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Litigation & Valuation

REPORT

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Damage control

Surviving a business interruption

Cash is a business's lifeblood. Even companies that are highly profitable on paper can't survive long without a healthy cash flow. That's why a business "interruption" is so dangerous. Whether it's minor, such as a lightning strike that shuts down production for a day, or major, such as a lengthy labor strike, a business interruption not only reduces income, but also simultaneously creates new expenses. The key to surviving a business interruption is to restore normal operations as quickly as possible. *Insurance* plays a critical role.

Business interruption insurance

Even if an interruption is caused by another party's negligence or other wrongful conduct, most businesses don't have the luxury of waiting for a settlement or court judgment. Business interruption insurance can replace lost income and cover extraordinary expenses, such as the cost of repairing a building or replacing damaged equipment, while management focuses on getting back to business as usual.



When a business interruption occurs, you should quickly establish the magnitude of the loss, review the scope of coverage under your business interruption policy to see what's covered (see "Determining the scope of coverage" on page 3), and put together an aggressive, but reasonable, claim.

Most policies require the insured to file a detailed "proof of loss" within a short period (30 days, for example) after a loss occurs. Then, after a preliminary review, the insurance carrier makes an initial estimate of the loss and establishes a loss reserve. Once this reserve is set, it can be difficult to convince the carrier to accept a larger claim, so make sure you document your losses as accurately as possible.

Estimating damages with a reasonable degree of accuracy in the early stages also demonstrates to the carrier that you're acting in good faith and supports requests for advance payments from the carrier — a boon for your company's cash flow. Throwing out a large number just to get something on paper and then filling in the blanks later is rarely effective.

Staking a claim

Make sure you get financial advisors involved soon after the loss occurs. The insurance company's experts have no incentive to interpret the facts in the insured's favor, so it's up to your experts to educate the carrier about the nature of your business and the financial impact of the business interruption.

Most policies reimburse the insured for some form of "lost business income," but regardless of how that term is defined, there's room for interpretation. Even an insured's method of accounting can have a significant impact. If its financial statements are prepared using the cash method, for example, the carrier's first impulse might be to calculate the loss on that basis. But the insured's financial experts may be able to demonstrate that the accrual method more accurately reflects its damages.

DETERMINING THE SCOPE OF COVERAGE

Addressing scope-of-coverage issues early is critical to a successful business interruption claim. For example, does the policy cover extraordinary expenses, such as the cost of operating the business at a temporary location until the original location is restored?

Does the policy cover “denial of access” losses? This can occur when a natural disaster or other incident causes governmental authorities to block access to your property for security reasons, even though the property isn’t damaged.

If you’re required to rebuild your facility, what costs are reimbursed by the policy? Depending on the policy language, some courts have found that the insured should be reimbursed for the extra cost of safety enhancements or other improvements that would help avoid a similar business interruption in the future.

One of the biggest challenges in putting together a business interruption claim is establishing the insured’s lost income. Insurers tend to focus on a company’s track record to project what its revenues would have been but for the interruption. A financial expert who’s familiar with the business and its industry may be able to point to certain factors — such as industry trends, market changes or company-specific developments — that indicate a higher level of growth going forward.

Determining your continuing and noncontinuing costs is another critical issue. Most business interruption policies compensate the insured only for the former. In other words, to calculate recoverable lost income, you’d take lost sales and then subtract *noncontinuing* costs. Continuing costs aren’t subtracted because they’re incurred despite the business interruption.

Suppose, for example, that a labor strike causes a manufacturer to shut down production for a month. Variable costs — which increase or decrease with the level of production — would be avoided during the interruption period and, therefore, wouldn’t be reimbursed. But fixed costs, such as rent and other overhead, would continue. To make the manufacturer whole, therefore, these costs shouldn’t be subtracted in determining its recoverable loss.

Mitigating the loss

The insured’s duty to mitigate its loss is an area that’s ripe for controversy. Although there are many actions a company can take to limit its damages, not all of them are reasonable. For example, you might be able to reduce your company’s loss by laying off salespeople or other staff. But that may not be a smart move if the business interruption is relatively short, the cost of hiring replacements when normal operations resume is high, and the loss of experienced staff would hurt your company in the long term.

Make sure you address these issues early in the process, and educate the insurer about the costs and other implications of various mitigation strategies.

Establishing the loss period

The period of time that your business’s operations are interrupted is also critical to measure. That’s because you’re entitled to recover business income you would have earned during that period but for the interruption.

A typical definition of the loss period is the “length of time that would be required with the exercise of due diligence and dispatch to rebuild, repair or replace” the damaged property. Some policies provide (or have been interpreted by the courts to provide) extended coverage, allowing a business to recover losses beyond the time it takes to restore the property to its original condition.

One of the biggest challenges in putting together a business interruption claim is establishing the insured’s lost income.

Whatever the policy’s terms, a financial expert with relevant business experience can help you estimate and document an appropriate loss period.

Assessing the damage

To survive a business interruption, you need to move quickly to estimate the losses and put together a persuasive, well-documented insurance claim. Because this requires you to establish the business’s lost income and extra expenses during the interruption period, the assistance of financial experts with experience calculating lost profits damages can be invaluable. ♦

Nonqualified deferred compensation

Independent appraisals offer protection against 409A challenge

Businesses that provide employees with stock options, stock appreciation rights (SARs) and other types of nonqualified deferred compensation have been subject to Internal Revenue Code (IRC) Section 409A for years. As you can imagine, compliance is particularly challenging in the current economic environment. To avoid Sec. 409A problems, options and SARs must be issued at or above fair market value (FMV), so accurate valuations are critical. The best way for privately held companies to protect themselves now is to have regular, independent stock appraisals by a qualified valuation expert.

What Sec. 409A requires

Sec. 409A was designed to help discourage certain types of compensation arrangements that give executives too much control over the form and timing of benefits. It applies to most deferred compensation arrangements other than qualified retirement plans. Failure to comply results in immediate taxation of vested benefits plus a 20% excise tax and interest.

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Sec. 409A and the regulations that accompany it are complex, and a detailed discussion is beyond the scope of this publication. But, generally, it requires deferral elections to be made well in advance and imposes strict limits on an employee's ability to alter the form or timing of deferred compensation payments.

The rules don't present a significant problem for supplemental executive retirement plans (SERPs) or other nonqualified deferred compensation plans that contemplate payments on a specified date or according to a fixed schedule. But they do defeat the purpose of stock options and SARs, whose value lies in an employee's ability to choose the optimal time to exercise them.

Fortunately, the regulations provide an exception for options or SARs that have: 1) an exercise price that can never be less than the stock's FMV on the grant date, and 2) no other feature for deferring compensation.

Establishing fair market value

The regulations permit a company to determine FMV through "reasonable application of a reasonable valuation method." A reasonable valuation method should consider the following factors, as applicable:

- ◆ The value of the company's tangible and intangible assets,
- ◆ The present value of anticipated future cash flows,
- ◆ Stock prices of comparable public companies,
- ◆ Recent arm's-length sales prices of comparable private companies,
- ◆ Other relevant factors, such as control premiums and discounts for lack of marketability, and
- ◆ The valuation method's use for other material purposes.

A valuation method is *not* reasonable if it fails to consider all available information that's material to the company's value, including a previously calculated



value that fails to reflect material information available after the calculation date. Moreover, valuations performed within 12 months before the grant date are presumed to be reasonable.

3 presumptive valuation methods

To provide some peace of mind, Sec. 409A outlines three “presumptive” valuation methods. Using these methods is presumed to be reasonable unless the IRS can show that the method — or its application — was “grossly unreasonable.”

1. The *formula method* allows a company to set exercise prices according to a formula based on book value, earnings multiples or some combination of the two, provided the formula is used consistently to value the company’s stock for certain compensatory and noncompensatory purposes and meets certain other

requirements. Given these restrictions, this method won’t be an option for most private companies.

2. Under the *illiquid startup method*, a valuation of stock in a privately held company that’s less than 10 years old is presumed reasonable if it meets several requirements. It must be performed by a person who’s qualified based on “significant knowledge, experience, education or training.” In addition, the valuation must be documented by a written report that considers the valuation factors set forth in the regulations; the stock must not be subject to any put or call rights (with certain exceptions); and the company must not reasonably anticipate a sale, initial public offering or change in control within 12 months after the grant date.

The illiquid startup method may be less costly than an independent appraisal, especially if it’s performed in-house, but it’s also riskier. There are many uncertainties that make valuations vulnerable to IRS attack. The IRS may be more likely to challenge an employee’s qualifications or methods. And it may be difficult to rebut a claim that the company anticipated a sale or IPO.

3. *Independent valuations* are presumed reasonable if they’re performed within 12 months before the grant date (unless subsequent events have a material impact on value). So long as the appraiser is qualified and his or her valuation methods aren’t “grossly unreasonable,” it’s difficult for the IRS to mount a successful challenge under Sec. 409A.

Noncompliance isn’t an option

Companies that use stock options or SARs as part of their compensation programs should pay close attention to valuation issues. Awards with a below-FMV exercise price, or which otherwise violate Sec. 409A, can quickly erase the benefits these programs are designed to confer.

The most effective way for a privately held company to comply with Sec. 409A is to obtain independent appraisals of its stock within 12 months before each grant date and after any significant events that have a material impact on stock values. ♦

In valuation, timing is everything

The primary focus in valuation is “how much” — but “when” comes in a close second. The valuation date can have an enormous impact on value, particularly for assets such as stock, whose valuations can fluctuate dramatically, literally overnight. Here are a few examples of situations in which the valuation date comes into play.

Estate planning

For estate tax purposes, assets are normally valued on the date of death. But under certain circumstances, an executor may elect to use the “alternate valuation date,” which is six months *after* the date of death. The later date may be advantageous if the decedent’s estate includes securities, real estate or other property that’s declined substantially in value since the date of death.

There’s a catch, though. The executor can’t selectively apply the election to assets whose values have declined sharply. Rather, if the alternate valuation date is selected, it must be used for all assets in the estate (except for those sold between the date of death and the alternate valuation date, which are valued on the sale date).

Divorce

For purposes of divorce, the valuation date is usually prescribed by state law. Typically, it’s the date the divorce action was commenced, but it could also be the trial date, the date a divorce decree is issued or some other date established by law or by agreement of the parties. In some states, the court may select a valuation date that would be fair to both parties. In most cases, however, it’s up to the attorney to decide which valuation date should be used.

Shareholder litigation

In shareholder oppression cases, applicable law often provides that the presumptive valuation date is immediately before the wrongful act that triggered the

litigation. But it’s not unusual for the parties to argue for an alternate valuation date if they feel that using the presumptive date would be unfair.

Circumstances that might call for an alternate date include:

1. The unavailability of sufficient market information on the presumptive valuation date,
2. The existence of a contingency or potential liability that wasn’t yet resolved on the presumptive date,
3. An aberration that temporarily increased or decreased the stock’s value around the time of the corporation’s wrongful act, or
4. Evidence that the corporation’s wrongful act was timed to take advantage of an historically high or low stock price.

To ensure the best possible valuation outcome, you and your valuation experts should discuss the valuation date. In cases where the date is a litigated issue, you should be prepared to address the appropriate date and present evidence of value on various dates. ♦



Estate wins the discount war

In *Estate of Litchfield v. Commissioner*, the Tax Court generally accepted the estate's proposed valuation discounts because the estate's expert's methods were more precise and relied on more recent, company-specific data.

Discounts debated

The case involved the valuation of minority interests in two family-owned corporations: Litchfield Realty Co. (LRC) and Litchfield Securities Co. (LSC). LRC invested in and managed Iowa farmland, marketable securities and other property with substantial built-in (that is, unrealized) capital gains.

LRC was originally formed as a C corporation but converted to an S corporation on Jan. 1, 2000. S corporations generally pay no corporate-level taxes. But under IRC Section 1374, preconversion assets sold before Jan. 1, 2010, remain subject to corporate-level tax on built-in gains existing on the conversion date. LSC was a C corporation that invested in marketable securities and also had substantial built-in capital gains.

Valuation experts on both sides used the net asset value (NAV) method to determine the fair market value of the estate's interests in LRC and LSC. They also agreed that valuation discounts were appropriate to reflect built-in capital gains tax liability, lack of control and lack of marketability. They differed, however, on the size of those discounts. The chart at top right shows the discounts proposed by the parties and those accepted by the court.

The court accepted the estate's expert's discounts for built-in capital gains largely because the expert relied on more current, company-specific information, including anticipated sales of corporate assets. The expert relied on historical data, recent data and conversations with management. The IRS expert relied solely on historical asset sales.

For each company, the estate's expert projected holding periods and sale dates for appreciated assets, estimated appreciation for those assets and the resulting capital gains taxes, discounted the tax liability to present value and subtracted that figure from the company's NAV.

PROPOSED DISCOUNTS IN LITCHFIELD CASE

Discount	Estate	IRS	Court
LRC			
Built-in gain	17.4%	2.0%	17.4%
Lack of control	14.8%	10.0%	14.8%
Lack of marketability	36.0%	18.0%	25.0%
LSC			
Built-in gain	23.6%	8.0%	23.6%
Lack of control	11.9%	5.0%	11.9%
Lack of marketability	29.7%	10.0%	20.0%

The court also preferred the estate's expert's discounts for lack of control. With regard to LRC, the two experts used methods that were similar in many respects. But the estate's expert calculated separate discounts for real estate and securities and used a weighted average of the two, while the IRS's expert used a straight average. With regard to LSC, the IRS's expert used the same 5% discount for its marketable securities that he applied to the marketable securities portion of LRC's holdings, even though the estate's interest in LSC was much smaller. The court found that the estate's expert correctly applied a higher control discount to LSC's securities holdings.

Although the court agreed with the estate's expert's methods for calculating marketability discounts, it adjusted them downward because it felt they were too high compared to benchmark studies, and they relied on outdated data relating to restricted stock discounts. In addition, the discounts were higher than those the same expert had used a year earlier in valuing the interest in LSC for federal gift tax purposes.

What can be learned?

The *Litchfield* case highlights the need not only for retaining qualified valuation experts, but also for using the most precise methods and the most current data available for the particular situation. ♦