Valuation & Litigation Briefing

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Hiring outside professionals to help file business interruption claims

Natural disasters and other crises can interrupt normal business operations, causing significant financial losses — and possibly threatening a company's existence. Fortunately, companies can buy insurance coverage to help them weather the financial storm that comes from business interruptions.

Understand the policy

The purpose of business interruption insurance is to return the policyholder to the same financial position it was in before a crisis — as if the interruption hadn't happened. Most policies cover damaged assets, denial-of-access losses, lost income, and ordinary and necessary operating expenses that the business continued to incur during the loss period.

There are two basic types of business interruption coverage. First, "named perils" policies cover only occurrences specifically listed in the policy, such as fire, water damage and vandalism. Second, "all-risk" policies cover all disasters unless specifically excluded in the policy language. Typically, an all-risk policy excludes damage from earthquakes and floods, though coverage can generally be added for an additional fee.

Supplementary endorsements can be added to a policy that 1) extend coverage for a specified time after repairs are made but before income returns to pre-loss levels, and 2) provide for loss of income resulting from damage to the property of suppliers, providers or customers.

Seek outside help

Filing a timely business interruption claim and getting it approved can be challenging — especially when a company is in "crisis mode." Experienced financial advisors can help business owners in the following areas:

Scope of coverage. It's critical to resolve scope-of-coverage issues right away. For example, does the business interruption policy cover extraordinary expenses, such as the cost of operating at a temporary location? What types of rebuilding costs are covered? Financial advisors can help interpret the fine print in these complex policies to determine what's covered — and what's not.

Loss mitigation. Policyholders generally have a duty to mitigate financial damages during the loss period. But actions that compromise long-term operations typically aren't required. For instance, a company might be able to cut costs by laying off certain staff, but furloughing key employees and managers might slow recovery over the long run. A financial advisor can help develop and support reasonable mitigation strategies.

Loss estimates. Developing an aggressive, yet reasonable, "proof of loss" claim smooths the claims process, improves the chances for a speedy recovery and supports requests for advances from the insurer. A financial pro can help calculate business interruption damages and support claims with comprehensive, reliable documentation, such as financial statements, tax returns, receipts, utility bills and vendor information.

Definitions of key terms. Policies generally reimburse the insured for "lost business income," which leaves some room for interpretation. A financial professional can educate the insurer about the company and its finances, project future income, and calculate continuing and noncontinuing costs.

Another key term is the "loss period." Generally, this is the time required, with due diligence, to rebuild, repair or replace damaged property. A financial professional can help establish the proper loss period, thus maximizing the business's recovery.

Get it right

To resume normal operations after a business interruption, owners need to act quickly to estimate the loss and assemble a persuasive, well-documented claim. Claims may be delayed or denied if there are different interpretations of loss calculations, income projections or the meaning of policy provisions. When disaster strikes, it pays to contact a financial professional to help access the necessary funds for a quick recovery. ■

Connelly v. United States

Supreme Court weighs in on COLI debate

In the recent case of *Connelly v. United States*, the U.S. Supreme Court resolved an ongoing conflict among the federal circuit courts regarding the valuation of corporate-owned life insurance (COLI) for estate tax purposes. The Court unanimously held that COLI proceeds are includible in the company's value and that their value isn't offset by the corporation's obligation to redeem the stock.

All in the family

The case involved two brothers who owned a building supply company. The owners entered into a buy-sell agreement to ensure that the corporation would stay in the family. Under the agreement, if one brother died, the surviving brother would have the option to buy the deceased brother's shares. If the surviving brother declined, the corporation would be required to redeem them. To fund such a redemption, the company obtained $3.5 million in life insurance on each brother.

When one of the brothers died in 2013, he owned 77.18% of the corporation's outstanding shares and the surviving brother owned the remaining 22.82%. The survivor opted not to buy the shares, so the corporation was obligated to redeem them. The surviving brother and the deceased brother's son agreed on a purchase price of $3 million.

The deceased brother's federal estate tax return reported the value of his shares at $3 million. The IRS disagreed, estimating their value at $5.3 million and assessing nearly $900,000 in additional estate taxes. The estate paid the deficiency, then sued the government for a refund. The district court granted summary judgment to the government, concluding that the estate wasn't entitled to a refund, and the U.S. Court of Appeals for the Eighth Circuit affirmed.

Valuation matters

In response to the IRS audit, the estate hired an accounting firm to value the deceased brother's shares. The valuator determined that the company's fair market value was $3.86 million and the deceased shareholder's shares were worth approximately $3 million (77.18% times $3.86 million). In arriving at this figure, the valuator excluded $3 million in COLI proceeds used to redeem the shares, finding that they were offset by the obligation to buy the stock.

However, the IRS argued that the corporation's redemption obligation didn't offset the COLI proceeds. So, it valued the business at approximately $6.86 million ($3.86 million plus $3 million). Therefore, in the tax agency's view, the deceased brother's shares were worth about $5.3 million (77.18% times $6.86 million).

SCOTUS ruling

The Supreme Court sided with the IRS. The parties agreed that COLI proceeds were an asset that increased the company's value. The only question for the Court was whether the corporation's redemption obligation offset the value of the insurance proceeds used to fund the redemption. The estate argued that the two canceled each other out. The IRS countered that "no real-world buyer or seller would have viewed the redemption obligation as an offsetting liability."

The Court offered a simple example to explain why it sided with the government: Suppose a corporation has one asset, $10 million in cash, and two shareholders, A and B, with 80 shares and 20 shares, respectively. Individual shares are worth $100,000 each ($10 million divided by 100 shares). The company redeems Shareholder B's shares for fair market value ($2 million). After

What's a cross-purchase agreement?

A cross-purchase agreement is a type of buy-sell agreement that requires (or allows) the surviving owners, rather than the company, to buy a deceased owner's interest. These agreements are also typically funded by life insurance, but the coverage is bought by the individual owners. So, the insurance proceeds go directly to the surviving owner(s), bypassing the business. Cross-purchase agreements avoid the risk that the proceeds will increase the value of the deceased owner's interest. These agreements may also have tax advantages.

However, cross-purchase agreements have one major drawback: They require each owner to maintain insurance policies on the lives of the other owners. This can be cumbersome and expensive, depending on the total number of shareholders.

the buyout, the company has $8 million in cash remaining and 80 outstanding shares, all owned by Shareholder A. Shareholder A's shares are still worth $100,000 each ($8 million divided by 80 shares), and Shareholder B has $2 million in cash. So, the redemption has no economic impact on either owner.

Based on this reasoning, the Court opined that no willing buyer would have treated the corporation's obligation to redeem the deceased shareholder's shares as a factor that reduced the value of those shares. At the time of the shareholder's death, a willing buyer of his shares would acquire a 77.18% interest in a company worth $6.86 million, together with the corporation's obligation to redeem those shares at fair market value. Thus, a buyer would pay up to $5.3 million, which is the fair market value the buyer could expect to receive from the corporation for those shares.

Possible workaround

The Court acknowledged that its decision could make succession planning more difficult for closely held corporations. But it noted that shareholders can use alternative structures, such as cross-purchase agreements, to avoid this result. (See "What's a cross-purchase agreement?" on page 4.) An experienced financial advisor can help determine what's appropriate based on a business owner's situation. ■

Why bankruptcy courts may deny a debtor's discharge

The purpose of a discharge in bankruptcy is to "relieve an honest debtor from his financial burdens and to facilitate the debtor's unencumbered fresh start," explained the U.S. Bankruptcy Court for the District of Minnesota in the recent case of *In re Burg*.

However, such relief isn't available when a debtor destroys or conceals property with the intent to defraud creditors; conceals, destroys, or fails to preserve books and records; or engages in certain other dishonest acts. Here's why the court in this case denied the debtor's discharge under Chapter 7 of the Bankruptcy Code.

Case facts

The plaintiffs, a husband and wife who owned and operated two electrical contracting businesses, hired the debtor in 2011. The plaintiffs began to discuss selling their companies to the debtor in 2013. He subsequently took out a bank loan to finance the purchase, paying roughly half of the purchase price at closing with the remainder to be paid in monthly installments over 10 years.

> The court found that the debtor's actions destroyed the value of his stock in the companies.

Included in the loan terms was a subordination agreement that required the debtor to maintain a minimum debt service coverage ratio (DSCR) each quarter. This ratio is typically based on net operating income divided by debt service, including principal and interest. In this case, if the debtor's DSCR fell below 1.25 times debt service, payments to the plaintiffs would be suspended until the DSCR was brought back above the threshold.

Court sides with plaintiffs

The court denied the debtor's discharge under several Bankruptcy Code sections, including Section 727(a)(2)(A)-(B). Under this section, a court may deny a discharge if, among other things, the debtor removes, destroys or conceals property of the debtor with the intent to hinder, delay, or defraud a creditor or an officer of the bankruptcy estate.

The debtor argued that the property in question belonged to the companies, not him. The court disagreed, finding that the debtor's actions destroyed the value of his property — that is, his stock in the businesses.

The debtor also denied having the requisite intent. But the court found that the debtor's conduct overwhelmingly supported a finding of fraudulent intent. Specifically, he transferred, removed, destroyed or concealed the companies' assets and business records in order to:

- Manipulate the DSCR,
- Deplete the companies' assets or divert them to himself and related parties,
- Avoid paying installment payments to the plaintiffs, and
- Conceal evidence of his fraud schemes.

The court also denied his discharge under five other similar Bankruptcy Code sections.

Proving intent

Proving fraudulent intent with direct evidence is often difficult. However, in this case, the court noted that such intent may be "inferred from the facts and circumstances of the debtor's conduct." Its opinion provides a useful guide to the types of conduct that support such an inference. ■

Nefarious actions

The debtor made installment payments to the plaintiffs for over two years. Then the bank notified him that he'd failed to meet the DSCR threshold for two quarters and must suspend payments to the plaintiffs. He never made another payment.

Although the DSCR was below the threshold, the companies remained profitable. However, the debtor engaged in various questionable activities to siphon profits from the businesses. For instance, the debtor hired an old high school friend as a "consultant." According to the trial testimony, the consultant helped the debtor avoid paying the money he owed to the plaintiffs. For example, the debtor would take money out of the companies and pay it as a consulting fee to his friend, who would then invest it in real estate. The debtor also provided unpaid electrical services to the consultant and to another company he owned, then he deleted the accounting records associated with those services.

In addition, the debtor attempted to settle his debt with the plaintiffs, threatening to file for bankruptcy if they didn't settle. Ultimately, the debtor closed the companies; terminated their employees; and siphoned more funds through payments of severance benefits, wages and vacation time. He filed for bankruptcy, and the plaintiffs filed a motion to deny the debtor's discharge.

Look beyond the income statement to boost cash flow and add value

For operating companies, maximizing future cash flow is key to building long-term value. However, the obvious targets for improving cash flow — increasing revenue and decreasing costs — may not work if a business is facing flat demand or has already scaled back overhead. Here are some techniques that may help companies squeeze more out of existing operations.

Reducing working capital

Working capital is the difference between a company's current assets and its current liabilities. Businesses increasingly need working capital as they grow. But the more cash that's tied up in excess working capital, the less a business may be worth. Effective working capital management focuses on three key areas:

1. Collections. How long does it take to collect money from customers? Compare the current average collection period to the company's historic collection period as well as industry averages. Management should review policies and procedures regarding invoicing, collections, dispute resolution and deposits. Possible ways to streamline the collections process include investing in billing automation software, offering early payment discounts and charging interest on late payments.

2. Inventory. For many businesses, raw materials, work-in-progress and finished goods inventory drain cash. Companies should keep just enough inventory on hand to meet imminent customer needs. It's important to measure the days-in-inventory ratio as well as inventory composition. Businesses shouldn't tie up cash in slow-moving or special-order items. Instead, they need to ensure the bulk of inventory is high-demand, fast-turning items. Returning slow-moving items or writing off obsolete inventory is worth considering.

3. Accounts payable. Unlike receivables and inventory, payables are a liability. So, the goal should be to slow down payments without jeopardizing supplier relations or missing out on valuable early payment discounts. The slower that companies pay suppliers, the longer cash stays in the bank, preferably earning interest.

Evaluating fixed assets

Most businesses need equipment, computers, vehicles and real estate to operate. Purchases use up cash, but divestitures generate cash. Companies can generate cash flow by selling off underused or nonoperating fixed assets. Divestitures can lower insurance and storage costs, too.

Rather than buying on gut instinct, owners should conduct accounting payback or net present value analyses to ensure capital expenditures make financial sense. Creative alternatives — such as adding a second work shift or leasing — may be more efficient than upgrading equipment or buying new.

Thinking beyond the income statement

Effective cash flow management builds shareholder value. Many business owners focus on the income statement, which shows revenue and expenses. But those who overlook the balance sheet, which shows a snapshot of current financial position, could miss out on value-building opportunities. ■

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Our Valuation and Forensic Services:

Our firm has partner and manager level staff who hold certifications as Certified Valuation Analysts (CVA's), Certified in Financial Forensics (CFF's) and Accredited in Business Appraisal Review (ABAR). They have extensive experience in providing valuation services and expert witness testimony in various courts on a wide range of litigation issues including:

- Shareholder/Partner and Business Disputes
- Lost Profits Analysis
- Damage Analyses
- Domestic Relations Matters
- Bankruptcy Services
- Fraudulent Actions
- Criminal Tax Matters
- Valuing Closely Held Businesses
- Purchase or Sale of Business
- Succession Planning
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