

The Expert

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An objective eye

Financial experts can play a valuable role in coping with bankruptcy

Should a company find itself in severe financial distress, assembling the right team of advisors may help mitigate the situation. A financial expert can play an integral role on such a team, providing an objective eye regarding valuation, finance, accounting and expert witness issues.

Stopping the bleeding

Financial experts often help start the recovery process by identifying ways the business might regain control of its cash flows. Once a daily cash budget stops the immediate bleeding, the expert can help determine which form of bankruptcy is most appropriate — Chapter 7 (liquidation) or Chapter 11 (reorganization) — or whether the business can take steps to avoid bankruptcy altogether.

For example, he or she might develop financial projections for several reorganization options, including best-, probable- and worst-case scenarios. Experts often use a Z-score formula to assess a struggling company's financial strength and

estimate the risk and probability of whether the business will go bankrupt.

Liquidation

Sometimes a business is worth more dead than alive. When liquidation value exceeds going concern value, owners should consider filing for Chapter 7 bankruptcy protection. (See “A closer look at liquidation value” on page 3.)

A financial expert can help “sell” a reorganization strategy, such as debt forgiveness and restructuring, to lenders and other creditors.

Liquidation value is often seen as a “floor” for a company's value. Sometimes a business is actually insolvent, which means its liabilities exceed its assets. As a court-appointed receiver and turnaround consultant, a financial expert can facilitate the liquidation process — including winding down operations and paying out creditors in order of legal preference.

Reorganization

If a Chapter 11 filing is deemed appropriate, a financial expert can help “sell” a reorganization strategy, such as debt forgiveness and restructuring, to lenders and other creditors.

Many loans are over-collateralized because of the current conservative nature of banks. By appraising assets (including inventory,



equipment and receivables), the expert can assist in renegotiating working capital covenants. As debt terms are eased, cash is usually freed up for imminent needs.

Divestiture or sale

Alternatively, a reorganization might call for divestitures of unprofitable segments, so ownership can refocus on core operations. Or a distressed business might solicit an offer from a competitor or larger conglomerate to buy the company or its assets. An expert can help owners find potential acquirers and evaluate whether divestitures and offers appear reasonable.

When minority shareholders or creditors contest a divestiture or sale, distribution or other transaction, a financial expert can write a fairness opinion to help demonstrate that management exercised good judgment in analyzing a transaction. Fairness opinions are especially important when transactions involve related parties or if the CFO's compensation package includes a "golden parachute" clause.

Buying out shareholders

Another unfortunate side effect of financial distress is shareholder disputes. When management squabbles impair daily operations and decision-making, owners may decide to split the assets — or one owner may choose to buy another's interest.

In these cases, buyers tend to undervalue the business while sellers tend to overvalue it. So an expert can objectively estimate what the company and its underlying assets are worth. He or she also can help the parties identify assets that aren't on the balance sheet, including:

- ◆ Contingent legal and tax liabilities,
- ◆ Customer lists,
- ◆ Brand names, and
- ◆ Business goodwill.

In addition, the expert can explain the tax implications of buyout terms, such as installment sales and earnouts.

A closer look at liquidation value

In a bankruptcy situation, most business appraisals estimate going concern value, which includes the value of intangible assets. Examples of intangibles are a trained workforce, operating systems, customer lists and brand names.

But another meaningful benchmark is liquidation value — or the net amount that would be realized if the business were terminated and the assets sold piecemeal. Liquidation can either be "orderly" or "forced," according to the *International Glossary of Business Valuation Terms*. In addition, liquidation expenses (such as remaining rental obligations, severance pay and professional fees) are customarily subtracted from liquidation value.

Orderly liquidations presume assets are sold over several months to maximize value. Sometimes assets are bundled and sold to competitors to increase proceeds. But forced liquidations (also known as fire sales) occur as quickly as possible, often in an auction.

The appropriate premise of value — forced or orderly liquidation, or going concern value — is a matter of time constraints, investor and creditor preferences, bankruptcy court mandates and relevant laws.

Choosing the right path

Distressed companies contemplating bankruptcy need the help of the right advisors. A financial expert can assist ownership in finding the optimal bankruptcy path — Chapter 7 or Chapter 11. In some cases, he or she may even save owners from filing a formal bankruptcy claim altogether.

Once the dust has settled, a financial expert can help the new-and-improved business address its accounting and tax reporting requirements going forward. Existing accounting personnel are often unfamiliar with how to account for changes following a reorganization, liquidation or buyout — such as debt restructuring, asset transfers and divestitures. The expert could serve as an interim CFO to help implement a reorganization plan. ◆

Widespread market participation leads to more securities fraud

The Investment Company Institute, an association of U.S. investment companies, reported last year that 44% of U.S. households own stocks and securities through mutual funds. Unfortunately, such widespread participation in the markets has led to more securities fraud, according to the FBI. Qualified financial experts can play a critical role in helping victims recover some of their losses.

Ponzi schemes

Ponzi schemes are examples of high-yield investment fraud, which is characterized by promises of low- or no-risk investments with unusually high rates of return not available from traditional investments.

In Ponzi schemes (named after their creator, Charles Ponzi), the perpetrator pays “dividends” to initial investors with the funds received from subsequent investors. The most famous case in recent years was Bernie Madoff’s house of cards. After it collapsed, teams of forensic experts swooped in to pick through the remains in search of any remaining funds. They also traced the fraudulent transactions to document how the missing funds disappeared.

Financial experts can also help when a Ponzi scheme is only suspected. Rather than relying on financial statements that may have been tampered

with, they’ll scrutinize sources such as the “company’s” accounts, invoices, purchase orders, and e-mail and text messages. A qualified financial expert can use evidence like this to spot danger signs that attorneys might miss.

Broker scams

When investors suffer large losses, they often point an accusing finger at their brokers. They may pursue suitability or churning claims in an attempt to recoup their losses.

Suitability claims allege that the broker’s selection of investments were inappropriate for the particular investor’s objectives, resources, time horizon and risk tolerance. For example, a risk-averse investor close to retirement may be lured into a particularly risky investment.

Churning claims relate to excessive trading, with or without the investor’s knowledge, conducted to generate higher commissions and fees for the broker. Victims can also suffer losses if the trading creates short-term capital gains that are taxable at the investor’s ordinary-income rate, rather than the lower long-term capital gains rate.

Both schemes are marked by high-turnover trading, high-volume trading in cheap stocks, options trading and the sales of mutual funds more frequently than annually. Financial experts can uncover these red flags by poring over account application forms, broker-investor correspondence, broker research on the investment(s), monthly account statements and monthly invoices from the broker.

Just a sampling

The above schemes represent just a sampling of securities fraud. As mentioned, a qualified financial expert can help victims follow the money and maximize their recoveries. ♦



Getting a grasp on the value of intellectual property

Valuing an intangible asset such as intellectual property (IP) isn't easy. But appraisers do have ways of estimating the value of assets such as patents, copyrights and trademarks.

3 methods ... and beyond

Qualified appraisers generally apply one or more of the three common valuation methods when appraising an intangible asset such as IP:

1. The income approach. The appraiser considers the economic benefits that are reasonably attributable to the subject asset and the risks associated with realizing those benefits.

2. The market approach. The appraiser looks at the relevant differences between the subject and guideline assets that have been sold.

3. The cost approach. The appraiser assesses the direct and indirect costs associated with the reproduction or replacement of the subject asset and accounts for any loss of value due to functional or economic obsolescence or reduced life expectancy.

Complicating the process, however, are various factors that affect the applicability of any of these approaches. One way to account for these variations is to turn to a standard issued by the American Society of Appraisers known as *BVS-IX, Intangible Asset Valuation*.

It enumerates several factors that, no matter which of the three common approaches an appraiser takes, should be considered. Examples include the bundle of legal rights, protections and limitations; the economic benefits (direct or indirect) that the asset is expected to provide to its owner during its life; any previous or existing litigation involving the asset; and the feasibility and character of potential commercial exploitation.

An appraiser is also expected to consider the type of intangible asset to be valued and apply any additional factors, as appropriate.



Patent research

When valuing a patent, an appraiser generally considers an extensive list of additional factors. He or she looks at scope of protection — including jurisdictional coverage, status of registrations and maintenance fee payments, breadth of patent claims, and alternatives to the patented invention. The appraiser also determines whether the patent is a design patent or a functional patent and considers the patent's remaining life and expiration date.

Also important is risk of patent exploitation. This includes the likelihood of infringement, invalidity, technological or economic barriers to successful commercialization, and alternative innovations that could reduce the patent's economic benefit. Specifically, the appraiser must assess a scenario of competition with patents vs. competition without patents. Also, how easily could a competitor duplicate the same patent design?

An appraiser can also research public and private information. Data regarding the patent and comparable or competing technologies is generally

available from sources such as the U.S. Patent and Trademark Office (USPTO), the Securities and Exchange Commission (SEC) and market research.

In addition, patent portfolio factors may come into play. These include relevant synergies enabled by the aggregation of rights, such as the elimination of blocking patent rights.

Other IP

Copyright valuations must recognize the scope of protection, including jurisdictional coverage, status of registrations and renewals, and whether the copyright relates to the original work or a particular derivative. Value also is affected by any public and private information that may be available regarding the copyrighted work and comparable or competing works.

As for trademarks, an appraiser accounts for the ability of the holder to extend the trademark to related products and services without infringing on the trademarks of others. He or she must also consider the nature and extent of protections

afforded by any registrations and determine the possibility of abandonment because of nonuse and of the mark becoming generic.

An appraiser accounts for the ability of a holder to extend a trademark to related products and services without infringing on the trademarks of others.

Finally, an appraiser may review public and private information about the subject trademark and comparable or competing marks, such as USPTO data, public disclosures filed with the SEC, market analysis and research, and surveys.

Not hard to imagine

There's an entire field of law dedicated to IP. So, it's not hard to imagine the complexity of appraising these assets. Nonetheless, a qualified appraiser can get the job done. ♦

Which valuation adjustments are acceptable in divorce?

In marriage dissolutions, family courts don't always embrace U.S. Tax Court precedent regarding ordinary income taxes, capital gains and valuation discounts. A recent decision, *Shuck v. Shuck*, illustrates the dichotomy between valuations prepared for tax purposes and those prepared for divorce cases.

Divvying up the shares

When the Shucks decided to end their 35-year marriage, the primary point of contention was the value of the following family-owned business interests:

- ♦ 31 shares of Shuck Drilling, an irrigation drilling and equipment company operated by the husband, appraised at \$17,697.51 per share using the income approach,
- ♦ 3,827 shares of Lazy T Milliron, a farmland lessor operated by the husband's brother, appraised at \$117.73 per share using the asset-based approach,
- ♦ 6,206 shares of Diamond Seven, a farming and land leasing venture operated by the husband's other brother, appraised at \$92.54 per share using the asset-based approach, and
- ♦ One share of Quatros Hombres, a farming business that merged into Diamond Seven in 1984, appraised at \$79,869.60 per share using the asset-based approach.

Throughout the Shucks' marriage, the husband's parents gifted shares of these businesses to the

husband and wife as individuals (not as a couple). The parties stipulated that the wife personally owned six shares of Shuck Drilling and 200 shares of Lazy T. The trial court ordered the husband to buy these interests from the wife.

In addition, the husband had used marital funds to buy 187 shares of Diamond Seven, and those were deemed a divisible marital asset. The remaining shares were considered to be the husband's nonmarital assets.

3 issues on appeal

On appeal, the wife argued that the court-appointed appraiser had done three things erroneously:

1. Subtracted built-in capital gains tax from his valuation of Lazy T and Diamond Seven — even though a sale wasn't imminent,
2. Tax-affected Shuck Drilling's earnings, and
3. Adjusted all four valuations for a 25% lack of control discount and a 25% marketability discount.

Although each of the contested valuation adjustments is common in appraisals for tax purposes, they are less certain in divorce cases.

First, the Nebraska Court of Appeals reversed the 40% adjustment for built-in capital gains tax. The court acknowledged that hypothetical buyers, indeed, might consider built-in capital gains tax. But the court decided that discounting for the “embedded” tax consequences is speculative and improper unless a sale is imminent or a property settlement forces a party to liquidate his or her business interest.

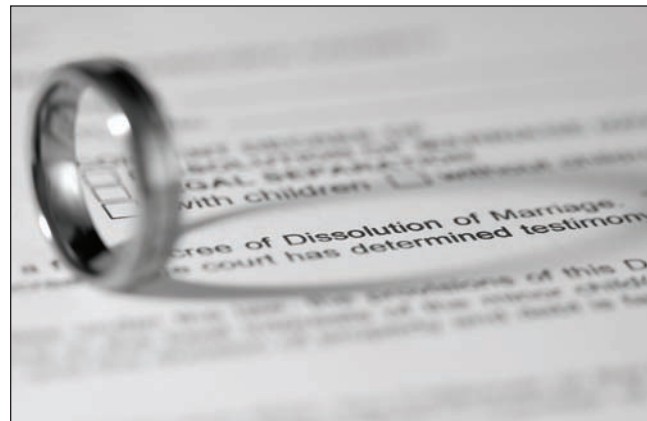
Next, the court upheld the adjustment to Shuck Drilling's cash flows for income taxes. It deemed it appropriate to subtract these taxes, because they relate to “required payment of annual ordinary income taxes.”

The court also permitted an effective combined discount of 43.75% for lack of control and marketability. Family courts in many jurisdictions don't recognize these discounts. But here it was

undisputed that neither spouse was a majority shareholder. Moreover, the parties' ability to liquidate the business interests was severely limited because the companies were privately held and family-owned.

Citing a precedent

The wife argued that valuation discounts were inequitable, citing *Grace v. Grace*. Under that decision, if the marital estate is inadequate, a court may take significant leeway in considering valuation issues — including discounts.



In fact, according to Nebraska state law, a non-monied spouse may be granted a “*Grace* award” if the primary asset is a family-owned business and the monied spouse's take-home pay is insufficient. But because of factual dissimilarities between *Shuck* and *Grace* — for example, the size of the Shuck marital estate and the wife's alimony award — the appellate court accepted the appraiser's lack of control and marketability discounts.

Nonetheless, the court ultimately increased the wife's award by \$15,477 for the erroneous inclusion of built-in capital gains tax.

Thumbing toward equity

Whether a couple resides in Nebraska or elsewhere, equity is the universal rule of thumb that guides family court decisions in divorce proceedings — leaving much to the court's discretion. Tax adjustments and valuation discounts that are common in Tax Court cases may be denied. Often, out-of-court settlements provide more predictable outcomes. ♦

