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LITIGATION SUPPORT

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Appellate court affirms “blue-sky” method for valuing car dealerships

The Tennessee Court of Appeals recently affirmed a lower court’s application of the so-called “blue-sky” method to determine fair value in a shareholder oppression case. The appellate court found that the Chancery Court didn’t err in straying from both the normalization factors and the amount of adjusted net assets included by the opposing valuation experts.

“Oppressive and fraudulent” acts

The case was brought by the minority shareholder in an “ultra-high-end” car dealership. The shareholder sought to dissolve the business, contending that the defendant employed oppressive and fraudulent acts to squeeze him out. He also claimed that the defendant wasted the company’s assets and usurped corporate opportunities, engaging in self-dealing transactions with the company and breaching his fiduciary duty to do it.

After a bench trial, the court held the defendant’s actions were indeed oppressive of the plaintiff’s shareholder rights. But the judge ruled that dissolution was “too extreme” of a remedy. The plaintiff pivoted and requested redemption of his shares as relief; the trial court agreed that redemption was more appropriate.

Both sides presented expert testimony as to the fair value of the minority shareholder’s 20% interest in the dealership.

Lower court’s computation

The plaintiff’s expert valued his shares at \$3.3 million, based largely on the blue-sky method. Using this technique, intangible value (including goodwill and franchise value) is estimated by applying a blue-sky multiple to normalized earnings, then adding the result to the business’s net asset value to arrive at the value of the business. The expert chose a blue-sky multiple of eight, based on “his experience in ultra-high-end dealership transactions and automotive dealership publications.” He also considered prior transactions involving the dealership’s stock.



Prevailing party recovers only partial attorneys' fees

The court's fair value determination wasn't the only disappointment for the plaintiff in *Buckley v. Carlock* (see main article). The plaintiff was also denied full recovery of his attorneys' fees.

The trial court awarded only a portion of his fees, explaining that he was the prevailing party in only one of the two "phases" of the case — the first phase, where he proved shareholder oppression. According to the trial court, he didn't prevail in the second phase because the court's valuation of his interest was closer to the value offered by the defendant's expert.

The Tennessee Court of Appeals criticized the trial court's description of the plaintiff as "not the prevailing party" in the valuation phase. But, while the plaintiff was indeed the prevailing party in the case, he had only "limited success" on the valuation question. The appellate court found it wasn't unreasonable for the trial court to decline to award fees for that phase of the litigation.

The defendant's expert valued the shares at approximately \$1.09 million, using a version of the income approach that was loosely based on the blue-sky method. He applied a lower normalization factor to arrive at the dealership's normalized earnings. He also applied a lower blue-sky multiple than the opposing expert (7.5 times normalized earnings versus 8.0). However, the defense expert did *not* add in the company's assets. He said doing so would result in double counting because the income approach assumes that assets contribute to earnings, thus their value is shown by earnings.

The trial court accepted the plaintiff's expert's blue-sky approach and multiple. But it found his normalization factor (5% of revenue) too high and the defense expert's normalization factor (1.5% of revenue) too low. Instead, the court turned to data compiled by the National Auto Dealers Association (NADA) to determine that normalization factors of 2.8% and 2.9% of revenue were appropriate for the two years at issue (2015 and 2016). The court added only half of the dealership's adjusted net assets, arriving at a fair value of roughly \$1.75 million for the plaintiff's interest.

Appellate court's reasoning

The plaintiff appealed, challenging the fair value determination. Among other things, he faulted the court for disregarding his expert's testimony on the

normalization factor, which he viewed as the only competent evidence of normalization.

The appellate court noted that both experts testified that the NADA data compilation was authoritative and reliable. And a court isn't bound to accept an expert witness's testimony as true; it can reject testimony it finds inconsistent with the credited evidence.

The court also considered the correct treatment of adjusted net assets, which the experts agreed should be added under the blue-sky method. Although the court found that it might have been appropriate to account for the full adjusted net asset value, rather than only half, it reasoned that valuation "is as much art as science."

Moreover, a court's calculation of fair value need only be *equitable*. The court therefore concluded that "splitting the difference" on the inclusion of tangible assets was an "acceptable and equitable disposition."

Look to the sky

The Tennessee Court of Appeals ultimately found that the blue-sky method is generally acceptable in the financial community, endorsed by authoritative automotive publications and used in the great majority of ultra-high-end dealership transactions. But that doesn't mean a court can't or won't make tweaks, as the Chancery Court did here. ■

Trapped-in gains: To discount or not to discount?

When valuing a C corporation, is it appropriate to apply a discount for trapped-in capital gains, even when a sale of the business (or its highly appreciated assets) isn't imminent? The Louisiana Court of Appeals recently weighed in on this question, finding it appropriate in "certain circumstances."

Round 1: Discount allowed

In *Shop Rite, Inc. v. Gardiner*, the court considered the fair value of the shares of a withdrawing shareholder in a C corporation. After the shareholder sent formal notice of withdrawal, the corporation had 60 days under state law to accept her offer to sell her shares at fair value.

The company accepted the offer to sell, but the parties failed to reach an agreement as to fair value. The company then filed a declaratory action against the shareholder, asking the court to determine fair value. The trial court employed a discount for tax-affecting when valuing the corporation. The withdrawing shareholder appealed, arguing

that the lower court erred as a matter of law by tax-affecting.

Round 2: Discount under attack

As the appellate court noted on review, the opposing valuation experts agreed that the adjusted net asset value method was the proper approach to determine fair value. They parted ways, though, when it came to whether potential trapped-in (or "built-in") capital gains tax liabilities should be added to the business's balance sheet.

Trapped-in gains occur when a company owns assets with values that are substantially greater than their book value.

Trapped-in gains occur when a company owns assets with values that are substantially greater than their book value — which would lead to a capital gains tax if those assets were sold. The company here held substantial real estate, and the properties had increased in value.

The plaintiff's expert acknowledged that the company, as a going concern, didn't have plans to sell the real estate. He also testified, though, that when the value of real estate on a company's balance sheet is based on real estate appraisals, as here, it's common and accepted to recognize the trapped-in gains as a liability.



Thus, he applied a discount of almost \$7 million, based on a blended federal and state tax rate of 26%. The discount reduced the value of the business from about \$41 million to about \$34 million, in turn significantly reducing the fair value of the withdrawing shareholder's shares.

The shareholder's expert testified that the discount was improper because any capital gains tax liability was speculative and uncertain. The trial court accepted the discount, though, finding that a sale of assets was "inevitable, not hypothetical."

Defendant suffers major blow

The shareholder argued on appeal that Louisiana's statutory concept of fair value prohibits tax-affecting discounts, including the trapped-in capital gains discount. But the Court of Appeals found otherwise. Under certain circumstances, it said, this type of

entity-level discount might be appropriate as long as there's a factual basis for it.

The appellate court found no such factual basis in this case. The company didn't plan to sell any of its assets. It wasn't clear when, if ever, the company would be subject to capital gains taxes. Further, the remaining shareholders will benefit financially from the company's use of its fixed assets far past the valuation date.

Uncertainty KOs discount

The court declined to predicate fair value on the tax consequences — whether at the entity or shareholder level — of a future uncertain event. The uncertainty over if and when the event will occur, the tax rates at that uncertain time and other presently unknown future factors, the court said, justify this conclusion. ■

Discounting damages

A dollar today is worth more than a dollar tomorrow

When calculating economic damages, financial experts must discount lost profits to their net present value. But what discount rate is appropriate? The answer depends on market conditions and the risk of the business or product. A small difference in the discount rate can have a big impact on an expert's conclusion, so it's important to get it right.

Duration of losses

To project damages for losses, an expert first determines the relevant loss period. For example, this could be the term of a contract, the useful life of a product or the amount of time required for the plaintiff to reasonably mitigate losses. Undiscounted lost profits generally represent the difference between the plaintiff's expected profits (or other measure of economic benefit), "but for" the

alleged legal violations of the defendant, and the plaintiff's actual profits.

An expert then uses discount rates to compute the present value of lost profits from each month or year. Each period's discounted losses are combined to arrive at the net present value of lost profits. Discount rates must accurately reflect the time value of money and the risks a particular business faced in the absence of an injury — specifically, uncertainty that lost profits the business has claimed would actually have been achieved.

It's important to note that the value of the *entire business* may be more appropriate for computing damages involving the destruction of a business, shareholder oppression, family law or tax issues — or when the loss is permanent and complete. In these cases, damages equal the difference between

the company's value before and after the defendant's alleged wrongdoing, because the plaintiff is unlikely to ever fully recover.

Discount rate

The discount rate itself generally includes two components: 1) an assumed rate of return that recognizes the time value of money, and 2) a risk factor that recognizes the uncertainty of achieving profit expectations. If the company has a consistent earnings history and is likely to achieve its projected future earnings, a lower rate of return may be appropriate. Experts also consider relevant case law, contract terms and the lawsuit's context when deciding on an appropriate discount rate, though never as a primary or sole support for calculations.

Common rates chosen by experts include:

Safe rate. The so-called safe rate, or Treasury rate, is often a good starting point. It reflects inflation and a "rental rate" for the use of funds.

Cost of equity. A financial expert can determine the cost of equity using one of several build-up methods or the capital asset pricing model, which considers market, industry and company-specific risks. The discount rate may begin with the Treasury rate and increase based on risk, using stock market benchmarks and qualitative assessments of the plaintiff's operations.

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Cost of debt. The use of this discount rate presumes that the plaintiff's borrowing rate approximates both the time value of money and the risks the plaintiff faced in the absence of an injury.



Weighted average cost of capital (WACC). The WACC represents a weighted average of the returns paid to debt and equity holders for their investments, based on the costs of equity and debt.

Choosing the appropriate discount rate is just as critical as quantifying projected losses, but it often gets less attention by the parties. Subtle changes in the discount rate can have a major impact on an expert's conclusion. For example, \$100 discounted over five years is worth \$56.74 using a 12% discount rate (assuming annual compounding). But the present value increases to \$64.09 if you apply a 10% discount rate — a difference of nearly 10%.

Experience counts

Selecting an appropriate discount rate involves subjective judgment, which can lead to dramatically different damage calculations. An experienced financial expert knows how to develop a discount rate that's supported by objective market data. ■

New study highlights use of crypto in fraud

Every two years the Association of Certified Fraud Examiners (ACFE) publishes its Report to the Nations, which highlights key fraud trends. New to the study in 2022 were statistics on the role cryptocurrency plays in fraud. Here are the details.

Why is crypto in the spotlight?

Cryptocurrency is “digital money” that’s usually issued and controlled by software developers and accepted as payment by an increasing number of individuals and businesses. Also known as virtual currencies, cryptocurrencies can be transferred, stored or traded electronically. Bitcoin and stablecoin are common examples. Each cryptocurrency has an equivalent value in real currency. Cryptocurrency can be digitally traded between users and can be purchased for (or exchanged into) real currencies, such as U.S. dollars or euros.

A recent survey found that one in five Americans has invested in, traded or used cryptocurrency. Despite its growing popularity, crypto is sometimes associated with black market transactions because it’s hard to trace to a specific person. Anonymity makes it easy for criminals to skirt international borders and regulations.

What did the ACFE find?

For the first time in its 24-year history of publishing its biennial fraud study, the ACFE’s latest report, “Occupational Fraud 2022: A Report to the Nations,” reveals the prevalence of cryptocurrency in fraud schemes. The study found that 8% of schemes involved crypto.

The ACFE expects this percentage to increase as more businesses engage in cryptocurrency transactions. For example, companies may accept crypto payments from customers or pay certain vendors

with crypto. The use of virtual currency in day-to-day business operations may seem appealing because there aren’t transaction fees or exchange rate risks when dealing internationally. However, the use of crypto comes with potential fraud risks.

How is crypto used to defraud?

The use of crypto in a business’s regular operations provides new opportunities for dishonest individuals to perpetrate fraud. In fraud cases involving crypto, it was most commonly used to make bribery and kickback payments (48%) and to convert stolen assets (43%).

In addition, the ACFE study found that some fraudsters stole cryptocurrency assets outright, while others manipulated reported cryptocurrency assets on their financial statements. Laypeople are generally unfamiliar with how cryptocurrency works, which allows opportunistic individuals to hide their fraud schemes using shady reporting practices.

Risky business

Many business owners are understandably hesitant to enter the volatile world of cryptocurrency transactions. However, pressure from supply chain partners, contractors and employees to receive cryptocurrency payments may force them to take the plunge. Forensic accounting experts can help facilitate a secure transition to crypto by conducting risk assessments, drafting or enhancing policies and procedures, and providing customized training for company personnel. ■

