

MARCH/APRIL 2022

LITIGATION SUPPORT



How to combat supply chain fraud
Using ESOPs to transfer ownership

Yaquinto v. Thompson St. Capital Partners
Bankruptcy trustee falls
short on transfer challenge

Are “calculations” of value admissible in court?

How to combat supply chain fraud

Supply chains in many industries have been under unprecedented stress over the last two years. Companies have experienced disruptions during the COVID-19 pandemic, along with cyberattacks, labor shortages and even political volatility in some geographic regions. When stress runs high, internal controls may fall apart or fail to adapt to operational changes. In turn, weakened internal controls provide opportunities for fraud. Here's how companies can fortify their defenses.

Evaluating vulnerabilities

Supply chains are especially vulnerable to fraud due to the involvement of third parties — such as agents, intermediaries, resellers and distributors — that may operate outside of the United States. Each partner usually has different policies and procedures, codes of ethics, and IT systems, which can make it difficult to implement consistent controls across the supply chain.

The sheer volume of ordering and shipping transactions also can provide cover for dishonest workers who want to hide theft and misstatement. Plus, small supply chain frauds tend to snowball over time into significant financial losses.

Examples of supply chain frauds include:

- Falsified billing and payment schemes (for instance, when a contractor submits duplicate or inflated invoices),
- Misrepresentation of goods or services provided (such as a supplier that knowingly fails to meet contract specifications),
- Intellectual property theft,
- Bribery and kickbacks (money or gifts exchanged for, say, preferential treatment during the bidding process or other benefits).

Collusion often plays a role in these schemes. In some cases, multiple employees conspire to override the company's internal controls. Other times, external partners may collude with employees to commit fraud.

Companies typically conduct a *targeted* risk assessment each year that focuses on what's changed in the operating environment.

Implementing strong internal controls

Internal controls are policies and procedures that companies put in place to help ensure 1) effective, efficient operations, 2) reliable financial reporting, and 3) compliance with relevant laws and regulations. Examples include physical restrictions on assets, account reconciliation and job descriptions. What's appropriate depends on an assessment of the risk factors the company faces — and those risk factors may evolve over time, requiring updates to the company's internal control system.

Strong internal control systems protect the company from such threats as theft, embezzlement,



and mismanagement of funds by employees, suppliers or customers. If possible, companies should vet the internal controls of their supply chain partners before doing business with them.

Updating the risk assessment

Companies typically conduct a *targeted* risk assessment each year that focuses on what's changed in the operating environment. During the pandemic and the ensuing economic downturn, conditions have changed at many companies. For example, remote working arrangements and digital payments are increasingly common — and both trends could expose a company's networks to cyber-risks.

Any change in how a business operates can create risk, especially if it occurs quickly and doesn't adhere to the company's policies and procedures. To illustrate, suppose a company engaged new suppliers during the pandemic and, because of supply shortages, didn't vet them according to policy. To remedy this situation, management should

backtrack and vet the new suppliers according to the prescribed control procedures. Does it still make sense to use those suppliers? Or should some be removed from the company's vendor list?

If new or increased vulnerabilities are revealed, the business should update its controls accordingly — as well as software and monitoring systems — to ensure that all supply chain transactions are appropriately tracked and secured. Management should also monitor regulatory developments and legislation in the jurisdictions where the company and its partners operate.

Outside help

Independent forensic accountants can provide fresh insights into internal controls — without improper influence. They can also refresh a company's risk assessment in today's uncertain marketplace — and suggest ways to remedy any weak links in the supply chain. ■

Using ESOPs to transfer ownership

An employee stock ownership plan (ESOP) can facilitate the transfer of a business to the owner's children or employees over a period of years in a tax-advantaged way. There are about 6,500 ESOPs and equivalent plans in the United States today, employing roughly 14 million U.S. employees, according to the National Center for Employee Ownership. Here's some critical information when deciding whether an ESOP is the right strategy for a particular client.

Differences from buyouts

An ESOP is a qualified retirement plan that invests mainly in company stock. ESOPs are subject to the same IRS and U.S. Department of Labor (DOL) rules as other qualified retirement plans,

including minimum coverage requirements and contribution limits.

Generally, ESOP distributions to eligible employees are made in stock or cash. For closely held companies, employees who receive stock have the right to sell it back to the company (exercising "put" options, or an "option to sell") at fair market value during certain time windows.

While an ESOP involves transferring ownership to employees, it's distinguishable from a management or employee buyout. Unlike a buyout, an ESOP allows owners to cash out and transfer control gradually. During the transfer period, owners' shares are held in an ESOP trust and voting rights on most issues (other than mergers, dissolutions and other

Federal court rejects DOL's ESOP valuation

In *Walsh v. Bowers*, the District Court of Hawaii found that the U.S. Department of Labor's (DOL) valuation of the employee stock ownership plan (ESOP) at issue "rests on errors." The defendants owned all of an engineering company's shares and sold them to an ESOP for \$40 million. The DOL claimed the defendants manipulated data to induce the ESOP to pay more than fair market value for the shares.

The DOL's expert valued the company at about \$27 million. But that valuation didn't persuade the court. Specifically, it noted that the amount was based on several errors — including the reliance on a private company's "preliminary nonbinding indication of interest" to purchase the firm for \$15 million.

The indication of interest expressly recognized that adjustments were needed to reflect the cash and debt on the firm's balance sheet. After adjustments, the court said the amount would have increased to about \$29 million. Regardless, the firm never agreed to sell for \$15 million, so the amount didn't reflect what a willing buyer and willing seller would mutually agree on.

The court also found that the government's expert ignored the Uniform Standards of Professional Appraisal Practice and made "notable errors" that may have undervalued the firm by about \$13.5 million. As a result, the court sided with the defendant and concluded that the firm wasn't sold for more than fair market value.

major transactions) are exercised by the trustees, who may be officers or other company insiders.

Mandatory valuations

The fair market value of the sponsoring company's stock is important, because the DOL specifically prohibits ESOPs from paying more than "adequate consideration" when investing in employer securities.



In addition, because employees who receive ESOP shares typically have the right to sell them back to the company at fair market value, the ESOP essentially provides a limited market for its shares.

The Employee Retirement Income Security Act of 1974 requires trustees to obtain appraisals by independent valuation professionals to support ESOP transactions. Specifically, an appraisal is needed:

- When the ESOP initially acquires shares from the company's owners, and
- Each year thereafter that the corporation makes contributions to the plan.

The owners also may decide to obtain an informal valuation before the ESOP is set up to help evaluate whether it's a feasible exit strategy.

Costs and limited availability

Although ESOPs offer substantial benefits, there are some drawbacks. In addition to administrative and

compliance costs incurred by qualified retirement plan sponsors, there are costs associated with annual stock valuations and the need to repurchase stock from employees who exercise put options. It's also important to consider the potential negative impact of ESOP debt and other expenses on the company's financial statements and bonding capacity.

Another disadvantage is that ESOPs are available only to corporations. Limited liability companies (LLCs), partnerships and sole proprietorships must convert to the corporate form to take advantage of an ESOP. This raises a variety of financial and tax issues.

S corporations *are* eligible for ESOPs. In fact, the National Center for Employee Ownership estimates that more than half (55%) of ESOPs

are in S corporations. But they have different rules than C corporations when it comes to contributions and tax treatments. With proper planning, income passed through to shares held by an S corporation's ESOP escapes federal — and in some cases, state — taxes.

Outside help

Companies that sponsor ESOPs come in all sizes and participate in almost every industry. However, there's one common denominator: Valuing stock held by an ESOP is an ongoing challenge for the fiduciaries who administer it, especially when the sponsoring company is privately held. Hiring a qualified, independent expert is critical to withstand IRS and DOL scrutiny. ■

Yaquinto v. Thompson St. Capital Partners

Bankruptcy trustee falls short on transfer challenge

In a recent fraudulent transfer case, flaws in the financial expert's testimony proved to be the trustee's Achilles' heel. The trustee showed that the debtors transferred a property interest without receiving reasonably equivalent value. But the bankruptcy court concluded that the trustee didn't meet his burden of proving the transfer was fraudulent. Here are the details.

Transfer at issue

The debtors were a manufacturer of composite paneling used in construction (SPI) and the holding company that was formed to facilitate the July 2014 acquisition of SPI by Thompson Street Capital Partners (Holding). Holding was controlled and principally owned by Thompson Street.

Holding purchased the stock of SPI. But Thompson Street funded the purchase with cash directed to Holding as a \$20.3 million capital contribution and \$16 million loan.

As part of a refinancing transaction in September 2014, SPI and Holding jointly borrowed about \$14 million. It was immediately transferred to Thompson Street to partially satisfy the debt for which only Holding was obligated. After SPI and Holding filed for bankruptcy in July 2016, the trustee sought to avoid transfer.

Fundamental principle

A trustee generally can avoid transfers made within two years before a bankruptcy filing if the debtor



didn't receive a reasonably equivalent value for the transfer and:

- Was insolvent on the date of the transfer or became insolvent as a result of it,
- Was engaged, or about to be engaged, in business or a transaction that would leave the debtor with "unreasonably small capital," or
- Intended to incur debts that the debtor wouldn't be able to pay.

Judicial reasoning

The court found that SPI didn't receive a reasonably equivalent value for the transfer of \$14 million borrowed jointly by the debtors. Only Holding benefited from the transfer because SPI wasn't obligated to pay the Thompson Street loan.

But the trustee's expert testimony and other evidence didn't establish the "fragile financial conditions" the trustee also needed to show to prove that the transfer was fraudulent. For example, although SPI's total assets exceeded its total liabilities by approximately \$20 million, the trustee's expert concluded that SPI was insolvent at the time of the transfer — because the majority of the assets were intangible. However, the court said that intangibles should be considered when determining solvency.

It credited Thompson Street's expert's testimony that SPI's assets significantly exceeded its liabilities.

The court noted that the expert properly relied on industry data, market conditions, SPI's audited financial statements and the results of a transaction between unrelated parties.

The court addressed the capital and ability to repay debt questions — which it referred to as the adequate capital and cash flow tests — together. It found Thompson Street's expert's testimony that SPI satisfied the two tests "significantly more persuasive" than the testimony by the trustee's expert.

The court faulted the trustee's expert's analysis on multiple grounds. For example, it contained some errors, such as overstating interest expense and working capital requirements. The court cited problems with his assumptions, too. For example, it disagreed with his assumption that SPI wouldn't experience any revenue growth in any year from 2015 to 2019.

The evidence didn't establish the "fragile financial conditions" the trustee needed to prove that the transfer was fraudulent.

Finally, the court questioned his decision not to even consider the forecasting and projections Thompson Street had prepared at the time of the acquisition as part of its thorough due diligence. By contrast, the other expert prepared a "base case" using the conservative projections Thompson Street relied on when making the acquisition decision and tested it with a sensitivity analysis that was supported by a wealth of data.

Domino effect

The court concluded that the absence of proof of fragile financial conditions doomed the fraud claim against SPI. As a result, the claim against Thompson Street also failed. ■

Are “calculations” of value admissible in court?

The development and reporting requirements for a *calculation* are generally far less stringent than those that apply to a *valuation*. However, budget-conscious clients may request a calculation rather than a full-blown valuation. A recent Arizona divorce case — *Larchick v. Pollock* — demonstrates that, although calculation reports aren't necessarily inadmissible, caution still is warranted.

Lower court excludes expert's report, testimony

The couple separated only 10 months after they married. The husband claimed a community interest in the increase in the value of a business the wife started before the marriage.

The husband hired an expert to prepare a calculation of value, which found that the business's value had increased by \$546,000. The wife's expert submitted a “full appraisal” report, which concluded that the value had increased by \$93,000.

The wife objected to admission of the report and testimony of the husband's expert. She argued that the calculation report wasn't as reliable as more complete valuation reports. The Superior Court in Maricopa County sustained her objection, noting that the husband's expert didn't follow “all possible methods that an expert should be using, all reliable methodology.” The court also excluded the expert's testimony because he conceded that he didn't expect his report to be admissible.

Appellate court vacates, remands

The Arizona Court of Appeals began its review by stating that Rule 702 of the Arizona Rules of Evidence doesn't require expert opinion evidence to account for “all possible methods” of

assessment. However, the lower court didn't base its exclusion solely on that rule. It excluded the evidence based on deference to the expert's “self-imposed cautionary views regarding admissibility.”

The appellate court dismissed this reasoning. The expert wasn't put forth to offer legal opinions on the admissibility of the evidence. The husband, as the proponent of the evidence, was entitled to have the family court evaluate it under Rule 702.

The appellate court acknowledged that the calculation evidence may have been questionable and, if admissible, vulnerable to effective cross-examination. It explained that the family court could give it little or no weight at trial. But it couldn't simply declare the evidence inadmissible without the proper analysis.

Calculated risk

Although calculations may sometimes be admissible, relying on them in litigation can be risky. A calculation report will generally contain cautionary language, stating that 1) the expert didn't perform all necessary procedures required for a valuation engagement, and 2) the results may have differed if a comprehensive valuation had been conducted. These admissions may discredit an expert's analysis and testimony in the eyes of factfinders. When in doubt, a full conclusion of value generally is a safer bet. ■

