Valuation & Litigation Briefing

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Measuring commercial damages

Bankruptcy court addresses effects of COVID-19 on value

Eye on earnouts

Lucero v. United States
Court rules "severely distressed" company was overvalued

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Measuring commercial damages

In commercial litigation, it's common for experts to measure damages based on lost profits, diminished business value — or both. Here's an introduction to these concepts.

Lost profits vs. diminished value

Generally, it's appropriate to estimate lost profits when a plaintiff suffers an economic loss for a *discrete* period and then returns to "normal." Diminished business value is generally reserved for businesses that are *completely* destroyed or otherwise suffer *permanent* loss, such as destruction of an entire division or product line.

There may be rare situations in which lost profits fail to adequately capture a plaintiff's damages. For example, suppose a defendant's wrongful conduct damages a plaintiff's reputation, but it doesn't directly impact the plaintiff's expected profits. Nevertheless, the defendant's actions have rendered the plaintiff's business less marketable and, therefore, less valuable. In this situation, diminished business value may be an appropriate measure of damages, even though the plaintiff's business lives on.

Double dipping

There are important similarities between how lost profits and diminished business value are measured. Typically, lost profits are a function of lost revenue caused by the defendant's wrongful conduct and avoided costs that otherwise would have been incurred to generate the revenue. Once lost profits have been estimated, the amount is adjusted to present value.

Alternatively, business value is generally determined using one or more of the cost, market and income approaches. All three valuation approaches generally boil down to a business's ability to generate future economic benefits.

For this reason, awarding damages based on both lost profits and diminished business value is derived from the same earnings stream and is usually considered double dipping. A possible exception is the "slow death" scenario: A defendant's wrongful conduct initially causes the plaintiff's profits to decline, but the plaintiff continues operating. Eventually, however, the plaintiff succumbs to its injuries and goes out of business. In these cases, it may be appropriate for the plaintiff to recover lost profits for the period following the injury, plus diminished business value as of the "date of death."

Key differences

Both metrics calculate the present value of future economic benefits. So, you might expect damages to be identical, regardless of which measure is used. But consider the following differences between the two metrics:

- Business value is usually based on expected *cash flow*, which can be more or less than expected *profits* depending on the case facts.
- Lost profits are typically measured on a *pretax* basis, while business value is generally based on *after-tax* cash flow.
- Differences in the discount rates that are used to calculate present value of lost profits vs. diminished business value may have a substantial impact on the expert's conclusion.
- Business value is based on what's "known or knowable" on the valuation date, while lost profits calculations may consider developments that have occurred up to the time of trial.

Use management's projections with caution

Experts often rely on management's projections when estimating lost profits or business value. After all, no one knows the company's operations better than the managers who control day-to-day functions.

However, internally generated projections may not always be accurate for a variety of reasons. For example, management may be inexperienced in financial matters or biased due to its financial interests in the outcome of the case.

During the COVID-19 pandemic, reliance on management's projections can be especially risky. Managers may over- or underestimate how the pandemic will affect the company's earnings stream. And projections prepared simply by applying a reasonable growth rate to historical results may not be realistic.

Given the uncertainty and volatility associated with the current economy, it's important to ask these types of questions to determine whether management's projections are reasonable:

- How has the pandemic affected the business's operations, employees, customers and supply chains? Has disruption of the business been so extreme as to render historical results irrelevant?
- Will the company's operations return to normal? If so, when?
- How do management's projections compare to expectations for the industry and the overall economy? Are its short-term and long-term growth rates reasonable based on these trends and the company's operating capacity?
- Does the business have sufficient working capital and short-term funding sources to survive until normal operations resume? If not, can the company make changes to extend its life expectancy?
- Has the business put capital expenditures, research and development projects, marketing, and other outlays on hold? If so, will this affect its long-term growth prospects?

The pandemic has impacted each business differently. It's critical to examine company-specific factors when making this assessment.

In addition, "fair market value" is generally based on the perspective of a *hypothetical* buyer, while lost profits can consider the *specific* plaintiff's perspective. The plaintiff may have a special tax situation, benefit from unique synergies or view the business as less risky than a hypothetical buyer would. Likewise, a business's value may include adjustments, such as discounts for lack of marketability and key person risks, that may not be considered when estimating lost profits.

Picking the right metric

Lost profits and diminished business value are closely related, but they're not identical. When evaluating a case, it's critical to understand which measure is appropriate and how it might affect the outcome. ■

Bankruptcy court addresses effects of COVID-19 on value

The COVID-19 pandemic has caused many businesses to struggle financially, forcing some to file for bankruptcy. A critical factor when valuing a debtor in bankruptcy is *current* economic conditions. A recent case — *In re Body Transit, Inc.* — demonstrates that expert opinions may not pass muster today if they fail to fully consider the effects of the COVID-19 pandemic on value.

Case facts

In this case, the debtor operated three fitness clubs and filed a voluntary petition under Chapter 11 of the U.S. Bankruptcy Code in January 2020. It sold the assets of two clubs and sought to reorganize through the operations of the remaining club.

A creditor with a $970,000 unpaid balance filed an election to have its claim treated as fully secured, pursuant to Section 1111(b) of the bankruptcy code. The debtor objected to the election on grounds that the creditor's interest in property securing its claim was of "inconsequential value," an exception to a Sec. 1111(b) election. To resolve this issue, the U.S. Bankruptcy Court for the Eastern District of Pennsylvania needed to determine the value of the debtor's business and evaluate whether that value was inconsequential compared to the creditor's claim.

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Debtor's witnesses

The debtor presented two witnesses, but neither was qualified as a business valuation expert. The first, a fitness industry consultant, testified that the pandemic had caused the industry to be illiquid. He opined that a traditional business valuation wouldn't present an accurate picture of the debtor's value because historical data had "lost its predictive power." He concluded that the only basis for valuing the business was liquidation value.

The second witness, a fitness equipment broker, concluded that the debtor's equipment was worth between $28,000 and $30,000. Additionally, the expert opined that the equipment's value had fallen at least 10% more by the hearing date.

Creditor's experts

The creditor presented two witnesses who were both accredited in business valuation. The first appraised the debtor's equipment "based on limited information and assumptions … and a limited appraisal of market conditions." Although he didn't inspect the equipment, he valued it at roughly $130,000. He used the market approach, but his report didn't discuss the specific data he analyzed.

The creditor's second expert valued the business using the market approach. He analyzed approximately 30 sales of fitness and yoga businesses between January 2019 and March 2020. He applied revenue multiples from those comparable transactions to the debtor's projected revenue for the first and third post-confirmation years, then he reduced those amounts to present value.

The witness acknowledged that COVID-19 had temporarily affected the company's value. But, citing the stock market's speedy recovery, he was optimistic about the future of the debtor's business. He reduced his multiples for the first year for the impact of the pandemic, but he used pre-pandemic multiples for the third year. He also increased the discount rate used to estimate present value to reflect uncertainty over the gym's ability to achieve projected revenue. Based on these assumptions, he valued the debtor at $170,000 and allocated $130,000 to tangible assets.

Court decision

The bankruptcy court didn't fully accept any of the valuation evidence provided in this case. Neither of the debtor's witnesses were accredited in business valuation, and the creditor's first expert, though accredited, performed a limited "desktop" valuation. The court followed the approach used by the creditor's second expert, but it doubled the risk factor in his discount rate, arriving at a value of $80,000.

Because this value was inconsequential to the creditor's total claim, the court rejected the Sec. 1111(b) election. This case demonstrates the importance of using credentialed financial experts and fully considering current market data when valuing a business for bankruptcy purposes. ■

Eye on earnouts

M&A activity has grown during the COVID-19 pandemic. That trend is expected to continue in anticipation of higher capital gains tax rates under the Biden administration. Earnouts — which may spread the potential tax liability over a number of years — have become particularly common for deals that happen during these uncertain times. Before negotiating a transaction, it's important to understand how earnouts work and how they can help facilitate deals.

Put earnouts in your M&A toolkit

In a business acquisition, the buyer and seller may have difficulty agreeing on the business's value. With an earnout, the seller enjoys the fruits of its labor *if* the company performs as expected. At the same time, the buyer is protected from overpaying in the event the acquisition target's performance falls short of projections.

Earnouts can be incorporated into seller-financed deals. Here, a seller might agree to accept a lower

offer remedies in the event the business is mismanaged and the buyer can't meet its financial obligations.

Anticipate potential contingencies

Earnout provisions also address certain contingencies that could affect the business's ability to reach the agreed-upon milestones. Say, for example, an acquired company is required to achieve a specific level of earnings. After the sale, the new owner decides to write down the value of a large asset or invest in expensive new equipment that boosts depreciation expenses. Or the company may be required to adopt accounting rule changes. These types of developments could significantly lower earnings, causing a seller to lose out on one or more earnout payments.

The term an earnout provision covers generally runs no longer than three years.

The seller may require regular open-book access to accounting reports and other proof of financial operability to ensure accurate earnout payments. The parties will also need to address "Acts of God," receiving insurance proceeds, selling the business early and arbitration procedures (in case of disputes). Finally, to avoid disagreements in the future, both parties should specify how they expect each contingency to affect earnout payments.

Need help?

An earnout can help bridge a valuation gap and ensure that a deal will be beneficial for both parties. Contact an outside financial professional during deal negotiations to develop an earnout provision that covers all the bases. ■

payment at closing along with held interests and the promise of receiving additional remuneration *if* the business meets certain financial milestones. As the buyer pays these remunerations, the seller releases the held interests. The seller may maintain rights to assets of the company should the buyer fail to meet a specified schedule.

Spell out the terms

Earnout provisions have several components. A financial professional can help the parties establish a quantitative formula to determine how much is to be paid if the business reaches a certain financial target.

For instance, a buyer might be willing to pay the seller 10% of annual earnings that exceed the previous year's earnings by a certain amount. The target also might be based on annual cash flow, sales or other metrics. The payout provision specifies when and how many payments are to be made.

In most situations, the earnout term runs three years or less. A longer period can subject the seller to additional risk because it increases the possibility of adverse business events that are beyond the seller's control. If a longer period will be used, the seller might consider financing in the form of a loan or preferred stock in the company — both of which

Lucero v. United States

Court rules "severely distressed" company was overvalued

The U.S. District Court for the District of New Mexico recently held that the plaintiffs, a married couple, were entitled to a tax refund for a 2014 court settlement that included stock in a private business. Here's why the court determined that the stock was significantly overvalued for federal income tax purposes.

Why the plaintiffs amended their return

The wife was an employee at Good Technology Corporation (GTC), a private business, until July 2012. In October 2012, she sued GTC for disability discrimination and wrongful termination, and the parties settled in April 2014. The only financial information that GTC gave the plaintiffs was a list of stock sales between March 2012 and November 2013. The most recent sale was for $2.38 per share.

The settlement agreement called for a $500,000 cash payment, a $1.75 million payment to a trust and 650,000 shares of GTC's common stock. The agreement stated that the stock's value was $1,547,000 ($2.38 per share × 650,000 shares).

The plaintiffs relied on the value in the agreement when reporting settlement proceeds on their 2014 tax return. They subsequently filed an amended return, reducing the stock's value to $0.57 per share. The IRS denied the refund claim, and this lawsuit followed.

How the experts valued the shares

The plaintiffs hired a business valuation expert who appraised the stock using the market approach. Then he applied discounts for lack of control and marketability of 25% and 18%, respectively, to arrive at a minority, nonmarketable value of approximately $0.57 per share.

The expert rejected the cost and income approaches because the "cash poor" company had negative earnings, working capital and book value. Moreover, the company's Altman Z-score indicated that it was "severely distressed" and "unlikely to survive the next two years."

The IRS valuation specialist didn't perform a formal appraisal of the stock. Instead, he asserted that the stock's value was at least $2.38 per share, based on the value stated in the plaintiffs' settlement agreement and a recent merger transaction in which GTC's stock was valued at $4.92 per share.

The appropriate standard of value for federal income tax purposes is *fair market value*. The court ruled that the settlement agreement didn't reflect fair market value, because the parties weren't willing participants. The court also held that the merger was based on *fair value*, an entirely different standard of value.

Why the plaintiffs prevailed

The court ruled that the analysis from the plaintiffs' "experienced" business valuation expert was "thorough and credible." As a result, it valued the stock at $0.57 per share, upholding the plaintiffs' amended return and refund. ■

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