenges to financial expert witnesses — including appraisers, economists, statisticians, business consultants and accountants — from 2000 to 2012. Over that period, economists and accountants were the most frequently challenged, with each accounting for 24% of the challenges. But economists and accountants were *more likely* than other financial experts *to survive* a challenge during that period.

In 2012, though, economists faced exclusion more often than other financial experts, seeing all or part of their testimony excluded 49% of the time. The testimony of appraisers, on the other hand, was excluded in only 32% of *Daubert* challenges.

PLAINTIFF VS. DEFENSE EXPERTS

Plaintiffs' financial experts were challenged two to three times as often as defense experts during the 2000 to 2012 period. In 2012, though, the challenges to plaintiffs' experts fell to a 13-year low of 64%. The outcome of those challenges varied greatly on an annual basis. The success rate of challenges to plaintiffs' financial experts ranged from a low of 36% in 2002 to a high of 58% in 2005. For defense experts, it fluctuated from 11% in 2002 to 70% in 2004.

Over the entire period, plaintiffs' experts were excluded completely or partially less often (45% of challenges) than defense experts (48%). In 2012, 42% of plaintiffs' financial experts had their testimony excluded or partially excluded, compared with 50% of all defense experts.

REASONS FOR EXCLUSION

In 2012, the most prevalent reason for exclusion of financial expert testimony was lack of relevance. But during the previous 12-year period, the top reason for exclusion was lack of reliability — in 66% of the full or partial exclusions of testimony. Lack of relevance was a cause in 41% of the exclusions and lack of qualifications in 19%.

As the report's authors noted, when an expert is discussing a topic requested by an attorney, "exclusion for relevance speaks more to the suitability of the task assignment" than to the expert's execution. The exclusion is frequently the result of testimony that was beyond the financial expert's role.

DODGING *DAUBERT*

Every expert is subject to admissibility scrutiny by the court. So hire financial experts carefully to testify only in areas of proven expertise and experience.