



Litigation &

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REPORT

MAY/JUNE 2008

A financial expert's role in alter-ego cases

Fraud's a factor in solvency analysis

Something to prove

Courts increase burden on experts

How do taxes "affect" S corporation valuations?



Beason & Nalley, Inc.
101 Monroe Street • Huntsville, Alabama 35801
Phone: 256-533-1720 • Toll Free: 800-416-1946 • Fax: 256-534-8558
www.beasonnalley.com

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A financial expert's role in alter-ego cases

Businesses incorporate for many reasons, but the most important advantage of the corporate form is limited liability. Operating as a corporation — or as a quasi-corporate entity, such as a limited liability company (LLC) or limited partnership — encourages investment by insulating shareholders' personal assets against liability for corporate debts.

But protection isn't absolute. A plaintiff unable to collect a judgment from a corporation may ask a court to invoke its equitable powers to "pierce the corporate veil" and hold the owners responsible. Such legal show-downs are often referred to as "alter-ego" cases.

Lack of separateness can be an issue when a parent corporation has one or more subsidiaries.

A careful look

There's no bright-line test for determining whether it's appropriate to pierce the corporate veil: It depends on each case's facts and circumstances. The mere fact that a corporation is judgment-proof isn't enough.

After all, the protection of the corporate form isn't just for a successful business and can't be discarded simply because poor management or unavoidable losses depleted its assets.

Rather, a plaintiff must show that the shareholders abused the corporate structure in such a way that it would be unfair to let them hide behind it. Typically, this means showing that the corporation and its shareholders lack separate identities — that is, the corporation is the owners' alter ego.

An expert's role

There are several key factors in alter-ego cases. One is lack of separateness. A court is more likely to disregard

the corporate form if the shareholders themselves disregarded the corporation's separate existence.

For example, if the shareholders neglected corporate formalities — such as electing officers and directors, keeping minutes, and maintaining accounting records — the corporation might be an alter ego. In addition, commingling of funds and assets can blur the distinctions between corporations and their shareholders.

Lack of separateness also can be an issue when a parent corporation has one or more corporate subsidiaries. Plaintiffs who dealt with a subsidiary may have believed they were dealing with the parent. The corporations may have been so similar that it was difficult to tell them apart. Or the parent's actions or representations may have led the plaintiff to believe that the parent would stand behind the subsidiary's obligations.

Several similarities between a parent and subsidiary can create confusion and support application of the alter-ego doctrine. Entities may not be separate when they share:

- The same, or a similar, line of business,
- The same, or a similar, name or trademark,
- Officers or directors,
- Office space,
- Letterhead, invoices or purchase orders,
- Lawyers, accountants or banks, or
- Accounting systems.

Lack of separateness also may be indicated by transactions between a corporation and its parent or shareholders that aren't conducted at arm's length. For example, the parent might sell or lease property for less than fair market value.

A financial expert can provide insight into whether particular practices — such as shared services or related-party transactions — are ordinary and appropriate or indicate abuse. The expert applies valuation techniques and analyzes financial statements, internal accounting records and other business documents.

He or she might also study these documents to determine whether the corporation and its owners are commingling assets or using corporate funds to pay the owners' personal debts.

Lack of financial independence

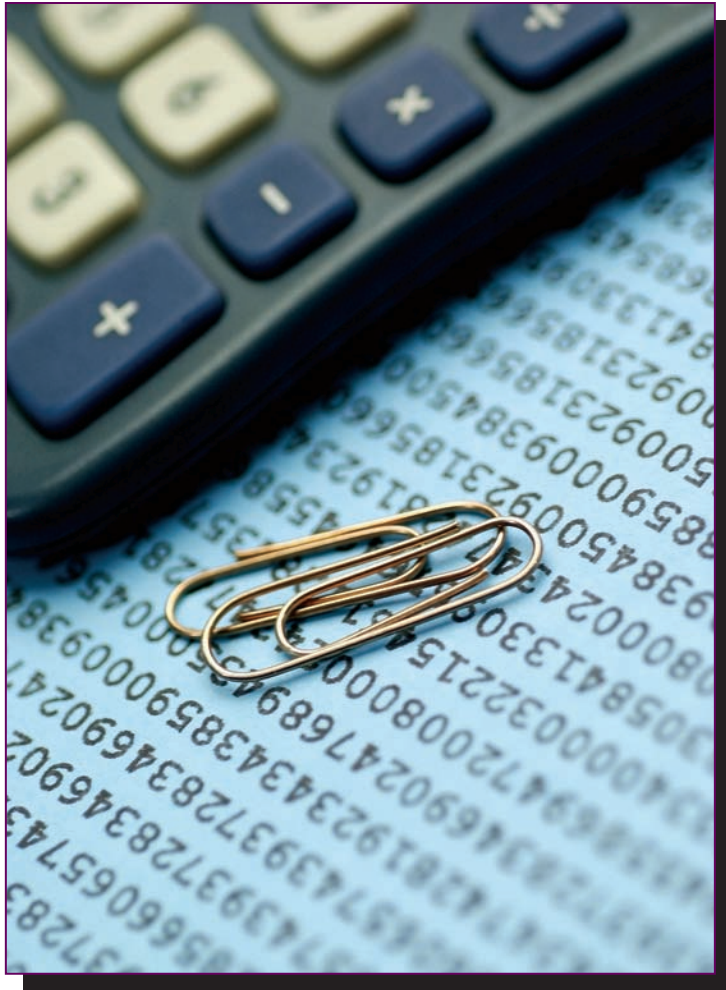
A common sign that a corporation has an alter-ego relationship is when it's financially dependent on its shareholders or parent, demonstrated by any of the following:

- The corporation is undercapitalized.
- The parent or shareholders own most of the assets used in the business and lease them to the corporation.
- The parent or shareholders make undocumented or below-market loans to the corporation or relieve the corporation from its payment obligations.
- The parent uses zero-balance or "sweep" accounts to automatically move a subsidiary's cash into the parent's accounts.
- The corporation can't survive without the parent's or shareholders' financial backing. Lenders and other third parties, for example, won't extend credit without the owners' guarantee.

A financial expert can analyze the corporation's capital structure and compare key financial ratios and indicators to similar companies to determine whether it's undercapitalized.

The expert also may review the corporation's operating history and analyze intercompany transactions and relationships to determine whether the corporation became undercapitalized as a result of operating losses or irregularities in its financing. In addition, the expert can analyze transactions between a corporation and its subsidiaries to determine whether they were conducted on an arm's-length basis.

Finally, the expert can analyze credit ratings and documents lenders and others used to evaluate the corporation's creditworthiness. This analysis may reveal



that a parent and its subsidiary are presenting themselves as a single entity when seeking credit.

Owner domination

Nothing says "alter ego" like a parent/shareholder that exercises undue influence or dominates a corporation. In this case, a parent/shareholder may cause the corporation to favor it over third parties (by, for example, giving it a preferred status over other creditors).

The parent/shareholder might exert its influence to engage in non-arm's-length transactions that benefit it at the corporation's expense. And the parent/shareholder might take part in a "de facto" merger, transferring the corporation's assets (but not its liabilities) to another corporation in which it also has an ownership interest.

A financial expert will review the corporation's operations and transactions, examine accounting records and

A two-pronged test (sometimes three)

The remedy of piercing the corporate veil is available in all 50 states. Typically, courts apply a two-pronged test, requiring the plaintiff to prove that:

1. There is such unity of interest and ownership between the corporation and its shareholders that they no longer have separate identities — that is, the corporation is the owners' alter ego, and
2. Observing the corporation's separate legal existence would be unfair to third parties.

Some courts add a third prong to the test, requiring evidence of defendant fraud or bad faith.

apply valuation techniques. This will help the expert determine whether the corporation's dealings with related parties are legitimate or involve undue control or domination by its owners.

Beneath the surface

Alter-ego liability can be a critical issue for both plaintiffs and defendants. For a plaintiff, it can make the difference between collecting and getting stuck with an award against a judgment-proof corporation. For a defendant shareholder or parent corporation, the liability protection of the corporate form is at stake.

In some cases, alter-ego relationships are obvious. But more often than not, a financial expert needs to dig beneath the surface to distinguish legitimate arrangements from improper ones — and determine whether the corporate veil should be pierced. □

Fraud's a factor in solvency analysis

In bankruptcy cases, a lot hinges on whether the debtor was insolvent when certain transactions took place. For example, some payments and transfers the debtor made within a specified time before filing for bankruptcy may be recovered as fraudulent transfers or preferences if the debtor was insolvent at the time of the transaction.

A recent case, *Edgewater Medical Center v. Edgewater Property Company*, addresses issues regarding fraud's impact on insolvency.

Hospital takes a turn for the worse

In 1994, after a complex series of transactions involving multiple holding companies, the principal owner of Edgewater Medical Center (EMC) sold hospital operations and the land under the hospital to a not-for-profit organization, which continued to do business as EMC.

The owner retained the "adjacent properties" that had been part of the hospital campus. These included a professional office building, a nurse's residence and some

other facilities. Edgewater Property Company (EPC) held these properties.

As part of the sale, EMC received an option to purchase the adjacent properties from EPC, but it never exercised the option, which expired in 1998. Instead, beginning in 1996, EMC leased the properties from EPC for just under \$80,000 per month. The lease also required EMC to pay all property taxes, operating expenses and insurance premiums. The initial term of the lease was 10 years, with options to extend it an additional 25 years.

EMC stopped paying rent in May 2001 and ceased operations in December of that same year. In February 2002 it filed for relief under Chapter 11 of the U.S. Bankruptcy Code.

Insolvency diagnosis

A key issue in the case was whether EMC could recover rent and other payments it made within one year before bankruptcy — either as fraudulent transfers under state

law or as preferences under the Bankruptcy Code. To succeed, EMC would have to prove that it was insolvent at the time it made the payments.

The Bankruptcy Code and the state fraudulent transfer act defined insolvency similarly: A debtor is considered insolvent if, when fairly valued, its debts exceed its assets.

In this case, EMC's assets clearly outweighed its debts at the time of the transfers. But EMC argued that this wasn't an accurate financial picture because rampant Medicare fraud occurred at the hospital during the same period. The theory was that, if the fraud had been discovered, the hospital would have suffered devastating financial consequences. Thus, a "fair valuation" of the debtor should have considered this possibility.

According to expert witnesses, if the fraud had come to light:

- The Department of Health and Human Services (HHS) would have ceased making Medicare payments to EMC and imposed fines and penalties,
- The hospital's reputation would have suffered significant harm,
- Patient admissions would have decreased, and
- The hospital would have struggled to attract good doctors and staff.

The bankruptcy court observed that EMC was in a "strong cash position" at the time of the transfers. It also found that, if the potential financial impact of the Medicare fraud were considered, EMC would have been insolvent. But if the fraud's impact weren't considered in the analysis, EMC would have been solvent.

The arguments

In support of its argument, EMC cited a New York bankruptcy case in which the debtor was insolvent but appeared to be solvent because its financial troubles were concealed by false accounts receivable and other misrepresentations. The court in *EMC* found this case to be "easily distinguishable" because the debtor in the previous case was *actually* insolvent. The fact that it appeared to be solvent because it was "cooking the books" was irrelevant.

By contrast, EMC was actually solvent at the time of the transfers. The court acknowledged that the Medicare fraud had been hidden — and that, if HHS had discovered it, EMC likely would have ended up insolvent. But to find insolvency, the court explained, it "would have to disregard the large amounts of cash the debtor had on hand and *speculate* on what [HHS] would have done if it had discovered the Medicare fraud."

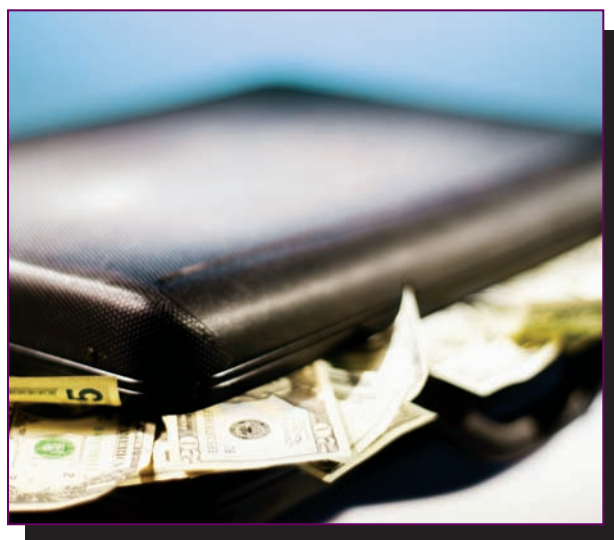
Because the court found such speculation to be inappropriate, it concluded that EMC had not met its burden of proving insolvency.

Solvency vs. value

The EMC case illustrates the significant conceptual differences between business valuation and solvency analysis. Fair market valuation looks at the amount a willing buyer would pay a willing seller when both parties have reasonable knowledge of the relevant facts.

Is it reasonable to assume that a buyer would have discovered the Medicare fraud? If so, it seems likely that it would have affected the price the buyer was willing to pay. Thus, it's possible for a business to be solvent and, at the same time, virtually worthless.

In this case, the court distinguished between fraud that *conceals* insolvency and fraud that, if discovered, would *cause* insolvency. In the first situation, the debtor meets the definition of insolvency. In the second situation, it does not. □



Something to prove

Courts increase burden on experts

Three recent cases highlight the critical role that burden of proof can play in cases involving expert financial testimony.

In legal proceedings, it's imperative for a plaintiff's (or taxpayer's in IRS cases) experts to present credible prima-facie facts and conclusions to meet the minimum burden-of-proof standards required by the courts.

1. Interest swaps

J.P. Morgan Chase & Co. v. Commissioner addressed the proper method of calculating the fair market value of interest rate swaps for income tax purposes, with nearly \$100 million in assessed tax deficiencies at stake.

In a 160-page opinion, the Tax Court provided what the appellate court described as “a veritable treatise on interest swaps.” The Tax Court appointed its own two experts (in addition to the parties' five). After hearing testimony from 21 fact witnesses and seven experts, reviewing more than 10,000 pages of exhibits, and considering 3,300 pages of additional briefing, the appellate court rejected both the taxpayer's and the IRS's methods — and came up with its own.

It took the parties more than a year and a half to submit computations using the Tax Court's method. In a “cursory order,” the court adopted the IRS's computations and concluded that the taxpayer owed more than \$7 million in taxes.

The appellate court found nothing wrong with the Tax Court's valuation method. But, it explained, after the Tax Court rejected the taxpayer's valuation, the taxpayer failed to meet its burden of proof. Thus, the Tax Court should have deferred to the IRS's valuation.

Under Internal Revenue Code Section 446, if a taxpayer's method doesn't clearly reflect income, a court must defer to the IRS's method unless it is “clearly unlawful” or “plainly arbitrary.” The appellate court remanded the case to the Tax Court to determine whether the IRS's method was either.

2. Fraudulent scheme

The case of *Morgan Stanley v. Coleman* involved a merger between Coleman (Parent) Holdings Inc. (CPH) and Sunbeam, Inc. CPH alleged that Sunbeam, with the help of its investment banker (Morgan Stanley), carried out a fraudulent scheme to inflate its stock price. A jury awarded CPH more than \$1.5 billion in compensatory and punitive damages for conspiracy as well as aiding and abetting fraud.

At trial, Morgan Stanley unsuccessfully challenged CPH's damages expert. Rather than determine the “fraud-free” price of Sunbeam's stock on the closing date (which was his usual practice), the expert followed CPH's instructions and assumed that CPH couldn't have recovered any value — which ultimately was the case three years later when Sunbeam went bankrupt.



But, as the appellate court noted, the expert “did not consider whether other factors affected the stock price ... analyze whether Sunbeam's acquisition of other small companies ... created problems [or] look at Sunbeam's expenses” under new management.

Finding no proof at trial of the correct measure of damages, the appellate court reversed the judgment. It ordered the trial court to enter judgment for Morgan Stanley and rejected CPH's request for a new trial.

3. Estate tax value

At issue in *Estate of Thompson* was the value, for estate tax purposes, of an interest in a closely held business. The Tax Court rejected both parties' valuations as “deficient and unpersuasive” and undertook its own valuation. It also criticized the estate for offering experts with “relatively little valuation experience.”

The estate cited Internal Revenue Code Sec. 7491, stating that, after it introduced “credible evidence” in

support of its valuation, the burden of proof shifted to the IRS. Because the Tax Court rejected the IRS expert's valuation, the estate argued, the IRS had failed to satisfy this burden and the court should have adopted the estate's valuation.

The appellate court disagreed, observing that, even though the Tax Court had rejected the IRS's valuation, the IRS expert had also successfully rebutted the estate's

valuation by pointing to inaccuracies and inconsistencies in the estate's calculations.

Be prepared

These cases illustrate how important it is for litigants to engage qualified experts and to avoid taking shortcuts when it comes to damages or valuation analysis. A qualified expert can perform a thorough analysis that can stand up in court. □

How do taxes "affect" S corporation valuations?

For many years, "tax-affecting" the earnings of S corporations and other pass-through entities was a widely accepted valuation practice. But that changed in 1999, when the Tax Court ruled in *Gross v. Commissioner* that tax-affecting was inappropriate when valuing a minority interest in an S corporation.

In 2001, the Sixth Circuit Court of Appeals upheld the Tax Court's decision. Since then a series of court rulings has bolstered this position. Does this mean that business valuers and their clients should throw in the towel on this issue? Not necessarily.

What is tax-affecting?

Appraisers often value S corporations using data derived from comparable, publicly traded C corporations. But unlike C corporations, S corporations pay no corporate income taxes. Instead, their shareholders report their pro-rata shares of the entities' earnings on their individual income tax returns. As a result, all other things being equal, an S corporation's earnings will be higher than those of its C corporation counterpart.

To adjust for this difference, valuers would reduce a pass-through entity's earnings by an assumed corporate tax rate to reflect specific factors that affected its shares' value in the eyes of a hypothetical buyer. The factors included the risk that it would lose its S corporation status or that it wouldn't distribute sufficient income to cover its shareholders' tax obligations.

The future of tax-affecting

Recent cases tell us that courts won't accept full tax-affecting to reflect risks that may be remote. But that doesn't mean tax-affecting isn't appropriate under the right circumstances. Even in *Gross*, the court partly based its decision on the fact that there was no evidence that the corporation was likely to lose its S status.

To support tax-affecting, valuers now must use detailed analytical models that address the actual risks associated with a particular S corporation. The models reflect five primary factors:

1. Whether a minority or control interest is being valued,
2. The corporation's dividend payout history and expected future distributions,
3. The current tax rate on dividends,
4. Applicable restrictions on S corporation shares, and
5. A hypothetical buyer's likely exit strategy.

These models haven't been tested in the courts, but anecdotal evidence suggests that, under the right circumstances, they can survive IRS scrutiny.

We deliver objectives

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- Eminent Domain
- Employee Stock Ownership Plans (ESOPs)
- Initial Public Offerings (IPOs)
- Obtaining Financing
- Split-ups/Spin-offs
- Succession Planning

Our Valuation Expert



Donald W. Nalley, Jr., CPA, CFP®, CVA, AM, ABV, is a founder and a director of the CPA and consulting firm Beason & Nalley, Inc. He is a holder of the appellation of Certified Valuation Analyst (CVA), an accreditation that recognizes special training and experience in business valuations and adherence to the standard established by the NACVA and an Accredited Member (AM), awarded by the American Society of Appraisers. Mr. Nalley, a former tax manager with Price Waterhouse, has over twenty-five years of valuation, management consulting, litigation, tax and accounting experience, and is a member of the NACVA, the American Institute of Certified Public Accountants, the Alabama Society of Certified Public Accountants, the Florida Institute of Certified Public Accountants, the American Society of Appraisers, a former member of the NACVA advisory board, and the former president of the Alabama Chapter for the NACVA. Mr. Nalley has performed multiple business valuations for gift, estate and inheritance tax, corporate and marital dissolutions, stock options, income tax, shareholder disputes, business transfers, and other personal and litigation related matters. Mr. Nalley has also served as special master and an expert witness in litigation matters.