Valuation & Litigation Briefing

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415 Sargon Way • Suite J • Horsham, PA 19044
Tel: (215) 675-8364 • Fax: (215) 675-3879
www.wm-cpa.com

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Arrowsmith v. First United Methodist Church Centre, Alabama

Church ordered to return more than $500,000 in donations

The U.S. Bankruptcy Court for the Eastern District of Virginia recently awarded the bankruptcy trustee a $569,435 judgment against a church. This amount represented the portion of donations to the church that were traceable to fraudulent transfers by the debtor.

Fraudulent transfers?

The debtor operated a health care laboratory. The bankruptcy trustee had obtained a judgment for more than $220 million against the debtor's exclusive sales agent for receipt of fraudulent transfers from the debtor (the "avoided transfers"). The trustee also sought to recover transfers that had been received by one of the debtor's shareholders, a principal and insider of the sales agent. However, because the shareholder and several of his business entities filed for bankruptcy protection, the trustee's action against him was stayed.

The church stipulated that transfers of just over $1.7 million from the debtor to the shareholder were avoidable under the Bankruptcy Code's fraudulent transfer provisions (the "avoidable transfers"). (See "Recovering fraudulent transfers in bankruptcy" at page 3.) The instant action involved $1,085,000 in donations the shareholder made to the church. These donations came from bank accounts containing funds that had been commingled with the avoided and avoidable transfers. The trustee sought to recover the portion of the donations traceable to the debtor.

Tracing methodology

The trustee's expert witness, a forensic accountant, traced the money flow in and out of the bank accounts to determine the amount of the debtor's funds that went to the church. Although several tracing methods are available, the expert applied the following two techniques:

1. The lowest intermediate balance rule (LIBR) method. This assumes "trust or secured funds deposited into a commingled bank account are the last funds disbursed from that account, and any disbursements made from the account are taken first from funds other than the trust or secured funds until the balance in the account dips below the amount of those trust or secured funds." In simpler terms, "clean" funds are assumed to exit the account before the "dirty" funds until no clean funds are remaining, then withdrawals are made

Recovering fraudulent transfers in bankruptcy

The U.S. Bankruptcy Code's fraudulent transfer rules are designed to prevent debtors from depleting their assets to place them beyond creditors' reach. Bankruptcy trustees have the power to prevent fraudulent transfers and bring the assets back into the bankruptcy estate.

Under Bankruptcy Code Section 548, trustees can avoid transfers made within two years before a bankruptcy filing if they involve actual or constructive fraud. *Actual* fraud means a transfer was made with actual intent to hinder, delay or defraud creditors. *Constructive* fraud happens when a debtor transfers assets without receiving "reasonably equivalent value" under certain conditions. Examples include insolvent debtors, transfers that render debtors insolvent and transfers to insiders.

Section 550 permits trustees to recover the value of fraudulent transfers from 1) an initial transferee (or the entity for whose benefit the transfer was made), or 2) any immediate or mediate transferee of such initial transferee, such as the church in *Arrowsmith* (see main article). However, a trustee may not recover from a mediate transferee that "takes for value … in good faith, and without knowledge of the voidability of the transfer avoided."

from dirty funds. Using this method, the expert estimated that the amount traceable to the debtor was $569,435.

2. The restated tracing rules (RTR) method. This technique assumes that withdrawals are made from the trustee's funds provided they don't exceed the account's lowest balance between when the debtor's funds were deposited and when they were withdrawn. Using this method, the expert found that the amount traceable to the debtor was $845,015.

> If the church believed a different tracing method was appropriate, it could have offered a rebuttal expert — but chose not to.

The court determined that the LIBR method was best suited to trace the funds and awarded the trustee $569,435.

Court's reasoning

The court rejected three key arguments the church raised in its defense. First, the court found the trustee wasn't obligated to present his case in the light most favorable to the church. If the church believed a different tracing method was appropriate, it could have offered a rebuttal expert — but chose not to.

Second, the church failed to show that it provided value in exchange for the donations, which could have precluded the trustee's recovery. The church provided no goods or services in exchange for the donations, and neither the "intangible and emotional benefits of charitable giving" nor charitable acts performed by its congregation in the community were sufficient. The donor must receive a *tangible, quantifiable* economic benefit.

Finally, the fact that the church had already spent more than half of the donations wasn't a valid defense. The Bankruptcy Code's fraudulent transfer provision doesn't consider "the potential hardship to … a subsequent transferee."

Lessons learned

This case highlights the need for forensic experts to establish the source of funds in fraudulent transfer cases. It also demonstrates that fairness to the transferee, regardless of how innocent, isn't a consideration when seeking the return of fraudulently transferred funds. ■

Exercise caution when valuing a business for ESOP purposes

The U.S. District Court for the District of Arizona recently found that a company's former owners violated ERISA and breached their fiduciary duties when establishing an employee stock ownership plan (ESOP). The owners set up the ESOP in 2014 and sold 100% of the company's shares to the ESOP for $105 million. But the federal court described the transaction as "extraordinarily one-sided." (*Su v. Bensen*, No. CV-19-03178_PHX-ROS, D. Ariz., August 15, 2024).

Former owners' expert grossly overstated value

In 2019, the U.S. Department of Labor (DOL) filed a complaint alleging that the price the ESOP paid for the company was unfairly inflated. The company's owners hired a business valuation expert who determined a range of values between approximately $107.6 million and $122.8 million for the company's equity. He used two valuation techniques:

1. The guideline public company method, and

2. The discounted cash flow (DCF) method.

The court found several significant flaws in his analyses. Notably, the comparable companies used in the guideline public company method "bore no meaningful resemblance" to the subject company.

> The court called the expert's argument that the ESOP had substantial elements of control "nonsensical."

Additionally, when applying the DCF method, the expert relied on projected financial results prepared by the company's management for 2014 through

2018. He then estimated a terminal value (the expected net cash flows after the end of the projected period) using the same companies identified in his application of the guideline public company method. Because terminal value often represents a significant portion of a company's value under the DCF method, the result wasn't reliable.

Moreover, the expert failed to subtract the company's line of credit when valuing the business's equity. And he didn't apply a discount for lack of control (DLOC), even though the company's owners retained complete control over all aspects of the company before and after the ESOP purchased the stock. The court called the expert's argument that the ESOP had substantial elements of control "nonsensical."

Court favors the DOL's expert's analyses

The methodology used by the DOL's expert corrects many of these shortcomings. He concluded that the guideline public company method was inappropriate due to the lack of reliable comparables and relied exclusively on the DCF method.

The expert used management's projections for 2014 through 2018 in his DCF analysis. But when determining terminal value, he applied the Gordon

growth model. This model capitalizes projected earnings, rather than relying on comparable stock prices. After subtracting debt (including the line of credit) and adding cash and cash equivalents, the expert arrived at a preliminary value of roughly $44.3 million for the company's equity. Then he applied a 17% DLOC and a 10% discount for lack of marketability.

Finally, the DOL's expert subtracted the value of warrants issued to two former owners as part of the transaction, viewing them as claims on the company's cash. His final value conclusion was approximately $13.7 million.

The court generally accepted the DOL's expert's approach. However, it disagreed with his treatment of the warrants. The court decided that they were meant to compensate the former owners for accepting a below-market interest rate on seller notes.

Adding the value of the warrants ($19.3 million) to the DOL expert's valuation resulted in a fair market value of $33 million for the company's equity — less than one-third of the price the ESOP paid for the stock.

Pick the right trustee

Using an independent ESOP trustee is essential to arrive at a reasonable stock price. In this case, the trustee — which was also targeted by the DOL — had a pre-existing relationship with the former owners' ESOP financial advisors. The trustee accepted the highly one-sided deal and let the former owners retain complete control of the company. The trustee also performed limited due diligence in order to close the deal quickly and maximize the former owners' tax benefits. The transaction may have turned out differently if a truly independent trustee had been used. ■

Using business valuations to bolster financial discussions

A company may obtain a formal business valuation for various reasons, such as a shareholder dispute, marital dissolution or tax matter. The valuation report contains detailed information that may also be relevant to a lender if the company applies for a new loan or renegotiates the terms of existing debt. Such insights usually can't be gleaned from the financial statements alone.

Business owners can use information in valuation reports to communicate with lenders more effectively. Or they might even consider sharing valuation reports with lenders to obtain more favorable credit terms. Here's an overview of how a business valuation can supplement a company's financial statements.

Cost approach: Beyond the balance sheet

The *book values* of assets and liabilities reported on a company's balance sheet may differ significantly from their *fair market values*. Why? For accounting purposes, assets typically are reported at the lower of historical cost or market value. For example, a building acquired 50 years ago may be worth far more than the balance sheet reflects. Accelerated depreciation methods also tend to underestimate the value of fixed assets. Likewise, accounts receivable may include stale, uncollectible invoices, especially if the company isn't audited.

Additionally, intangible assets — such as brands, patents, customer lists and goodwill — are usually

Valuators use various criteria — such as industry, size, location, target markets and financial performance — to select comparables.

omitted from the balance sheet, unless acquired from a third party. Contingent liabilities also may be excluded.

When applying the cost (or asset-based) approach, valuators convert the book values into market-based values. They also factor in unreported assets and liabilities.

Income approach: Eyes on the future

The income statement and statement of cash flows provide insights into a company's *historical* performance. However, valuation experts focus on *future* earnings because that's what matters to prospective buyers.

Various factors may cause future expectations to differ from past results. Examples include new competitors, changing consumer tastes or emerging technology. Valuators typically use cash flow projections when applying the income approach. Moreover, they may evaluate company-specific risks when calculating discount and capitalization rates.

Market approach: Real-world M&A transactions

Under the market approach, a company's value is based on prices paid for similar companies.

When applying the market approach, valuators often rely on private transactions from proprietary databases. Business owners and lenders normally don't have access to this information. This data includes the selling prices and terms of deals in the company's industry, which can be particularly helpful when financing mergers and acquisitions.

Review the fine print

A comprehensive valuation report contains more than financial data. It also describes the company's operations and industry. This information can be beneficial if lenders aren't familiar with the borrower's business.

In addition, a valuator explains the subject company's risk profile and evaluates its financial performance over time and against competitors. For example, these analyses may be addressed when estimating the cost of capital, adjusting pricing multiples, and developing discounts for lack of control and marketability.

What drives value, drives credit

Balance sheet adjustments, future earnings, industry trends and comparable transactions are important parts of the valuation equation. When refinancing or seeking new loans, leveraging past valuation reports can lead to more favorable outcomes and greater transparency about a company's future prospects. ■

Obtain a qualified appraisal when donating private stock — or else

Using a "qualified" appraiser is the key to unlocking deductions for contributions of private company stock. Failure to do so can lead to the loss of valuable tax breaks. Here's a recent U.S. Tax Court case where a business owner learned this lesson the hard way.

Estate of Hoensheid

In April 2015, the owner of a closely held business established a donor-advised fund (DAF) for tax planning purposes. He hoped to avoid capital gains tax from an impending sale of his company by contributing some stock to the DAF before the deal closed.

The taxpayer transferred the company's shares to the DAF in June 2015 and claimed a $3.3 million charitable contribution deduction on his 2015 federal income tax return. He used the transactional advisor who handled the business sale to value the stock for no charge.

The IRS disallowed the deduction and asserted a $647,489 deficiency and $129,498 accuracy-related penalty. These assessments were subsequently increased because the contribution wasn't made until two days before the transaction closed — when the sale was a virtual certainty. Therefore, the contribution triggered the anticipatory assignment of income doctrine. Under this doctrine, a person with a fixed right to receive income from property can't avoid taxes by arranging for another to gratuitously take title before receiving the income.

Tax Court ruling

The U.S. Tax Court agreed that the doctrine applied, but it found that the taxpayer made a valid gift that might support a charitable deduction. To claim such a deduction on a gift exceeding $500,000, taxpayers must submit qualified appraisals from qualified appraisers with their federal income tax returns.

In *Hoensheid*, the court determined that the taxpayer's appraiser lacked the appropriate qualifications. He didn't have business valuation credentials or hold himself out as a valuation professional. The advisor testified that he conducted valuations "on a limited basis" before joining the bank the year before the appraisal in question. Moreover, he performed business valuations for prospective clients only once or twice a year.

The court described the use of a qualified appraiser as the "most important requirement" for a qualified appraisal. Thus, it concluded that the taxpayer didn't show substantial compliance with substantiation requirements.

Forgone tax benefits

After being found liable for capital gains tax on the shares transferred to the DAF, the taxpayer might still have benefited from a hefty charitable deduction. But he lost that tax benefit, too, because he didn't use a qualified appraiser. ■

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415 Sargon Way • Suite J • Horsham, PA 19044
Tel: (215) 675-8364 • Fax: (215) 675-3879
www.wm-cpa.com

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