Willamette Management Associates

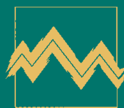
Insights

Issue 132

Spring 2022

Business Valuation, Forensic Analysis, and Financial Opinion Insights

Thought Leadership in Economic Damages Measurements and Forensic Accounting



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Insights, the thought leadership journal of applied microeconomics, is published on a quarterly basis, with periodic special interest issues. *Insights* is distributed to the friends and clients of Willamette Management Associates, a Citizens company.

Insights is intended to provide a thought leadership forum for issues related to the Willamette Management Associates business valuation, forensic analysis, and financial opinion services.

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We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to thought leadership topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from legal counsel, accountants, bankers, and other thought leaders involved in the valuation and forensic services community. Please address your comments or suggestions to the editor.

Annual subscriptions to *Insights* are available at $40. Single copies of current issues are $10. Single copies of back issues are $250. The cumulative collection of the 1991–2016 issues of *Insights* are $2,500. Single reprints of current articles authored by Willamette Management Associates analysts are complimentary. Single reprints of noncurrent articles authored by Willamette Management Associates analysts are available at $100.

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Thought Leadership in Economic Damages Measurements and Forensic Accounting

Editor for This Issue: Kevin M. Zanni

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Forethoughts

Clients often retain Willamette Management Associates forensic analysts as consulting experts and as testifying experts in disputes related to valuation, damages, or transfer price issues. The valuation forensic issues often relate to disputes involving businesses, business ownership interests, securities, or intangible assets. Our analysts also assist clients (and legal counsel) in complex litigation matters in which we measure damages in tort, breach of contract, and expropriation disputes.

The services of a forensic economist, forensic accountant, or valuation analyst may be an important component of the controversy matter. One discussion in this *Insights* issue focuses on due diligence in forensic-type engagements. This *Insights* issue also includes a discussion related to the income tax consequences of damages awards.

Also in this issue, an experienced corporate finance lawyer describes the financial structure of solar-energy-related businesses and how business valuation services may be required. Another discussion provides thought leadership regarding trends in security-related and derivative litigation.

It is probably no surprise that the number of litigation filings has decreased in the past two years. However, certain trends suggest two areas of increasing litigation: (1) SPAC filings and (2) COVID-19-related filings. This *Insights* issue discusses due diligence related to management-prepared financial projections in a fairness opinion context. Due diligence is an important component in transactions. A lack of diligence can often lead to transaction-related litigation.

One discussion in this *Insights* issue presents best practices related to equity incentive compensation programs. And, this issue includes a discussion related to an ESOP-related litigation matter and a discussion of the valuation reporting requirements for charitable income tax deductions.

Willamette Management Associates analysts regularly provide independent financial adviser, economic damages, forensic analysis, and valuation consulting services for securities-related tort claims or breach of contract litigation. These forensic analysis services often include testifying expert and related litigation support services.

About the Editor

Kevin M. Zanni

Kevin M. Zanni, ASA, CVA, CBA, CFE, CEIV is a managing director of Willamette Management Associates, a Citizens company. He resides in our Chicago office.

Kevin's practice includes valuation and financial advisory opinion services to publicly traded companies, private companies, professional sports franchises, professional practitioners, and high net worth individuals. He often works with legal counsel for private companies, public companies, and multinational corporations.

Kevin provides valuations of businesses, business interests, and securities for transactional, financing, taxation, financial accounting, and dispute resolution purposes. He provides valuations of intangible assets for income tax, estate and gift tax, and state and local property tax purposes. Kevin's practice also includes the analysis of intangible asset damages related to breach of contract claims and tort claims.

Kevin holds a bachelor of science degree in business administration, with a major in finance, and a master of arts degree in international business, both from the University of Florida. Prior to college, Kevin proudly served in the U.S. Army.

He has authored numerous thought leadership journal articles in such professional publications as the National Association of Certified Valuators and Analysts publication *The Value Examiner* and the Commerce Clearing House publication *Business Valuation Alert*.

Kevin has delivered thought leadership presentations to numerous professional associations and conferences including the Institute of Management Accountants and Valparaiso University School of Law.

In 2014, Kevin was interviewed twice by the National Public Radio *Marketplace* radio program regarding the valuation and sale of the Los Angeles Clippers. Kevin is a past president of the Chicago Chapter of the American Society of Appraisers. He is the past president and a current board member of the Business Valuation Association of Chicago.

Thought Leadership Discussion

Damages Awards—Income Tax Considerations

Robert F. Reilly, CPA

A damages analyst may be retained by legal counsel to any party in a damages claim dispute. Such a dispute typically results from a breach of contract, a tortious action, or some other cause. The damages analyst is typically not a causation expert or a liability expert. Rather, the damages analyst measures the amount of damages suffered by the damaged party related to the allegations made against the damaging party. There are numerous income tax considerations related to damages awards (or negotiated settlements). These income tax considerations include (1) is the receipt of the award/settlement payment taxable income to the damaged party recipient and, if so, is it ordinary income or capital gain and (2) is the payment of the damages award/settlement amount tax deductible to the damaging party payer? The damages analyst—and legal counsel and the disputing parties—should be aware of these tax considerations both (1) in the measurement of the amount of damages suffered by the damaged party and (2) in the analyst's recommendation of the total damages award in the judicial order.

Introduction

Companies often suffer damages due to the wrongful actions of other parties. Those other parties may be employees, customers/clients, competitors, suppliers, the company directors, joint venturers, potential acquirers, bankers, contract counterparties, and even government and regulatory authorities.

In addition, the company owners (e.g., shareholders, limited liability company members, partners) can also suffer damages due to the wrongful actions of other parties. These other parties could include the company itself, the company directors, other shareholders/owners, the company acquirer (actual or attempted), contract counterparties, and others.

For purposes of this discussion, the party suffering the damages (i.e., institutional or individual) is referred to as the damaged party.

For purposes of this discussion, the party responsible for (i.e., the party that causes) the damages is referred to as the damaging party.

When parties (whether companies or company owners) believe they have been damaged, they often pursue a legal claim in order to receive compensation for their damages. That legal claim may be pursued through litigation or through some alternative legal proceeding. For example, many contract-related disputes have to be prosecuted through an arbitration proceeding—according to the terms of the contract.

Regardless of the legal venue, the damaged party typically retains counsel to prosecute the claim. And, the damaging party typically retains counsel to defend against the claim. And, counsel for both parties typically retain (or at least consult with) forensic specialists to assist in the dispute process.

Causation, Liability, and Damages

Of course, there are numerous issues involved in any legal proceeding. With regard to damages claims, there are at least three issues that are relevant to this discussion: (1) causation, (2) liability, and (3) damages measurement.

And, these three issues are only relevant to this discussion if one accepts the following foundational assumption: that the damaged party actually experienced a damages event and suffered measurable damages.

The principal question related to the causation issue is: who or what caused the damages event? The principal question related to the liability issue is: who or what is legally responsible for the damages event? That liability question considers: what party has a duty (contractual or otherwise) to the damaged party? The principal question related to the damages measurement issue is: what is the amount of damages suffered by the damaged party? That damages measurement question considers: what is the amount of cash (or the value of property) needed to restore the damaged party to the economic position that the party enjoyed before the damages event?

The damages analyst often considers what is typically called the "but-for" scenario. That is, what economic (or wealth) position would the damaged party be in "but for" (or without) the impact of the damages event? And, what amount of compensation (whether cash or property) should be paid to the damaged party to restore that party to the economic (or wealth) position it enjoyed before—or but for—the damages event?

Forensic Specialists

As mentioned above, in these damages claim disputes, counsel often retain damages forensic specialists (hereinafter, "damages analysts") to measure the amount of damages experienced by the damaged party. These damages analysts can be forensic accountants, economists, financial analysts, engineers, industry specialists, or other types of professionals. The point is that such damages analysts measure, and provide expert opinions regarding, the amount of damages experienced by the damaged party.

The damages analyst is typically not the same professional who assesses and provides expert opinions with regard to the causation or liability issues in the dispute. That is, it is typically not the responsibility of the damages analyst to assign fault or blame or responsibility to the damaging party.

The damages analyst typically does not conclude that the damaging party is the wrongful party. Rather, the damages analyst quantifies how much the wronged party was damaged—not who is responsible for the damages or who is liable for making the damaged party whole.

Income Taxation Issues

This discussion focuses entirely on damages measurement issues—not on causation or liability issues. In particular, this discussion focuses on one technical, but important, issue related to the measurement of damages. That issue involves the income tax considerations related to the damages measurement.

These income tax considerations relate to the following:

1. The income recognition and the taxation of any payments received by the damaged party
2. The tax deduction and the taxation of any payments made by the damaging party
3. The amount of the judicial award (or the negotiated settlement) required to make the damaged party whole—after any adjustments necessary with regard to the related income tax considerations

This discussion focuses on what the damaged/damaging company, the company owners, legal counsel for these parties, and each party's damages analysts need to know about the income tax considerations related to damages measurements and damages awards (or negotiated settlements).

Types of Damages Claims

Parties to a damages claim-related dispute—and their legal counsel—often categorize damages claims into the following two categories:

1. Breach of contract claims
2. Tort claims

Breach of contract claims, of course, typically generate from a contract. Tort claims typically relate to an alleged breach of one party's duty to another party, where that duty is not documented in a contract.

Breach of contract claims may relate to the damaging party's alleged breach of, for example, a contractor/subcontractor agreement, a client/customer purchase agreement, an employment

agreement, a noncompetition/nonsolicitation agreement, a supplier agreement, a stock purchase or asset purchase acquisition agreement, a joint venture or joint development agreement, a franchise agreement, an intellectual property license, a real estate lease, or any other type of commercial contract.

The contract specifies the respective duties and responsibilities of the counterparties. If one of the counterparties allegedly violates a specified duty or responsibility, then the other counterparty may be damaged as a result of that breach of contract.

Tort claims may relate to the damaging party's alleged breach of a noncontractual duty or a responsibility. For example, a company and its directors have duties to the company's shareholders. A company's controlling shareholder has duties to the company's noncontrolling shareholders. A lender financial institution has duties to its borrowers. Competitor companies have certain duties to each other.

Partners have certain duties to each other (outside of the specific duties documented in the partnership agreement). Public companies have duties to both regulators and to the investor market in general. Trustees have duties to the trust beneficiaries. If one party commits a tortious action and violates its duty to another party, then that secured party may be damaged as a result of the tortious action.

The damages analyst typically considers the above-described categorization of damages claims. This claim categorization—as either a breach of contract or a tort—may affect which of the generally accepted damages measurement methods the analyst applies in the damages measurement analysis.

The damages analyst also considers another categorization regarding damages claims. The analyst considers whether the receipt of the damages award (or negotiated settlement) is a taxable event to the damaged party. That is, the analyst considers if the receipt of the damages award (or settlement) is ordinary income, a capital gain or loss, or a nontaxable event to the damaged party. Analysts may also consider whether or not the payment of the damages award (or settlement) results in an income tax deduction to the damaging party.

And, finally, the analyst may consider these income tax consequences when recommending the amount of a judicial award (or the amount of a negotiated settlement) with regard to the damages claim.

Income Tax Considerations

Even during the normal course of business, a company or a company shareholder may become the recipient—or the payer—of a damages-related judicial judgment or negotiated settlement. That judicial judgment or negotiated settlement may be the result of a commercial litigation, an arbitration, or some type of alternative dispute resolution proceeding.

The income tax considerations of such judgments, awards, or settlements can affect both the recipient and the payer. And, the income tax considerations related to the damages measurement may affect the amount of the judgment or settlement that would be required to make the damaged party economically "whole."

These income tax issues affect both the recipient and the payer of the damages judgment, award, or settlement. The specific terms of the judgment or the settlement typically affect whether the payment is:

1. tax deductible or not tax deductible,
2. taxable income or not taxable income, and
3. if taxable, whether the income is ordinary income or capital gain.

As with most income taxation issues, the taxpayer has the burden of proof regarding both the tax treatment and the income characterization (ordinary or capital gain) of the judgment or settlement payment.

These issues are typically determined by reference to the particular language included in the underlying litigation documents. Such documents include:

1. the pleadings,
2. the court's order or the arbitration award, and/or
3. the settlement agreement.

Taxpayers (both parties to the dispute) and their legal counsel should consider these taxation issues when drafting such litigation-related documents.

The income tax treatment of the payment is not influenced by whether the award is the result of:

1. a court or an arbitration order or
2. a settlement agreement between the parties.

However, generally, taxation issues are easier to deal with in the case of a settlement agreement that is drafted by counsel to the parties. This is simply because the court or the arbitrator may be less sensitive to the particular wording needed in the final litigation documents that may influence the desired income tax treatment.

Generally, taxation issues are harder to deal with in regard to a court's order or an arbitrator's award. This is because the judge or the arbitrator is typically more concerned with legal issues than with taxation issues.

The Origin of the Damages Claim

The origin of the damages claim may directly influence the tax treatment of the judicial award or the settlement payment. Many courts apply the so-called origin-of-the-claim test with regard to this taxation issue. That is, the courts typically consider the question: "in lieu of what was the damages payment award?"

This consideration affects the tax characterization of the damages payment. This test has been applied since at least the *Raytheon Production Corp* decision.[1]

For the recipient of a settlement payment, the origin-of-the-claim test may determine whether the payment receipt is taxable or not taxable. If the receipt of the settlement payment is taxable, then this test may determine if the income should be characterized as ordinary income or as capital gain. Typically, damages awards received related to either a judgment or a settlement are taxable income to the recipient.

However, the receipt of certain damages payments is not considered to be taxable income. Examples of such nontaxable payments include gifts or inheritances, payments as compensation for a personal physical injury, certain disaster relief payments, amounts for which the taxpayer did not previously receive a tax benefit, cost reimbursements, the recovery of capital, or a property or business acquisition purchase price adjustment.

Damages awards are typically taxable as ordinary income if the payment relates to a claim of lost profits. However, such an award may be characterized as a capital gain (to the extent that the amount of damages exceeds the property's tax basis) if the damages claim relates to the damage of a capital asset.

For the payer of the damages award, the origin-of-the-claim test will typically determine whether the payment is tax deductible or not tax deductible. In addition, the test will typically determine whether a tax deductible payment will be currently deductible or whether it has to be capitalized.

For example, a damages payment related to a personal transaction will be considered a nondeductible personal expense. In contrast, a damages payment related to a business activity may be deductible under Internal Revenue Code Section 162. And, business-related damages payments related to interest, taxes, or certain losses will be deductible under Section 163, Section 164, or Section 165, respectively.

Certain damages payments are not tax deductible. Other damages payments would have to be capitalized. For example, damages payments would have to be capitalized when the payer receives an intangible asset or an intellectual property license, say as part of a negotiated settlement, in exchange for the payment.

Again, the burden of proof is on the taxpayer to establish the appropriate income tax treatment related to the receipt or the payment of the damages judgment or settlement.

The types of documents that the Internal Revenue Service ("Service") will consider with regard to the tax treatment issue include the following: the legal filings, the terms of a settlement agreement, any correspondence between the parties to the dispute, any internal memos of the parties, party press releases, company annual reports, and news-related publications.

As a general guideline, the Service considers the initial complaint (or the equivalent legal document) to be the most persuasive evidence. This general guidance is presented in Revenue Ruling 85-98.

How to Allocate the Damages Payment

Sometimes the judicial award or the negotiated settlement payment can cover more than one claim. In that case, the parties to the dispute may have to allocate the payment for federal income tax purposes. Such an allocation is necessary when part of the payment represents a taxable event and another part of the payment relates to a nontaxable event.

In addition, such an allocation may be necessary when there are either multiple plaintiffs (claimants) or multiple defendants (respondents).

Some of the factors that the parties to the dispute should consider in that allocation process include the following:

1. Who made and who received the payment
2. Who was economically harmed or economically benefited by the damages event
3. Which party were the allegations asserted against
4. Which party controlled the litigation

5. Whether the dispute-related costs or receipts were required to be shared contractually
6. Whether there was joint and several liability among the parties related to the damages claims

The court's order or the settlement document may provide for an allocation in the text. If an allocation is already specified in the judicial judgment, then the Service and the taxpayers are typically bound by that allocation. In addition, the Service will typically accept an allocation that is specified in a negotiated settlement agreement.

However, the Service may challenge a settlement-related allocation if the Service concludes that the taxpayer had another (nontaxation) reason for the agreed-upon allocation. As with most issues, the taxpayer has the burden of proof with regard to defending the claimed award allocation before the Service.

Statutory Tax Deduction Disallowance

The Internal Revenue Code specifically disallows tax deductions related to certain payments or liabilities incurred with respect to a court's judgment or a negotiated settlement.

As amended by the Tax Cuts and Jobs Act ("TCJA"), Section 162(f) disallows a tax deduction (under any provision of Chapter 1) related to amounts paid or incurred:

1. by a lawsuit, an agreement, or otherwise;
2. to, or at the direction of, a government or governmental entity; and
3. in relation to a violation of law—or an investigation or inquiry into a potential violation of law.

This tax deduction disallowance does not apply for payments for:

1. the restitution (including the remediation of property),
2. taxes due, and
3. amounts paid pursuant to a court order when no government or governmental agency is a party to the dispute.

The Treasury Regulations also indicate that this tax deduction disallowance does not apply to:

1. disputes in which the government enforces its rights as a private party—for example, in a breach of contract dispute—or
2. routine audits or inspections not related to a possible wrongdoing.

The restitution exception to the tax deduction disallowance only applies if the court order or the settlement agreement identifies the damages payment (1) as a restitution or remediation payment or (2) as a payment to come into compliance with the law (i.e., collectively referred to as the identification requirement).

In addition, the taxpayer must establish that the damages payment was made:

1. for restitution or remediation or
2. to come into compliance with the law (i.e., collectively referred to as the establishment requirement).

The taxpayer may satisfy the identification requirement if the court order or the settlement agreement specifically states that the payment (1) constitutes restitution or remediation or (2) is for coming into compliance with the law—or uses some form of similar language. The taxpayer may satisfy the establishment requirement by providing the Service with documentation evidence of the elements of establishment.

The TCJA also added Section 162(g) related to tax deductions with regard to damages payments. Section 162(g) disallows an income tax deduction (under any provision of Chapter 1) for a settlement or other payment (1) related to sexual harassment or abuse and (2) related to the corresponding attorneys' fees—if there is a nondisclosure agreement.

However, this Section 162(g) tax deduction disallowance does not apply to the attorneys' fees incurred by the sexual harassment/abuse victim.

There are various other Internal Revenue Code Sections that disallow tax deductions related to certain types of damages payments. For example, Section 162(i) disallows a tax deduction related to illegal bribes and kickbacks. And, Section 162(q) disallows a tax deduction related to the treble damages imposed for antitrust violations.

Adjusting the Damages Measurement for Income Tax Consequences

The damages analyst often has to adjust a damages measurement amount for the income

tax consequences of the damages award receipt. Without such an adjustment, the damaged party will not be "made whole" by the receipt of the damages award.

The damaged party would not be "made whole" by the damages award receipt if the damages award or settlement payment was recognized as taxable income to the damaged party recipient.

In addition, without such a tax-related adjustment, the damaging party may benefit from the income tax deduction associated with certain damages-related payments.

For example, let's assume that Alpha Company is the damaged party and Omega Company is the damaging party. In this hypothetical example, Omega wrongfully caused Alpha to suffer $12 million of damages related to lost profits. Alpha brings a damages claim against Omega. The claim is litigated.

The finder of fact finds Omega to be liable and orders that Omega pay a $12 million lost profits damages award to Alpha. In compliance with the finder of fact's judgment, Omega pays the $12 million damages amount to Alpha.

Let's further assume that the lost-profits-related damages award is recognized as taxable income to Alpha. To simplify the calculation, let's assume a 25 percent effective combined federal and state income tax rate for Alpha.

Alpha suffered $12 million lost profits in damages. If Alpha receives a $12 million damages award, Alpha will pay $3 million in income taxes. After tax, Alpha will be left with only $9 million. Accordingly, Alpha will not be "made whole" by the $12 million damages award.

If Alpha recognizes taxable income related to the $12 million damages award receipt, it is likely that Omega will qualify for a tax deduction related to the payment. That is, after taxes, Omega will end up with $9 million less cash (even though Omega paid a $12 million payment to Alpha).

So, while Omega was determined to be liable for the $12 million of damages to Alpha, Omega will only suffer a $9 million negative economic impact. And, although Alpha was determined to have suffered $12 million in damages, Alpha will only recover $9 million in economic benefit.

There are two different tax-related adjustment procedures that the damages analyst may apply to account for these income tax considerations.

The first tax adjustment procedure is to calculate the present value the pretax lost profits suffered by the damaged party using an after-tax present value discount rate. In theory, this tax adjustment procedure increases the amount of the lost profits damages by the amount of the income tax impact on the lost profits.

This procedure may be the less frequently applied of the two tax-related adjustment procedures. This tax adjustment procedure really only works in a lost profits damages measurement calculation. That is, this adjustment procedure is generally not applicable to many other damages measurement methods—such as the cost to cure damages measurement method, for example.

And, the apparent mismatch in the damages measurement (i.e., pretax lost profits and an after-tax present value discount rate) may be somewhat difficult to explain to the finder of fact in the dispute.

The second tax-related adjustment procedure is more frequently applied by damages analysts. It is generally applicable to all damages measurement methods. And, this adjustment procedure is fairly easy to explain to a finder of fact—and to other parties involved in the dispute. In this second adjustment procedure, the damages analyst simply identifies and quantifies the two components of the recommended judicial award.

Let's return to the Alpha and Omega example. To apply this second tax-related adjustment procedure, the damages analyst will quantify both:

1. the amount of the lost profits damages that Alpha suffered and
2. the amount of the income tax liability that Alpha will incur with regard to the receipt of the damages award payment.

The sum of these two components would represent the amount of the total judicial award that the analyst would recommend to the finder of fact.

So, in our example, the analyst would conclude the recommendation with regard to the total damages payment as presented in Exhibit 1.

That is, the analyst would recommend that the finder of fact award (or that the parties agree to in a negotiated settlement) a $16 million total payment to Alpha.

Based on the receipt of the $16 million total payment, Alpha will incur a $4 million ($16 million × 25 percent) income tax liability. After that $4 million income tax liability is expensed (i.e., paid to the federal and state taxing authorities), Alpha will be left with $12 million. That is, as a result of the $16 million total award payment, Alpha will be made whole with regard to the $12 million of lost profits related to the damages event.

As a result of the damages event caused by Omega, Alpha's economic position decreased by

Exhibit 1
The Total Damages Award Calculation With an Adjustment for Income Taxes

Measurement of the Amount of Damages Suffered by Alpha Company	$12 million
Divided by: 1–25% Effective Income Tax Rate	75%
Equals: Total Damages Payment (the recommended total award amount) Required to Make Alpha Company Whole after the Damages Event	$16 million

$12 million. Based on the $16 million total award payment from Omega, Alpha's economic position (after income taxes) would increase by $12 million. Accordingly, the $16 million (pretax) payment is required to make Alpha whole after experiencing the impact of the damages event.

Again, assuming that the type of damages in this illustrative example relates to a taxable event, Omega will typically benefit from a $16 million income tax deduction if Alpha recognizes $16 million of taxable income.

In other words, after the income tax impact (assuming the illustrative 25 percent income tax rate), the $16 million payment will decrease Omega's economic position to $12 million.

This second tax adjustment procedure is typically applied by damages analysts because it separately reveals the impact of income taxes on the recommended amount of the damages award.

This second tax adjustment procedure clearly identifies that the recommended damages award should include two components:

1. The amount of the damages suffered by the damaged party
2. The income tax impact on the damaged party of the receipt of the damages award or the settlement payment

Summary and Conclusion

Companies may suffer damages due to the wrongful actions of various other parties. These damages may be caused by a breach of contract, a tortious act, or some other reason. And, the wrongful party may be a competitor, customer, employee, shareholder, banker, supplier, government agency, or other party.

When a company is damaged, it typically retains legal counsel to prosecute the legal claim. Counsel typically retain a forensic accountant, economist, or some other type of damages analyst to measure the amount of damages suffered by the damaged party.

In the development of the damages analysis, that damages analyst—and all of the parties to the dispute—should consider all of the income tax consequences to the parties.

There are income tax consequences related to the receipt or the payment of amounts relates to a judicial order or a negotiated settlement.

The taxable income recognition, the tax deduction, and the income character (that is, ordinary income versus capital gain) of the payments typically depend on:

1. the type of the damages claim and
2. the identity of the damaged party and the damaging party.

These issues are typically reflected in the legal documents related to the dispute. In particular, certain income tax deductions disallowances may apply with regard to the damages award payments.

All parties to a damages dispute should consider the income tax consequences of any damages payments when negotiating a dispute settlement agreement or when considering a court order or arbitrator's award.

In addition to the damaged party and the damaging party, legal counsel, damages analysts, and other professionals involved in the dispute should consider these taxation issues.

With some planning and some cooperation among the parties, some unfavorable tax consequences may be avoided.

In any event, all income tax consequences should be accounted for in the damages measurement analyses, any damages award recommendations or deliberations, the dispute settlement negotiations, and the litigation prosecution and defense.

Note:

1. Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944).

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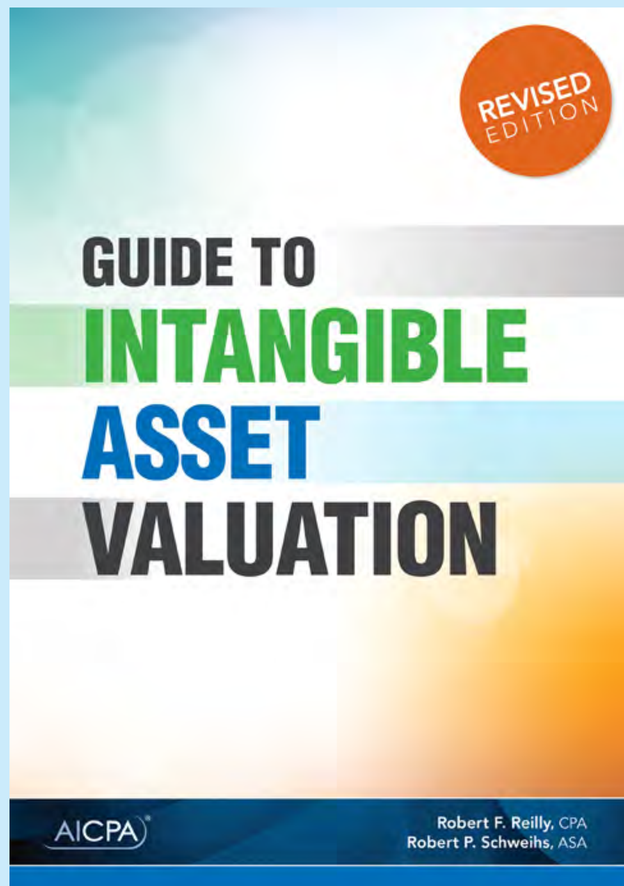
Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

Robert Reilly and Bob Schweihs, Willamette Management Associates managing directors, discuss such topics as:

- Identifying intangible assets and intellectual property
- Structuring the intangible asset valuation, damages, or transfer price assignment
- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

Illustrative examples are provided throughout the book, and detailed examples are presented for each generally accepted (cost, market, and income) valuation approach.

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- Litigation counsel involved in tort or breach of contract matters
- Intellectual property counsel
- International tax practitioners
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- Valuation analysts
- Licensing executives
- Multinational corporation executives
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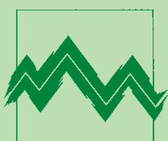
- Judges and arbitrators



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Guide to Intangible Asset Valuation

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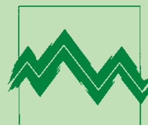

Willamette Management Associates

A CITIZENS COMPANY

Washington v. Kellwood Company: Applying an Unsupported Lost Profits Damages Analysis, the Plaintiff Is Awarded $1

Ben R. Duffy

This discussion summarizes both the Washington v. Kellwood Company *trial court decision and the associated appeals court decision. Specifically, this discussion focuses on how a not supported and not credible damages measurement analysis developed by the plaintiff's testifying expert resulted in a multimillion dollar damages award being reduced to $1.*

Introduction

The matter of *Washington v. Kellwood Company*,[1] involves a breach of contract claim in which the plaintiff sought compensatory damages. The United States District Court for the Southern District of New York (the "District Court"), determined that a breach of contract had occurred. However, the plaintiff and the plaintiff's damages analyst were unable to produce a credible and persuasive lost-profits-based damages measurement analysis. After multiple attempts to demonstrate a credible lost profits damages amount, the plaintiff was awarded $1.

The District Court decision was appealed and upheld by the Unites States Court of Appeals, Second Circuit (the "Appeals Court"). The Appeals Court decision brings an end to more than a decade of litigation.

This discussion provides insight as to why the plaintiff's expert damages analysis was not accepted by the Appeals Court. In addition, this discussion considers why the application of a supported and credible damages analysis could have resulted in a significantly greater damages award.

Specifically, this discussion (1) summarizes the plaintiff's expert yardstick method damages analysis and (2) highlights the importance of considering whether the selected damages measurement methods, damages analysis inputs, and damages measurement conclusions are credible.

Factual Background

Sunday Players

Sunday Players was a start-up company founded by Daryl Washington ("Washington") in 2002. Sunday Players designed and distributed compression sportswear. Washington believed that Sunday Players benefited from a competitive advantage due to:

1. its partnership with NFL player Izell Reese and

2. its “superior” clothing designs.[2]

During its entire period of business operations, Sunday Players only generated less than $200,000 in revenue. Sunday Players always lacked the capital to build or to purchase a manufacturing facility. Therefore, Sunday Players required the assistance of another company in order to produce its clothing products, and its clothing product samples.

Kellwood Company

Kellwood Company (“Kellwood”), a private label clothing manufacturer founded in 1961, manufactured clothing that retailers could sell under their own brand names.

Kellwood also manufactured clothing under its own brand names—in order to hedge against any earnings volatility related to its private label business operations.

Kellwood was organized into several divisions, including a performance apparel division. The Kellwood performance apparel division operated within the company’s intimate apparel division. This organization structure was selected because the process of manufacturing compression wear is similar to the process of manufacturing female undergarments.

Terms of the License Agreement

Sunday Players originally approached Kellwood. Kellwood had the manufacturing capacity and the capital to allow the Sunday Players clothing brand to expand.

Initially, Kellwood had the intention to acquire Sunday Players. However, Washington was unwilling to sell the company outright. Instead, the parties agreed to an exclusive three-year license. The license included a three-year renewal option, exercisable only by Kellwood.

The license agreement entitled Kellwood to the exclusive right to produce, manufacture, advertise, promote, import, distribute, and sell the Sunday Players brand. Kellwood agreed to spend an amount equal to 3 percent of the revenue generated from the sale of Sunday Players branded apparel on marketing the brand.

The license agreement included a carve-out, offering Washington the right to market the Sunday Players brand directly to universities, schools, and approved independent retailers and e-commerce platforms.

The license agreement also offered Washington 5 percent of all net sales derived from the Kellwood sale of Sunday Players branded apparel. But, the license did not guarantee a minimum payment. However, the license provided for Washington to receive an annual inventory of sample clothing, not to exceed $25,000.

The license agreement did not offer an early termination right to either party. And, the license required Sunday Players/Washington to give written notice if the opposite party was suspected of breaching the license.

Marketing Efforts

Kellwood management made a strategic decision to postpone the marketing of Sunday Players products directly to consumers and to sports teams—until a time when the Sunday Players merchandise was available in retail stores.

Kellwood unsuccessfully attempted to sell its Sunday Players merchandise to May Company, Olympia Sports, Modell’s, Marshall Field, and other retail store chains.

The Sunday Players marketing director, prior to the Kellwood license, applied a different approach to marketing the brand. This company executive believed that Sunday Players should use both a “top-down” approach and a “bottom-up” approach.

The top-down approach focused on endorsements and television exposure in order to bring the Sunday Players brand to the attention of young athletes. The bottom-up approach focused on Sunday

Players sponsoring local sports teams and marketing directly through social media platforms.

Between November 2003 and April 2005, the Sunday Players sales representatives sold less than $150,000 of merchandise.[3]

During August 2003, the Kellwood performance division executive met with an MTV marketing executive to discuss a potential marketing deal for Sunday Players.

The MTV marketing executive entertained the idea of placing Sunday Players products on MTV television programs and advertisements. However, the deal was contingent on Sunday Players selling $500,000 worth of performance apparel prior to receiving the advertising space.

In March 2004, Kellwood and MTV agreed to preliminary terms regarding a sublicense agreement. MTV agreed to produce and air a commercial for Sunday Players for a $50,000 fee, contingent on Kellwood selling $500,000 of Sunday Players merchandise. However, against the urging of Washington and MTV, Kellwood did not sign the sublicense agreement with MTV.

Breach of Contract

During March of 2005, Kellwood terminated the exclusive license agreement with Sunday Players after selling $0 in merchandise. Kellwood had also failed to market directly to consumers during the terms of the license agreement.

Washington filed a lawsuit and claimed lost profits and lost business value due to the Kellwood breach of the license contract. Washington claimed that the Kellwood early termination "destroyed the brand," ultimately putting Sunday Players out of business.

Washington submitted a letter to Kellwood, protesting the early termination and mentioning the absence of a termination provision in the license agreement. Washington also protested that Kellwood did not put forth a reasonable effort to market the Sunday Players brand effectively. Washington alleged that Kellwood failed to:

1. sign a contract with MTV,
2. buy advertising, or
3. sell to stores.

Kellwood management did not respond to the letter submitted by Washington.[4]

The Damages Measurement Analysis

Attempt at Recovering Lost Profits

Washington hired a forensic analyst to measure the amount of damages associated with the Kellwood early contract termination and the inadequate marketing attempts of the Sunday Players brand.

The Sunday Player forensic analyst constructed a lost profits and a lost business value damages measurement analysis—by applying the yardstick method of damages measurement.

The Yardstick Method

One objective of a damages analysis is to measure the amount of lost profits related to the damages event. Damages are typically measured from the damages event date through the expected conclusion of the damages period.

The yardstick method measures damages on the basis that the damaged company's projection is an independent variable, or a "yardstick." The independent variable (e.g., a widely accepted statistic or index) is typically one that is easier to project than company financial fundamentals.

In this case, the Sunday Players damages analyst relied on the historical sales performance of Under Armour, a market leader in the compression sportswear industry, as the "yardstick" in the damages analysis.

The damages analyst considered the following factors in the evaluation of the comparability of Under Armour and Sunday Players:[5]

- Manufacturing capability
- Retail distribution

- Business strategies
- Brand philosophy

The damages analyst concluded that the previously discussed television contract with MTV would have been comparable to the Under Armour television contract with ESPN. And, the Sunday Player contract should lead to a similar earnings growth trajectory.

The damages analyst concluded that the Sunday Players 2005 through 2007 revenue growth corresponded with the Under Armour 2002 through 2004 revenue growth. However, the damages analyst claimed that there were differences between Under Armour and Sunday Players that support an adjustment to the Under Armour revenue to better reflect the specific circumstances and risks associated with Sunday Players.

These differences included:

1. the Under Armour market dominance and
2. the increasing competition from other sportswear brands.

Based on these factors, the plaintiff's damages analyst reduced the 2002 through 2004 Under Armour revenue by 50 percent. Therefore, the projected Sunday Players—or Kellwood—sales of Sunday Players merchandise for 2005 through 2007 was estimated to be $82,000,000.

The amount of the damages associated with royalties that were lost during this period were measured as follows:

1. $213,000 for the period between the inception of the contract and the Kellwood early termination
2. $3,570,000 from termination through the end of the contract term

The damages analyst also calculated that Sunday Players had lost $532,500 in brand value as of March 2005. The brand value damages measurement relied on the assumption that Sunday Players would achieve 50 percent of the revenue level of Under Armour.

The Initial Judicial Decision

In the initial District Court proceeding, "[t]he jury returned a verdict in favor of Washington, stating that Kellwood breached contract, and awarded Sunday Players with $250,000 in lost profits between November 14, 2003, and March 14, 2005; $4,100,000 in lost profits between March 14, 2005, and January 31, 2007; and, alternatively, $500,000 in lost market value as of March 14, 2005."[6]

However, Kellwood put forth a post-trial challenge to the amount of damages awarded by the jury. The challenge was made in the District Court. But, the challenge was made to a different judge than the judge who presided in the initial jury trial.

Kellwood filed a motion under Federal Rule 50(a), which states, "if a party has been fully heard on an issue during a jury trial and the court finds that a reasonable jury would not have a legally sufficient evidentiary basis to find for the party on that issue, the court may . . . resolve the issue against the party."

According to Kellwood, the application of Rule 50(a) was justified for the following reasons:

1. First, Sunday Players had not proven that Kellwood breached any contractual obligation. And, second, that "the license agreement's language is explicit and unambiguous that . . . Kellwood shall spend 3 percent of gross sales" on marketing, and Kellwood met that obligation.[7]
2. Second, Sunday Players and its damages analyst had not provided a reasonable basis for the assumption that Sunday Players would be able to achieve 50 percent of the revenue of Under Armour, if Kellwood had applied reasonable marketing efforts.

The District Court accepted the Rule 50(b) motion. Rule 50(b) states the following:

> If the court does not grant a motion for judgment as a matter of law made under Rule 50(a), the court is considered to have submitted the action to the jury subject to the court's later deciding the legal questions raised by the motion. No later than 28 days after the entry of judgment—or if the motion addresses a jury issue not decided by a verdict, no later than 28 days after the jury was discharged—the movant may file a renewed motion for judgment as a matter of law and may include an alternative or joint request for a new trial under Rule 59. In ruling on the renewed motion, the court may:
>
> 1. allow judgment on the verdict, if the jury returned a verdict;
> 2. order a new trial; or
> 3. direct the entry of judgment as a matter of law.

The District Court (1) rejected the analyst's damages measurement analysis and (2) determined that the award for lost profits should be set aside

due to a lack of reasonable and convincing evidence of lost profits.

Initially, the District Court ordered a retrial, within the District Court, but with a new jury that had not been exposed to the previous expert testimony.

The District Court referenced the *Ashland Management v Janien* decision, which states that "The law does not require that it [damages] be determined with mathematical precision. It requires only that damages be capable of measurement based upon known reliable factors without undue speculation."[8]

In addition, the District Court cited the *Freund v. Washington Sq. Press, Inc.*, decision, which states that a plaintiff should provide a "stable foundation for a reasonable [lost profits] estimate" or the claim "fails for uncertainty."[9]

The District Court pointed out that Sunday Players did not have (1) a record of profitability or (2) a reasonable basis upon which to support the existence of lost profits.

Sunday Players was a start-up business, lacking capital, brand recognition, and sales contracts. Sunday Players management sought the license agreement with Kellwood in hopes that Kellwood would be able to:

1. provide capital,
2. grow the Sunday Players brand, and
3. manufacture its clothing.

Although Sunday Players management believed that the Kellwood license agreement would allow the Sunday Players brand to grow and succeed, the District Court found that the Sunday Players arguments for lost profits lacked support due to the company's lack of sales history.

However, Washington disputed that Sunday Players was not a "new business." Therefore, Sunday Players claimed that the District Court should consider the financial history and age of Kellwood when analyzing lost profits associated with the breach of contract.[10]

An additional argument against applying the Kellwood historical revenue figures to those of Sunday Players was that Kellwood did not have a record of selling branded compression wear. Although Kellwood had manufactured private label compression apparel in the past, Kellwood did not have experience selling branded compression wear to retailers.

Therefore, the District Court concluded that it was not reasonable to compare the Kellwood experience in selling private label compression clothing to the hypothetical success of Sunday Players clothing.

Since Sunday Players lacked sales history, lost profits could only be demonstrated by comparing Sunday Players to a similar business with a sales record and obtainable financial data. Therefore, Sunday Players was limited to comparing itself with a public company. However, the majority of similar public companies were significantly larger than Sunday Players.

The District Court decided that the following were the important issues with regard to the Sunday Players damages analyst selection of Under Armour as a comparable company.[11]

1. Lack of Causation: Sunday Players failed to prove that the marketing strategy of Under Armour would have been successful for Sunday Players.
2. Lack of Comparability: The sales history of Under Armour could not be used as a proxy to estimate the level of sales Sunday Players would have achieved because the companies vary significantly.
3. Lack of Understanding: There was not a common understanding between Washington and Kellwood that Sunday Players could have obtained 50 percent of the Under Armour revenue at the time the contract initiated.

While the facts of the case and certain information presented by Sunday Players supports the argument that the Kellwood breach of the license agreement was harmful, the District Court did not accept the Sunday Players claim for lost profits.

For the reasons discussed above, the jury's damages award was vacated, and a new damages trial was ordered in the District Court.

The District Court determined that at the subsequent trial, Sunday Players would not be permitted to apply the testimony of its damages analyst, under Federal Rules of Evidence 403. This was because the damages analyst's measurement presented a danger of "unfair prejudice" and "misleading the jury."[12,13]

The District Court determined that the jury at the subsequent trial should be instructed on nominal damages, in the event that Sunday Players could not provide credible evidence with regard to its lost profits damages measurement claim.

A Reattempt at Recovering Lost Profits

Before proceeding with a retrial, the District Court required that Sunday Players present enough non-speculative evidence to warrant a retrial. This presented a second opportunity for Sunday Players to prove a credible and supportable damages amount, since it was determined that Kellwood had in fact breached the license agreement.

Additional Evidence

After the District Court dismissal of the initial damages analysis, with measured damages of $4.35 million, Sunday Players increased its damages claim to a range of $5 million to $140 million.

Additional evidence that Sunday Players attempted to admit at the retrial included the following:

1. Profit projections produced by Kellwood
2. The Sunday Players business plan
3. MTV's projections and an MTV retail marketing executive's testimony
4. Washington's testimony
5. Sunday Players co-owners' testimony
6. The Sunday Players previous marketing strategist's testimony

The Kellwood profit projections and the Sunday Players business plan were not admitted as new evidence. The court made this evidentiary ruling because:

1. both documents were available during the initial trial and
2. Sunday Players had the opportunity to present the documents as evidence at that time.

"Federal Rule of Civil Procedure 59(e) and Local Civil Rule 6.3 govern motions for reconsideration, and these rules are intended to ensure the finality of decisions and to prevent the practice of a losing party examining a decision and then plugging the gaps of a losing motion."[14]

The District Court considered the MTV projections to be solely hearsay. Since the MTV retail marketing executive did not perform the projections, could not produce the projections, and could not speak on behalf of MTV, the MTV projections were not admitted as evidence.

Daryl Washington's testimony as an experienced accountant was also not admitted. This is because the testimony was not admissible under Rule 701. Federal Rules of Evidence 701 only allows lay opinion testimony when it is "not based on scientific, technical, or specialized knowledge."

The testimonies of Curley Kelly, Izell Reese, and Christopher Plumlee were not admitted for the same reason that Washington's testimony was not admitted under Federal Rules of Evidence 701.

Sunday Players also attempted to reopen discovery and hire a new damages analyst. However, the District Court denied this request on the grounds that Sunday Players had intentionally and strategically relied on a single damages analyst in the first trial.

And, that damages analyst had "engaged the jury in a flight of fancy that resulted in a multimillion dollar lost profits verdict for a company that sold less than $200,000 of merchandise in its entire history."[15]

District Court Final Ruling

The District Court determined (1) that a retrial would be an exhaustive and unproductive use of the resources of the trial court and (2) that it was unnecessary to proceed with a retrial.

The District Court stated that "Litigation is not an iterative process." Therefore, the plaintiff's motion for a retrial was denied and the District Court offered the plaintiff a nominal award of $1.[16]

The District Court referenced the *Parrish v. Sollecito* decision, in stating that a reconsideration motion is not "a vehicle for a party dissatisfied with the court's ruling to advance new theories that the movant failed to advance in connection with the underlying motion, nor to secure a rehearing on the merits with regard to issues already decided."

Instead a "motion for reconsideration should be granted only when the defendant identifies an intervening change of controlling law, the availability of new evidence, or the need to correct a clear error or prevent manifest injustice."[17]

Appeals Court Decision

Plaintiff Daryl Washington appealed the District Court's rulings in an attempt to:

1. exclude the damages measurement methodologies employed by the Sunday Players damages analyst,
2. deny the motion for a new trial on damages, and
3. award nominal damages in the amount of $1.

However, the Appeals Court upheld each of the District Court decisions.[18]

The Appeals Court affirmed the District Court opinion regarding the shortcomings of the plaintiff's expert's lost future profits analysis. The Appeals Court affirmed that "a new venture whose profits are 'purely hypothetical' and that would require 'untested' sales to 'hypothetical' consumers does not support a damages award."[19]

The Appeals Court determined that:

1. the District Court was correct to opine that Under Armour was not a reasonable "comparator" and
2. the damages analysis based on this comparator was so unfounded that it failed to establish any legal basis for awarding lost-profits damages.

The Appeals Court also determined that the District Court was correct to opine that the lost business value analysis provided by the plaintiff's damages analyst failed under the same premise as the lost future profits damages analysis. That is, both the lost business value damages analysis and the lost profits damages analysis relied on Under Armour revenue as a "yardstick" comparison.

Practical Considerations

This judicial decision provides important lessons both for damages analysts and for litigation counsel.

This set of judicial decisions illustrates the importance of:

1. selecting a reasonably comparable "yardstick" comparator in the application of a yardstick method damages analysis,
2. selecting and applying credible damages measurement methods, and
3. considering the credibility of the total damages measurement conclusion.

In order to produce a supportable yardstick method damages analysis, the damages analyst should carefully select the "yardstick." In this case, the yardstick applied by the Sunday Players damages analyst was determined not to be a credible basis for measuring lost profits.

When the subject company is a start-up, with no history of generating material revenue, a large publicly traded company is not likely to be a reasonable yardstick comparator. A damages analyst may consider if a guideline company would provide sufficient guidance in a business valuation analysis before relying on it as a benchmark metric in a yardstick damages analysis.

The assumption that Sunday Players, having lacked sales history, could achieve even half of the success that Under Armour had achieved was not supportable.

In the instance when a credible yardstick cannot be determined for a lost profits measurement analysis, then the analyst may consider the application of other damages measurement methods. Even if the analyst believes that the yardstick analysis is credible, support provided by the application and consideration of multiple lost profit measurement methods may improve the damages analysis.

In the case of Sunday Players, the damages analyst may have reached a more credible damages conclusion by applying the "but for" method, or a lost profits method that incorporated projections available at the time the damages event occurred.

In fact, the plaintiffs attempted to introduce draft budgets for Sunday Players for consideration by the Appeals Court. This effort was rejected by the Appeals Court because Sunday Players had not established a foundation for introducing the new evidence.

Had the damages analyst relied on the "but for" method and the more credible financial projections in the initial proceeding, the District Court may not have overturned the jury's initial damages award.

This lesson is valuable not only to damages analysts, but also to litigation counsel. Litigation counsel should work closely with damages analysts to ensure (1) that the damages measurement methods being applied are credible and (2) that the damages analyst has all necessary information to conduct a supportable analysis.

In the case of Sunday Players, both the damages analyst and the litigation counsel should have realized the problems with applying the yardstick method in the manner that it was applied here.

The damages analyst should have requested and considered any available projections when deciding which damages measurement methods to apply. Likewise, the litigation counsel should have ensured that the relevant projections were obtained during discovery.

Finally, both the damages analyst and litigation counsel should consider the credibility of any damages measurement conclusions reached before submitting an expert report.

The Sunday Players damages analyst got lost in the weeds when applying the yardstick method, considering specific product offerings and making adjustments to the Under Armour revenue to reflect prevailing market conditions. The damages analyst failed to

consider that no reasonable level of adjustments could account for the difference in size and maturity between Sunday Players and Under Armour.

Both the District Court and the Appeals Court were quick to recognize this fatal flaw in the plaintiff's damages measurement analysis. That is, a market leader with hundreds of millions of dollars in revenue was nowhere near a credible "yardstick" comparator for Sunday Players.

The Sunday Players litigation counsel should have considered the reasonableness of the damages conclusion and not submitted an expert report that could be so easily dismissed by both the District Court and the Appeals Court. Prior to submitting an expert report, the litigation counsel should be prepared to defend its damages analyst's methodology and conclusions.

Further, given a second chance to submit a more credible damages measurement analysis, the plaintiff submitted an even higher range of damages. By submitting a damages measurement range of $5 million to $140 million, after the initial damages award of $4.35 million was vacated as unreasonable, the District Court had no choice but to conclude that the plaintiffs had no intention of pursuing a realistic damages award.

The litigation counsel should have seen the writing on the wall and submitted a damages measurement range that was more credible to the District Court.

Summary and Conclusion

This set of judicial decisions illustrates the importance of developing a damages measurement analysis that is both credible and supportable. This lesson applies to:

1. the inputs relied on in applying a damages measurement method,
2. the methods relied on in conducting a damages measurement analysis, and
3. the conclusions reached in the damages measurement analysis.

In the case of the Sunday Players damages analysis:

1. Under Armour was not a credible yardstick for a start-up company.
2. The yardstick method was not the most appropriate damages measurement method given the lack of comparable publicly traded companies.
3. The damages measurement conclusions ranging from $4.35 million to $140 million were not credible for a company with total sales of less than $200,000.

If the Sunday Players damages analysis had been more credible, and if other methods for measuring lost profits damages had been applied, then Sunday Players may have received a significantly greater damages award than $1.

An earlier version of this discussion originally appeared in the Summer 2018 issue of *Insights*.

Notes:

1. Washington v. Kellwood Company, 05-CV-10034 U.S. Dist. Ct., 2016 WL 3920348 (S.D.N.Y. July 15, 2016).
2. Id.
3. Id. at *3.
4. Id.
5. Id. at *4.
6. Id.
7. Id.
8. Ashland Management, Inc. v. Janien, 82 N.Y.2d 395, 403 (N.Y. App. 1993).
9. Freund v. Washington Sq. Press, Inc., 34 N.Y.2d 379 (1974).
10. Washington v. Kellwood Company at *7.
11. Id.
12. Federal Rules of Evidence 403 states that the court may exclude relevant evidence if its probative value is substantially outweighed by a danger of one or more of the following: unfair prejudice, confusing the issues, misleading the jury, undue delay, wasting time, or needlessly presenting cumulative evidence.
13. Washington v. Kellwood Company at *13.
14. TufAmerica, Inc. v. Diamond, 12-cv-3529 (AJN), 2016 WL 3866578 (S.D.N.Y. July 12, 2016).
15. Washington v. Kellwood Company, 05-CV-10034 U.S. Dist. Ct., 2016 WL 5680374 at *8 (S.D.N.Y. Sept. 30, 2016).
16. Id. at *1.
17. Parrish v. Sollecito, 253 F. Supp. 2d 713, 715 (S.D.N.Y. 2003).
18. Washington v. Kellwood Company, 714 Fed.Appx. 35 (2nd Cir. 2017).
19. Id. at 40.

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Trends in Securities and Derivative Litigation: Fewer Merger and Acquisition Filings at the Forefront of Litigation Activity

Tim C. Ladd

Historically, the volume of shareholder litigation increases in periods of market turbulence and significant merger or acquisition activity. During the past two years, there has been a decrease in the number of shareholder complaints filed due to the decrease in merger objection filings. The number of complaints filed may have decreased even more if not for the litigation activity surrounding both special purpose acquisition companies ("SPACs") and COVID-19. This discussion analyzes this decrease in shareholder claims. This discussion also provides an overview of the types of litigation claims being filed, the impact of SPACs and COVID-19 on shareholder litigation, and the recent trends in shareholder litigation judicial decisions.

Introduction

As a general matter, investors are more likely to file a lawsuit during periods of economic turbulence rather than during periods of economic prosperity. Shareholders who own investments that are generating healthy returns are less likely to find fault with company directors than investors who are losing money. In addition to unsatisfied investor-related lawsuits, investors often pursue their statutory dissenting shareholder appraisal rights in objection to mergers and acquisitions.

In light of this general trend, it is notable that shareholder complaints decreased from the high levels observed from 2017 through 2019. After the record high period of shareholder lawsuits filed in those years, shareholder litigation activity has returned to more normal levels in terms of the number of cases filed.

This discussion provides observations related to the typical categories of shareholder litigation (including related statistics), particularly with regard to the following considerations:

1. The filing trends over the past two years
2. Special purpose acquisition companies ("SPACs") and the issue of fiduciary duty
3. The presence of COVID-19 in litigation
4. The recent trends in judicial decisions

General Shareholder Litigation and Derivative Litigation

As company owners, shareholders have rights and privileges as a collective group. These rights and privileges include, but are not limited to, the appointment and removal of officers and directors, calling meetings, proxy representation, information, and oversight.

Further, shareholders may be called on to approve dividends, approve the financial statements of the company, approve mergers and acquisitions, or approve a company liquidation.

While the duties of directors can vary by state, all directors have a fiduciary duty. As a result, corporation directors are compelled to act in the best interest of the company and of its shareholders.

However, directors occasionally make decisions that inevitably decrease the value of the shareholders' ownership stake. When the value of the shareholders' ownership stake decreases due to the decisions made by directors, then shareholders may use the judicial system to make their claim.

Classifying Shareholder Litigation

Federal Securities Litigation

While all claims filed with regard to securities laws fulfill the definition of "securities litigation," the remainder of this discussion concerns federal class action lawsuits. In effect, this discussion discusses new class action lawsuits citing Federal Rule of Civil Procedure 23 ("Rule 23").

Rule 23 enables someone to file a class action lawsuit for a group of people or entities (1) that purchased a company's securities during a specified period of time and (2) that allege that the company and/or its officers and directors violated federal securities laws.[1]

Many securities-related class action claims asserted in such Rule 23 cases cite Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5. Plaintiffs file lawsuits in reference to the above-stated provisions in order to compel liability on persons who were responsible for material misrepresentations or omissions.

Misstatements and omissions can often be found in financial statements or published investment guidance. Plaintiffs may allege such misstatements and omissions adversely cause harm through the decrease in shareholder value.

Rule 23 is not the only course of action for disgruntled shareholders. Shareholders of public companies can file claims citing a breach of the Securities Act of 1933.

Often, shareholders cite Section 11 of that Act. Section 11 imposes liability for material misrepresentations and omissions in a registration statement.[2]

Shareholder Derivative Litigation

Shareholder derivative suits are another type of representative litigation. While in a securities class action suit, the plaintiff represents other members of the same class, and the plaintiff in a shareholder derivative action asserts claims on behalf of the corporation itself.

To be considered derivative, a shareholder suit should be focused on actions detrimental to the well-being of the corporation. Any claims for monetary damages should be based on corporate mismanagement.[3]

Derivative suits can encompass many allegations. Typically these allegations include (1) self-interest by corporate executives, (2) mismanagement or misuse of corporate assets, or (3) shareholder objections to specific corporate transactions.

Filing Trends

As previously noted, the number of securities and derivative lawsuits filed in the United States decreased during the past two years. In 2021, the number of cases filed decreased for a second year in a row. There were only 205 new cases filed in 2021, as compared to the 321 new cases filed in 2020. The total number of cases filed had not fallen below 300 since 2016.

The decrease in the number of cases in 2021 outpaced the decrease in the number of cases filed in 2020. New cases decreased by 116 in 2021; while in 2020, there were 99 fewer cases as compared to 2019.[4]

The number of cases previously increased in 2017 and remained at a relatively high level through 2019. However, as the number of cases filed in 2021 decreased to 205, that number was more consistent with the number of cases filed from 2005-2015 time period.

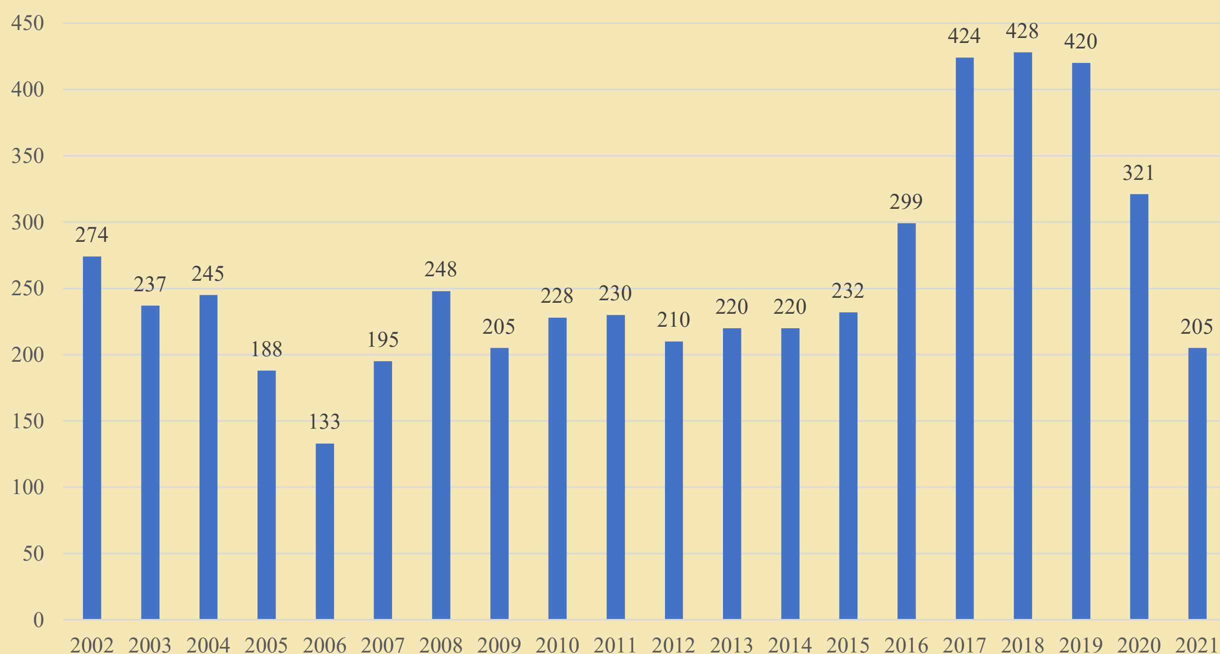
Figure 1 presents the number of new federal securities cases filed during the past 20 years.[5]

What's Driving the Decrease in Filings?

A healthy stock market often lacks material valuation (price) volatility. In times of major market disruption, shareholder and derivative litigation tends to emerge. This fact is fairly intuitive; if shareholders are receiving positive returns, they are much less likely to attribute fault or negligence to company management.

However, the trend in cases filed over the past few years have less to do with market turbulence. Instead, the decrease in the number of new securities cases filed centered around diminishing merger objections.

Figure 1
Federal Securities Filings
By Year during the Past 20 Years
From 2002 to 2021



The increase in the number of cases filed from 2017 through 2019 was due in large part to substantially greater merger objection cases. In 2018, for instance, plaintiffs filed a total of 182 merger objection cases, which accounted for more than 40 percent of total class action lawsuits filed.

After decreasing to 103 cases filed in 2020 from 162 cases filed in 2019, the number of new merger objection cases filed in 2021 decreased to only 14. That number represents more than an 80 percent decrease in merger objection litigation. The decrease may be attributable to increased individual filings.

Figure 2 illustrates the federal securities actions filed by type in over the past 10 years.[6]

In addition to a decrease in merger-related litigation, Rule 10b-5 filings decreased as well. Though the decrease was not as stark as merger objections, Rule 10b-5 filings decreased by more than 15 percent in 2021.[7]

Allegations

Of the cases filed that did not involve merger-related litigation, the most typical allegation in the cases filed in 2021 related to misleading future performance. Approximately 40 percent of the cases filed in 2021 related to misleading future performance allegations.

In addition, allegations concerning missed earnings guidance accounted for approximately 24 percent of cases filed in 2021. Allegations involving missed earnings guidance accounted for at least 20 percent of the new cases filed since 2018.[8]

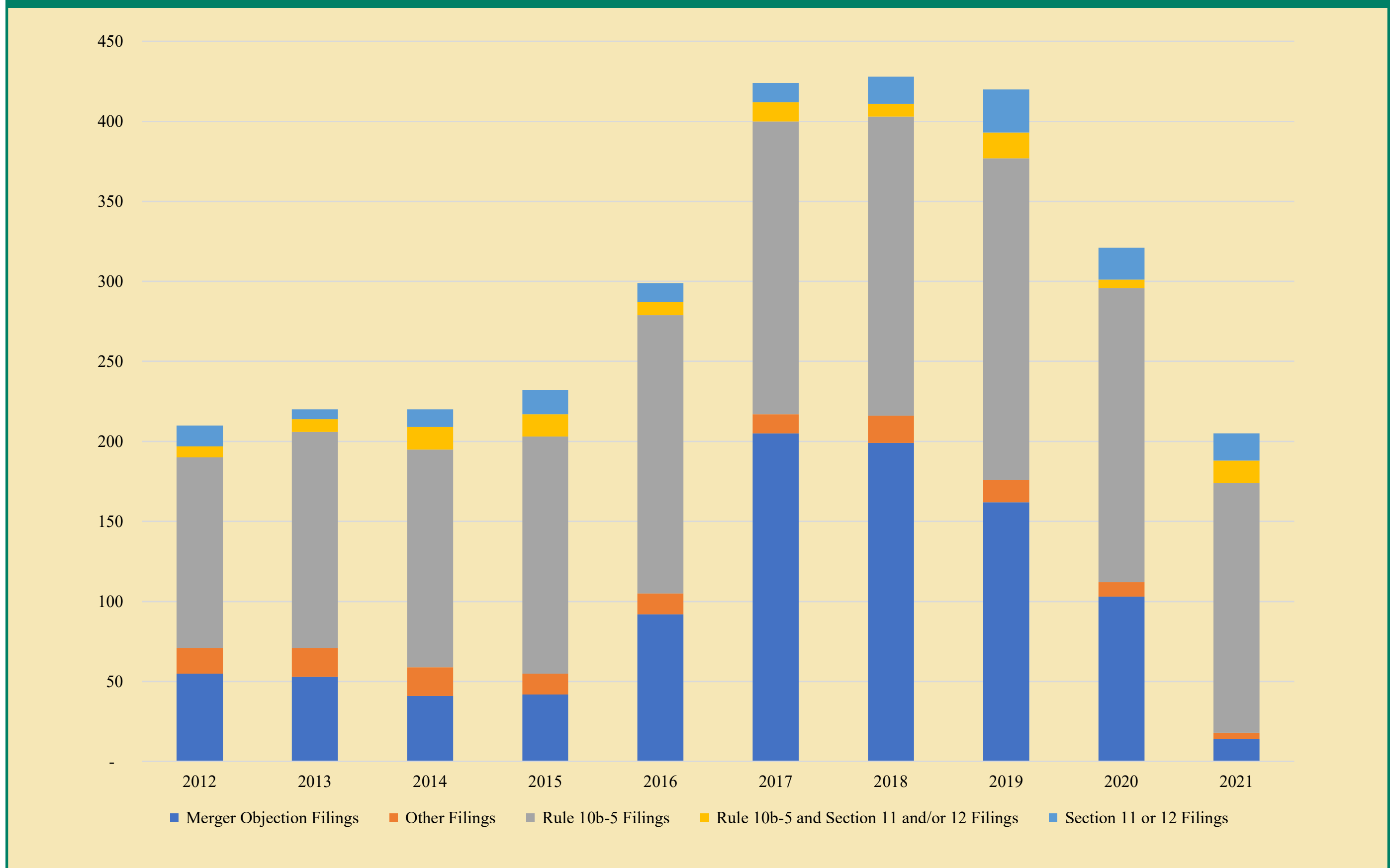
The number of cases related to accounting issues and regulatory issues decreased during the last two years. In 2019, cases filed concerning accounting issues and regulatory issues represented 28 percent and 25 percent of new cases, respectively. In 2021, new cases concerning accounting issues and regulatory issues only represented 16 and 17 percent of cases, respectively.[9]

It should also be noted that the number of cases involving merger integration issues more than tripled in 2021. In 2021, cases with merger integration issues accounted for 17 percent of new cases filed. It appears that the increase in 2021 can be correlated with the increasing popularity of SPAC investments.[10]

SPACs

A SPAC is a company formed for the sole purpose of raising capital through an initial public offering

Figure 2
Federal Securities Filings
By Type of Filing
From 2012 to 2021



("IPO") with the intent of acquiring or merging with a pre-existing company. While SPACs have existed since the 1990s, they have increased in popularity in recent years. In 2020, for instance, SPACs raised a record $82 billion.[11]

However, the increasing popularity may have led to increased litigation.

SPACs can present conflicts between sponsors and the shareholders. From an economic standpoint, SPAC sponsors are often incentivized to complete a merger even if the merger would not create value for the shareholders. Accordingly, shareholders may view such a merger with skepticism.

As fiduciaries, it is necessary for the members of a company's board of directors to review proposed mergers and to present the proposed merger to the shareholders. However, if the board members' compensation aligns their interests with the sponsor, the apparent conflict of interest could create concerns about the board of directors fiduciary duties to the company's shareholders.

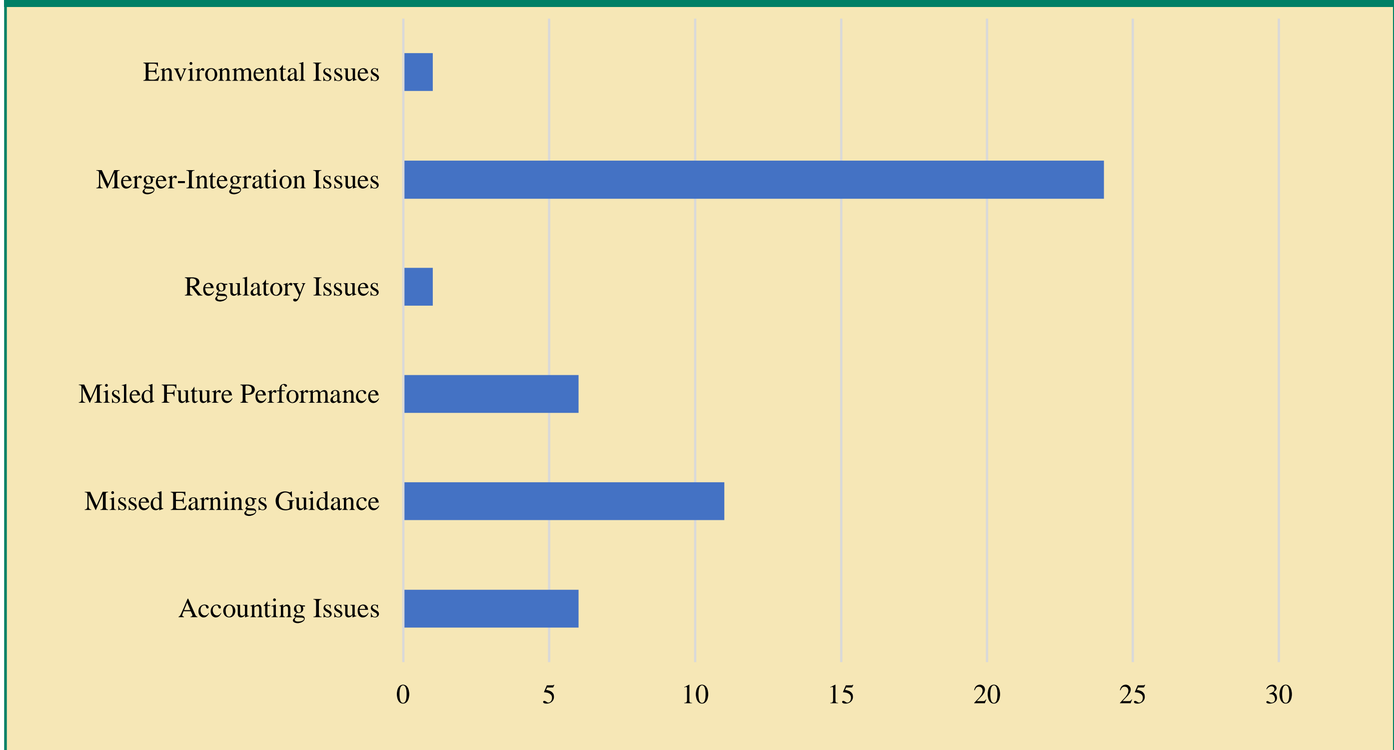
In 2021, merger integration issues were central to most SPAC-related court filings. There was a total of 24 such cases filed in 2021, or almost half of all cases. Other SPAC-related filings most typically involved missed earnings guidance and misled future performance—with 11 and 6 cases, respectively.

Figure 3 presents the composition of SPAC-related filings over the past year.[12]

The *In re Multiplan Stockholders Litigation* ("*Multiplan*") decision provides an example of this merger integration conflict. In *Multiplan*, Churchill Capital Corp. III ("Churchill") was formed as a SPAC in October 2019 and completed its $1.1 billion IPO in February 2020. The IPO was sponsored by M. Klein and Company, a financial services firm led by Michael Klein.

On July 13, 2020, Churchill and Multiplan Corp. announced the two had agreed to merge in a deal worth $11 billion. The deal was later approved by Multiplan Corp. and by the Churchill shareholders in October 2020.

Figure 3
SPAC-Related Federal Lawsuit Filings
By Type of Allegation in 2021



Soon after approval, a short seller published a research report painting Multiplan Corp. in a negative light, and soon after that, a lawsuit was filed in Delaware Court of Chancery. The lawsuit alleged that Michael Klein and the Churchill directors' ownership interests provided significant financial incentives to seek and to approve any deal.

The lawsuit claimed that even a bad deal for the SPAC public investors would provide a strong financial benefit to the directors' shares.

The board, as alleged, ignored advice from their standard third-party financial adviser, and instead retained Michael Klein's own vehicle and transferred an advisory fee of $30.5 million in addition to his founder shares.[13]

Claims for breach of fiduciary duty were made against the directors, and against Michael Klein and his related entities. This is one of the first instances in which a court had to consider the unique structure of SPACs in conjunction with a boards obligation to comply with fiduciary duty laws.

On January 3, 2022, the Delaware Court of Chancery denied the defendants' motion to dismiss, and the court addressed claims against the sponsor and other insiders of the SPAC for breach of fiduciary duties in connection with a de-SPAC merger.

While it appears that more time is needed for the court to examine the relationship of SPACs and fiduciary duties, the court's Vice Chancellor concluded that the entire fairness standard applied in *Multiplan* and not the business judgment rule. This is significant because the fairness standard is Delaware's most onerous standard of review.

The Vice Chancellor also noted that it is rare for the court to dismiss a fiduciary duty claim under the fairness standard.

The *Multiplan* matter may have a significant impact on securities and derivatives litigation as it could likely serve as precedent for future claims of breached fiduciary duty in SPAC-related litigation. However, if the court sides with Churchill and Klein, then it stands to reason that SPAC sponsors and directors may use the *Multiplan* decision as a reason to structure similar financial incentives that more heavily favor their own financial interests.

COVID-19 and the Courtroom

Since March 2020, there have been a total of 53 class action lawsuits with COVID-19-specific allegations. In 2021, there were a total of 20 lawsuits filed with COVID-19-related claims, as compared to the 33 claims filed in the previous year.

According to NERA Economic Consulting, filings related to COVID-19 were approximately 10 percent of total securities-related filings in 2020.[14]

In the first year of COVID-19, the types of allegations within the new cases filed appeared to vary.

Figure 4 presents the various groupings of allegations related to COVID-19 litigation matters filed in 2020. Regulatory issues were the most typical causes of new lawsuits filed, while missed earnings guidance and misleading future performance followed closely behind with 28 percent and 25 percent of new cases filed, respectively.

The reasons for COVID-19-related litigation shifted in 2021. Claims primarily centered around misleading future performance and missed earnings guidance with 43 percent and 38 percent of new cases filed, respectively. Meanwhile, cases alleging regulatory issues became a relative afterthought.

Figure 5 provides a an analysis of the claimed allegations for 2021.[15]

Litigation matters involving certain alleged misstatements related to company safety procedures and risk disclosures are still being filed in the courts. It is possible that if any additional COVID-19 variants arise, COVID-19-related litigation will continue into 2022.

Other Industries and Trends

While the number of new case filings was led by COVID-19 and SPACs issues, there were noteworthy trends across several industries.

Excluding all merger objection lawsuits, new cases filed against companies in the electronic technology and technology services sector increased in 2021. In 2021, lawsuits against companies in the electronic technology and technology services sector represented 31 percent of all new securities -related cases filed, as compared to 22 percent filed in 2020.

Securities-related lawsuits against companies in the health technology and services sector increased to 26 percent of all 2021 similar lawsuits, as compared to 22 percent in 2020.

Finally, lawsuits against companies in the finance sector decreased to 11 percent of all new cases filed in 2021, versus 17 percent filed in 2020.[16]

In 2021, class action lawsuits stemming from cybersecurity breaches increased from that of prior years. For example, there were only three of these types of lawsuits filed in both 2019 and 2020. In 2021, the number of filed class action lawsuits related to cybersecurity increased to five.

According to law firm Gibson Dunn, increased 2021 class action lawsuits stemming from cybersecurity breaches activity has been linked to ransomware attacks.[17]

The number of new filings in the cannabis industry decreased from six cases filed in 2020 to just one case filed in 2021. In 2020, filings revolved around accounting issues, misleading statements about projected performance, and missed earnings guidance. As an emerging industry, it would not be surprising

Figure 4
Percentage of COVID-19-Related Federal Securities Filings Categorized by Type of Allegation in 2020

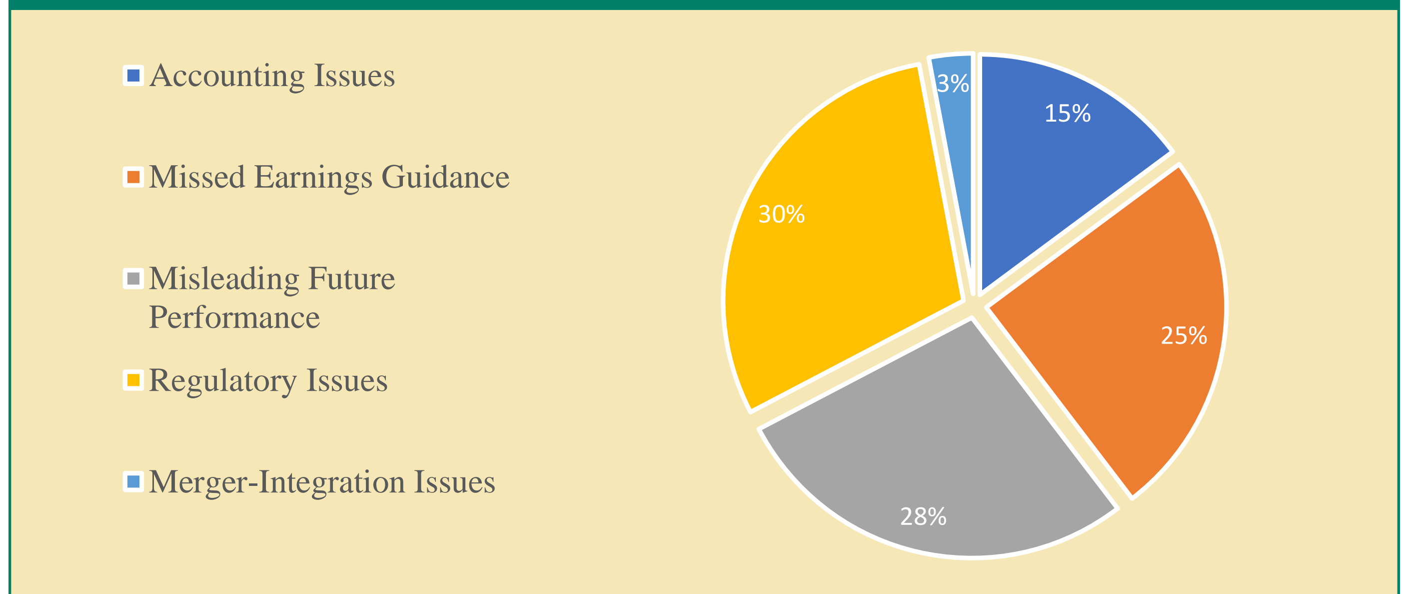
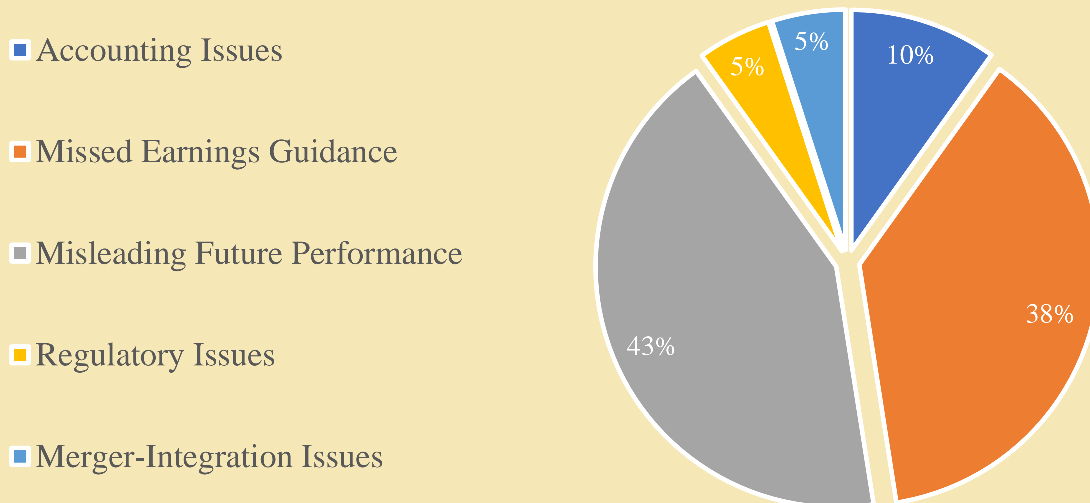


Figure 5
Percentage of COVID-19-Related Federal Securities Filings Categorized by Type of Allegation in 2021



to see more cannabis-related litigation emerge in 2022 and beyond.[18]

Resolution Trends

While many of the class action lawsuits go to trial, there are also many cases that are resolved. Cases may be dismissed by a judge or may be settled between the parties involved. A judge may dismiss a lawsuit for any number of reasons. Likewise, there are many factors involved in settling a lawsuit.

The number of cases that are either dismissed or settled typically varies by year. Often, more cases are resolved in periods of increased litigation activity and vice versa. In 2021, this observation proved to be true.

As the number of new cases filed decreased, the number of resolutions decreased to its lowest level since 2015. A total of 239 cases were resolved, with 153 of those cases being dismissed, while the remaining 86 were settled.

Figure 6 provides a summary of the trends in resolved cases from 2012 through 2021.[19]

There is not one trend that explains resolution activities. As presented in Figure 6, the number of nonmerger dismissals reached a 10-year period high in 2021. The relatively high number of nonmerger dismissals is noteworthy. However, the dismissal of merger objections decreased by nearly 100 cases in 2021. This trend is consistent with the decreased merger-related cases filed in 2021.

According to NERA Economic Consulting, in each filing year since 2015, more cases have been resolved in favor of the defendant than have been settled. In some cases, a litigation matter can last for several years. Typically, during the life of a lawsuit, newer cases are more likely to be dismissed while older cases are more likely to be settled.

Figure 7 presents trends in non-merger-securities-related case matter resolutions since 2012.

The relatively high percentage of pending cases from 2020 and 2021 is not surprising. However, the volume of pending cases from 2018 and 2019 is starkly different from pre-2018 levels.

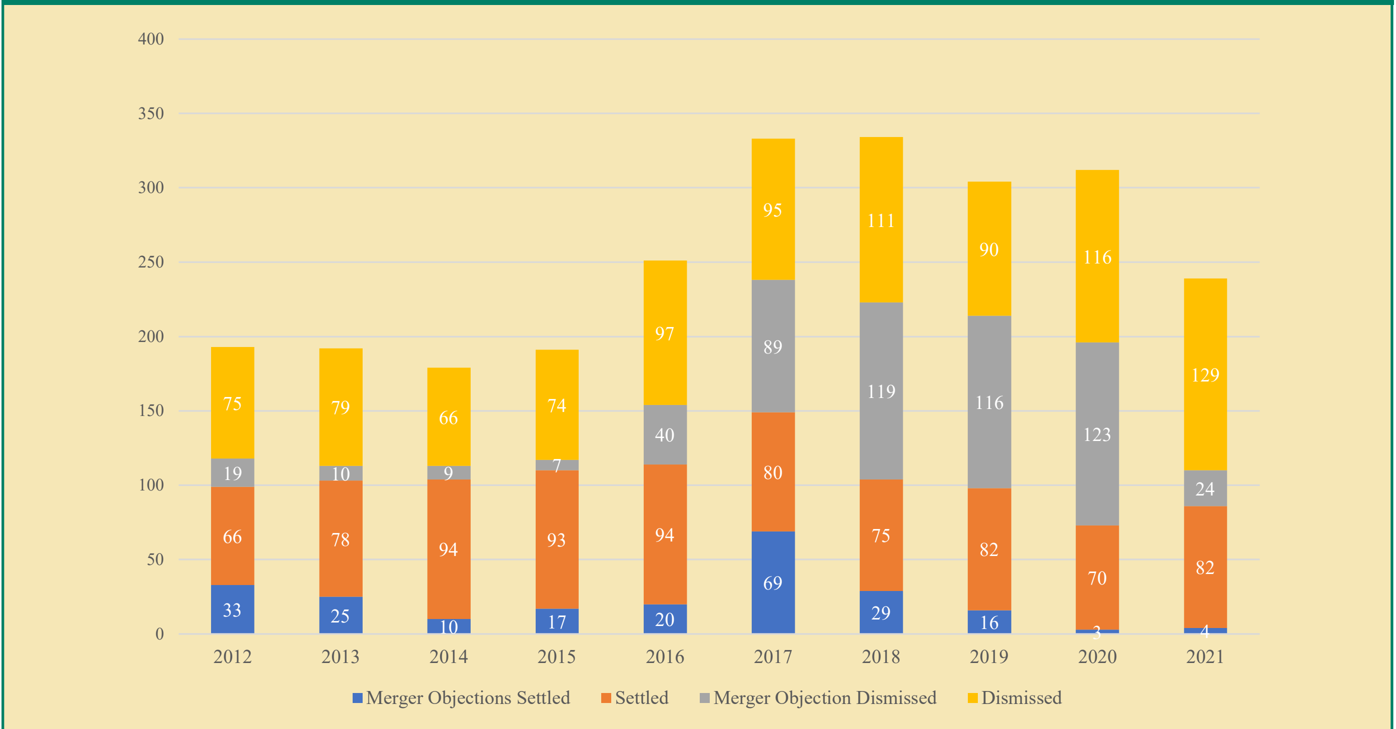
According to NERA Economic Consulting, of the cases filed from January 2003 through December 2017, only 17 percent have a life of more than four years.[20]

The increase in the number of pending cases in recent years suggests there is a significant backlog in the courts—which would be expected due to the current pandemic.

Settlements

According to NERA Economic Consulting, "In 2021, aggregate settlements amounted to $1.8 billion. This amount is $400 million lower than the inflation-adjusted $2.2 billion aggregate settlement amount in 2019, and considerably lower than the inflation-adjusted amounts of $3.1 billion and $5.2 billion in 2020 and 2018, respectively."[21]

Figure 6
Number of Class Action Lawsuits Resolved
Number of Cases by Year from 2012 to 2021



The median annual settlement amount for 2021 was approximately $8 million. This amount is a decrease from 2018, 2019, and 2020. Previously the median settlements, adjusted for inflation, were $14 million, $13 million, and $13 million, respectively.

Settlements in 2021 revolved around the technology services sector along with the health services and health technology sectors. Notable companies included within the top 10 securities class action settlements included Snap, Inc.; DaVita Inc.; Allergen plc; and Tableau Software, Inc.[22]

Summary and Conclusion

From 2017 through 2019, securities filings represented significantly more legal filings than in more recent years. However, in the past two years, the number of securities and derivative lawsuits decreased to more normal longer-term levels.

While the decrease in securities litigation has been attributed to a decrease in merger and acquisition filings, recent litigation activity has been bolstered by both:

1. increasing litigation related to SPACs and
2. issues tied to the COVID-19 pandemic.

Both issues represent new developments in the courts.

On one hand, the SPAC lawsuits involve boards of directors that are conflicted with fiduciary duty laws. On the other hand, COVID-19-related lawsuits continue to persist with the pandemic. Both developments suggest an increase in securities litigation activity for 2022.

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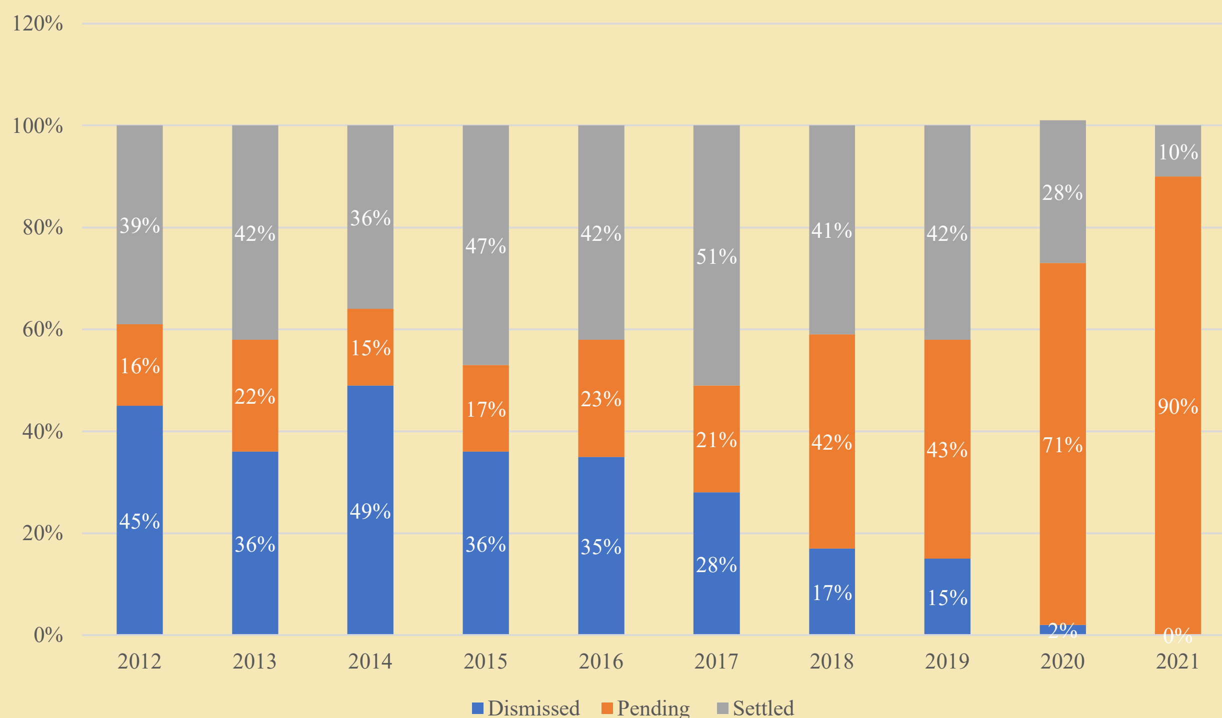
4. James McIntosh and Svetlana Starykh, “Recent Trends in Securities Class Action Litigation: 2021 Full-Year Review,” NERA Economic Consulting

Figure 7
Status of Nonmerger Securities Cases as a Percentage of Federal Securities Filings From 2012 to 2021



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18. McIntosh and Starykh, "Recent Trends in Securities Class Action Litigation: 2021 Full-Year Review," 10.
19. Ibid.: 11.
20. Ibid.: 12. From the time of the first complaint filing to resolution, only 17 percent of cases filed last longer than four years.
21. Ibid.: 17.
22. Ibid.: 19.

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ERISA Litigation Insights: *Walsh v. Bowers*

Nate Hesch

In Walsh v. Bower,[1] *the U.S. Department of Labor (the "DOL") sued Brian Bowers and Dexter Kubota, the former owners of Bowers + Kubota Consulting, Inc. ("B+K"). The DOL alleged that Bowers and Kubota had violated the Employee Retirement Income Security Act of 1974 ("ERISA") by manipulating data to induce the B+K newly formed employee stock ownership plan ("ESOP") to pay more than the company's fair market value. This judicial decision is noteworthy because it provides discussion of certain ERISA issues that other courts have avoided. This judicial decision provides practitioners with professional guidance as the DOL has not lost a major ESOP case on a valuation issue for over a decade.*

Introduction

On September 17, 2021, the judicial opinion was issued for *Walsh v. Bowers*. In that matter, the U.S. Department of Labor ("DOL") sued Brian Bowers and Dexter Kubota, former owners of Bowers + Kubota Consulting, Inc. ("B+K").

The DOL alleged that Bowers and Kubota had violated the Employee Retirement Income Security Act of 1974 ("ERISA") by manipulating data to induce the B+K newly formed employee stock ownership plan ("ESOP")to pay more than the company's fair market value.

The case was tried in the United States District Court for the District of Hawaii by Judge Susan Oki Mollway (the "District Court"). The District Court ultimately concluded that neither Bowers nor Kubota had violated his fiduciary responsibilities, nor were they liable for any damages owed to the B+K ESOP.

According to the defense experts, the District Court demonstrated a strong understanding of the underlying concepts of business valuation.[2] The judicial opinion echoed this statement. This judicial decision provides the practitioner with professional guidance regarding the application of important ERISA issues, particularly fiduciary duty, which other courts have avoided.

Case Background

B+K is an architectural and engineering firm based in Hawaii. B+K specializes in construction management, project management, architecture, civil engineering, and electrical engineering projects.[3]

B+K manages commercial, educational, government, infrastructure, and transportation projects from preliminary analysis and planning through complete design. The B+K award-winning work exists on all major islands of Hawaii and other areas of the Pacific Rim.

The firm was originally established in 1980 as KFC Airport, Inc. Brian J. Bowers purchased 100 percent of the shares of KFC Airport in 1997.

Dexter C. Kubota subsequently purchased a 49 percent interest in the firm from Bowers. After that time, the company became known as Bowers + Kubota Consulting, Inc.[4]

Prior Discussions of a Sale Transaction

From the period of 2008 through 2012, Bowers and Kubota explored selling B+K to several different types of buyers, including the following:

1. B+K management
2. Private parties
3. An ESOP

After ruling out a sale to B+K management, Bowers and Kubota entered into preliminary discussions with potential buyer URS Corporation ("URS"), a California-based engineering and design firm. In 2011, Bowers and Kubota discussed a possible purchase of B+K with URS. URS submitted a preliminary nonbinding indication of interest around December 5, 2011.[5]

The letter of interest stated that URS was interested in purchasing B+K for $15 million plus or minus "cash and debt on the B+K balance sheet." After considering cash and debt at the time, the indication of interest landed at about $29 to $30 million for 100 percent of the B+K equity.

Importantly, as will become relevant to the *Walsh v. Bowers* matter, URS stipulated in its letter that it did not constitute an offer: "If the proposal contained in this letter is acceptable to you, we are prepared to move to the next steps in the acquisition process, enter into an agreement for exclusivity for a period of 90 days, and begin initial due diligence."[6]

Bowers acknowledged and agreed to the terms of the letter (i.e., to begin the due diligence process and continue negotiations of the sale).

During discussions with URS, B+K retained a valuation analyst with GMK Consulting to provide a valuation of B+K "for internal use only." The valuation analyst concluded a fair market value for B+K of $39.7 million, about $10 million higher than the URS letter of intent implied.[7]

B+K delivered the business valuation to URS as a part of its negotiations.

However, the negotiations between URS and B+K ultimately ended by mid-2012, presumably because the parties were not able to agree upon a sale price. Bowers and Kubota, now over three years into its search to find a buyer, were back at square one.

Background of the ESOP Transaction

In late August 2012, Bowers and Kubota met with Gregory M. Hansen, an attorney with the Honolulu law firm of Case Lombardi & Pettit, to help with a potential ESOP transaction. On September 2, 2012, Bowers and Kubota signed a formal agreement with Hansen to draft preliminary plans.[8]

Soon thereafter, Bowers and Kubota concluded that they would form an ESOP for B+K.

The GMK Consulting valuation analyst withdrew from participating in a formal ESOP business valuation for Bowers and Kubota, stating they were "uncomfortable with the structure of the transaction."[9]

As a result, Bowers and Kubota were advised by Hansen to hire Greg Kniesel of LVA, a Chicago-based valuation firm to provide the formal business valuation.

On November 21, 2012, LVA sent the board of trustees of the proposed B+K ESOP and Trust a "preliminary fair market value of the common stock" of B+K. LVA's report appraised the ESOP controlling interest value between $37,090,000 and $41,620,000.[10]

LVA did not provide a final value to the board of trustees.

B+K hired Nicholas L. Saakvitne on November 26, 2012, to be the trustee of the ESOP on Hansen's referral. As trustee, Saakvitne's responsibilities included evaluating any proposed sales of the shares of B+K, negotiating terms on behalf of the ESOP in the sale, and continuing to serve as the ESOP's trustee thereafter.

Bowers and Kubota stood to benefit from tax advantages if the sale closed before the end of 2012.[11]

In addition, Hansen, who represented the Bowers and Kubota in the impending deal, had a vacation scheduled for late December. The approaching year end created a time crunch for Saakvitne to close the ESOP deal.

Bowers and Kubota, as board directors, officially formed the ESOP on December 3, 2012, and subsequently adopted the ESOP for B+K.

Saakvitne also hired Greg Kniesel of LVA to provide a business valuation of B+K for the ESOP, even though he had absolute discretion to hire any independent appraiser to perform the work.

The *Walsh v. Bowers* judicial opinion states that "on December 7, 2012, LVA changed its engagement letter to indicate that it was working for Nicholas L. Saakvitne." This decision became a concern identified in the DOL complaint.

The LVA business valuation report was sent to Saakvitne on December 14, 2012, and valued the company at $40,150,000.[12]

ESOP Transaction Description

Bowers and Kubota initially offered to sell B+K to the ESOP for $41 million and financed at a 10

percent interest rate over 20 years. Saakvitne countered, offering to pay $39 million and financed at a 6 percent interest rate over 25 years.

Bowers countered at $40 million and financed at 8 percent over 25 years. Finally, Saakvitne offered to buy B+K for $40 million and financed at 7 percent over 25 years, to which Bowers and Kubota agreed.[13]

On December 14, 2012, Bowers and Kubota, through their respective trusts, sold 100 percent of the B+K stock to the ESOP for $40 million. The ESOP was structured as a leveraged ESOP, receiving a loan from B+K to pay for the transaction with an interest rate of 7 percent over 25 years.

Saakvitne, the ESOP's independent fiduciary and trustee, executed the purchase agreement on behalf of the ESOP.

Overall, the deal was a straightforward leveraged ESOP transaction with few, if any, additional complicating considerations.

After four years of considerations and discussions, Bowers and Kubota had found a buyer for their company. However, between the failed deal with URS, business valuation from multiple valuation consultants, and the final transaction, the process had generated several indications of value, at times conflicting, and left open questions about the independence of the Saakvitne negotiations.

Post-ESOP-Transaction Developments

After Bowers and Kubota sold B+K, the employees, through the ESOP trust, became the owners of the company.

LVA submitted a valuation report for B+K as of December 31, 2012, just two weeks after the sale, valuing B+K at $6.53 million.[14]

The significant reduction in value of B+K was due to B+K now holding a large debt burden on its balance sheet as a result of the transaction. B+K had recorded this debt to finance the ESOP purchase of the company equity from Bowers and Kubota.

Bowers and Kubota filed Form 5500 with the Internal Revenue Service ("the "Service") in October 2013. Form 5500 is a required filing for employee benefit plans under ERISA, which describes basic details about the ESOP, such as contact information, employer identification number, and employee count.

Supplemental attachments described the ESOP transaction terms. The initial Form 5500 filing indicates to the Service and to the DOL that an ESOP has been formed.

Investigators at the DOL began reviewing the B+K transaction in December 2014 on the initial suspicion that the $40,000,000 sale price must have been predetermined and that the ESOP had paid significantly more than fair market value.

Particularly, the $40,000,000 value was a far stretch from the $15,000,000 (plus cash and minus debt) proposed by URS in 2011 and from the LVA valuation of B+K for $6,530,000 performed after the valuation date. At the time, the DOL did not recognize that the values were not reasonable representations of the fair market value of B+K.

The DOL filed a lawsuit against Bowers, Kubota, and Saakvitne on April 27, 2018.

Before trial, the DOL settled its claims against Saakvitne, the original trustee of the ESOP, and against the Saakvitne Law Corporation.

At trial, Bowers and Kubota argued in their defense that the three-year statute of limitations had begun when they filed the Form 5500 in October 2013.[15]

However, the DOL argued that the Form 5500 was not reviewed internally until December 2014.

The DOL and Bowers and Kubota had entered into a tolling agreement to toll the statute of limitations under ERISA from October 16, 2017, to April 30, 2018. As a result, the District Court sided with the DOL and concluded that the statute of

limitations was effectively extended beyond April 27, 2018, and the defense argument proved to be invalid.

The District Court Proceeding

The DOL complaint listed the following violations that it sought to redress:[16]

- Failure of Bowers and Kubota to discharge fiduciary duties with the proper care, skill, prudence, and diligence in violation of ERISA, specifically as follows:
  - Fiduciary duty related to a 2012 revenue prediction
  - Fiduciary duty related to 2013 through 2017 revenue predictions
  - Fiduciary duty by relying on LVA's "preliminary and fairness opinion"
  - Fiduciary duty by causing the ESOP to purchase the company shares for more than fair market value
  - Fiduciary duty to monitor Saakvitne
- Bowers and Kubota are liable for breaches of fiduciary duty by other fiduciaries, including the following:
  - Liability for each other's provision of allegedly inaccurate financial data to LVA in 2012
  - Liability for each other's failure to monitor Saakvitne
  - Liability for behavior by any other fiduciary that caused or contributed to payment by the ESOP of more than fair market value for the company
- Bowers and Kubota are liable for engaging in transactions prohibited by ERISA as follows:
  - Engaging in prohibited transactions between a plan and a party in interest
  - Engaging in prohibited transactions with the ESOP
- Bowers and Kubota are liable for knowingly participating in transactions prohibited by ERISA

The DOL complaints significantly relied upon the argument that Bowers and Kubota caused the ESOP to pay more than fair market value for B+K. The fair market value of the company, in turn, relied on the accuracy of revenue predictions for 2012 through 2017.

The Trial Court opinion in this case also provides a robust discussion of certain issues related to fiduciary duty.

Valuation Issues

The Trial Court qualified three expert witnesses to opine on the fair market value of B+K as of December 14, 2012, the ESOP transaction closing date:

1. A financial expert on behalf of the DOL
2. Two financial experts on behalf of the defense

2012 Revenue

The DOL argued that Bowers and Kubota provided inflated earnings and revenue projections for fiscal 2012 to their consultant, LVA, which contributed to an inflated fair market value conclusion.

Bowers and Kubota provided a 2012 earnings before interest, taxes, depreciation, and amortization ("EBITDA") of $9,235,000, while the DOL concluded that an EBITDA of $4,849,000 was more appropriate.

The District Court found, after taking into account relevant circumstances, that the DOL failed to prove that Bowers or Kubota breached their fiduciary duty based on the 2012 EBITDA projection. According to the defendants' experts, the DOL did not consider the upward trend in EBITDA, the size of the B+K contract backlog, and how certain contract accounting influenced the projection.[17]

B+K management had produced a detailed analysis of its contract backlog to support its projections that pointed towards a backlog of approximately $54,000,000. In comparison to 2011 revenue of $22,005,000, the backlog indicated over two years of work booked in advance, a strong indication of future income.

The DOL expert used an estimate of $17,000,000 in contract backlog, which would indicate weaker future earnings potential.

The defendants' experts stated after the case that the plaintiff's expert used increased operating expenses. They went on to describe that plaintiff's expert was likely assuming that increased earnings and revenue would result in increased operating expenses.

However, certain accounting rules for its contracts meant that subconsultant expenses charged in its contracts passed through the B+K accounting books. These rules can effectively result in one-for-one increased (or decreased) revenue and expense.

The plaintiff's expert applied adjustments to its valuation to increase subconsultant operating expenses without applying a corresponding adjustment to revenue, violating the relationship between these entries on the B+K income statement.

The District Court ultimately rejected the DOL claim that 2012 earnings were inflated and as a result found that neither Bowers nor Kubota had breached its fiduciary duties.

2013 through 2017 Revenue

The District Court determined that Bowers and Kubota also did not breach their fiduciary duty related to 2013 through 2017 projections. It is likely that this DOL complaint was contingent upon similar adjustments to the 2012 revenue figure and, therefore, collapsed when that argument was struck down.

Fair Market Value of B+K

The District Court quickly realized that the two value indications on which the DOL originally based its complaint—$15,000,000 (plus cash and minus debts) proposed by URS in 2011 and the LVA business valuation of B+K for $6,530,000 performed after the valuation date—were not suitable comparisons for the fair market value of B+K.

With respect to the URS proposal, the District Court also understood the URS proposal to be an opening offer to commence negotiations, not a closing sale price. The District Court provided the analogy of "an individual who makes an offer of $15,000 for a used luxury car with a Blue Book value of $40,000 does not, by virtue of making a 'lowball' offer that is never accepted, tend to establish that the car is worth only $15,000."[18]

The plaintiff's financial expert testified that the fair market value of B+K on the transaction date was $26,900,000. The plaintiff's expert valuation consisted of an initial fair market value of $32,197,000 less a 7 percent discount for lack of marketability and an additional $2,994,000 discount for the ESOP's lack of "limited control."[19]

One of the defendants' experts testified that the plaintiff expert failed to follow the *Uniform Standards of Professional Appraisal Practice* in developing its valuation. The defendant expert stated that the plaintiff expert did not perform sufficient research, such as conducting an interview of B+K management, and as a result his analysis suffered from certain missing accounting considerations related to the subconsultant expense pass-throughs.

Additionally, the defendants' expert argued that the plaintiff's expert was mistaken to apply a discount for the ESOP's lack of "limited control."

The plaintiff's expert based the discount on the argument that Bowers and Kubota themselves continued to exercise meaningful control of B+K after the transaction, evidenced by significant bonuses the company paid them without documenting approval by Saakvitne.

The judicial opinion recognizes that an ESOP is subject to limitations in its control relative to an independent buyer. However, the opinion also raises the defendant expert's argument that the plaintiff's rationale relies on bonuses paid after the sale and were not known or knowable as of the transaction date. The judicial opinion in this matter does not definitively conclude whether or not a discount for lack of control was appropriate.[20]

This control issue raises interesting questions, including whether B+K was aware of these bonuses at the time of the transaction; what degree of control Bowers and Kubota retained as managers after the transaction, whether these bonuses truly implied a degree of control over B+K, and under what circumstances a valuation analyst may rely on facts available only after the valuation date (for instance, it is likely that management would have an understanding of fiscal 2012 management bonuses on December 14, 2012).

However, the judicial opinion does not address these issues and does not further explore these questions as the DOL's fair market value indication

was already severely weakened by its error related to the subcontract expenses.

The defense expert provided additional testimony that the plaintiff expert undervalued B+K in aggregate by $13,515,000 ($10,521,000 related to the subcontract expenses and $2,994,000 related to an inappropriate discount for lack of control). Adjusting for these factors from the plaintiff expert's value of $26,900,000 results in a fair market value of B+K of $40,415,000, which exceeds the sale price.

The defendants' financial experts both concluded fair market values of the company greater than the sale price. One of the defendants' experts concluded a value of $43,200,000 and the other one of the defendants' experts concluded a value of $43,050,000.[21]

Fiduciary Duty

Since many of the complaints outlined by the DOL were based in the fiduciary responsibilities within ERISA and corresponding 29 U.S.C. Section 1104(a)(1), carried by Bowers, Kubota, and Saakvitne, the District Court provided a case review and discussion of fiduciary duty in its opinion.

The District Court cited conclusions from several Ninth Circuit cases, including the following citations:[22]

- "ERISA defines 'fiduciary' not in terms of formal trusteeship, but in functional terms of control and authority over the plan." (*Johnson v. Couturier*, 9th Cir. 2009)
- The Ninth Circuit "construe[s] ERISA fiduciary status 'liberally, consistent with ERISA's policies and objectives." (*Arizona State Carpenters Pension Trust Fund v. Citibank*, 9th Cir. 2015)
- "We have repeatedly stated that ERISA is remedial legislation that should be construed liberally to protect participants in employee benefits plans." (*Batchelor v. Oak Hill Medical Group*, 9th Cir. 1989)
- "ERISA fiduciary responsibilities thereunder, can exist even where a formal employee benefit plan ha[s] not been adopted." (*Solis v. Webb*, N.D. Cal. 2012)

The District Court determined that fiduciary responsibility applied to Bowers and Kubota from June 2012, when the ESOP was first proposed, to December 3, 2012, the date on which Bowers and Kubota formed the ESOP.[23]

The District Court conclusions related to the valuation issues resulted in the dismissal of a set of the DOL's fiduciary duty complaints. Two complaints were not immediately dismissed and required further scrutiny.

First, the complaint stated that Bowers and Kubota breached their fiduciary duty by relying on the LVA preliminary and fairness opinion.

The complaint implied that the LVA opinion included misstatements and errors which Bowers and Kubota should have identified prior to the transaction. The Bowers and Kubota failure to identify the alleged misstatements would have caused the ESOP to pay more than fair market value for B+K.

However, the District Court concluded that since the DOL failed to prove that the fair market value of B+K was less than the sale price of $40 million, the DOL does not have further basis to argue that the LVA opinion included misstatements and errors.[24]

If the DOL had identified a specific issue with the LVA analysis, then further arguments could have been contemplated. However, the DOL allegation relied on a gross difference in fair market value, not a specific issue. As a result, by failing to present a different fair market value for the company, the DOL failed to meet the burden of establishing a breach of fiduciary duty.

Monitoring the ESOP Trustee

The second DOL complaint was related to the Bowers and Kubota fiduciary duties to monitor the trustee, Saakvitne. Throughout the case, the DOL contested actions taken by Saakvitne, though these actions were not litigated in court as Saakvitne settled separately prior to the trial.

Therefore, the *Walsh v. Bowers* judicial decision focuses on the Bowers and Kubota responsibilities to monitor Saakvitne.

The District Court acknowledged that Bowers and Kubota, according to the ESOP agreement, held the power to appoint and remove a trustee.[25] Consequently, Bowers and Kubota held the fiduciary duty to monitor the ESOP trustee pursuant to both the ESOP agreement and ERISA guidance from the DOL.

Saakvitne was accused of not conducting due diligence in its preparations to buy B+K on behalf of the ESOP. The DOL alleged that this was, in part, the fault of Bowers and Kubota. Bowers and Kubota placed an unreasonable time frame on Saakvitne to close the transaction.

Saakvitne was hired on November 26 and Hansen had indicated he was leaving for vacation on December 19. The argument continues that this short time line forced Saakvitne to hire LVA as a valuation consultant since LVA had already developed

a fair market value analysis for Bowers and Kubota.

This analysis, according to the DOL position, was developed with errors or misstatements.

In short, the District Court found that the ESOP stood to benefit from tax advantages if the deal closed by the end of 2012.[26] Therefore, Saakvitne had a reasonable basis for closing the transaction before the end of the year.

In the Bowers and Kubota defense, they stated that no hard requirement was ever imposed by them that the deal close by the end of 2012, even though it was to their advantage.

The District Court concluded that the DOL failed to prove a breach of fiduciary duty by Bowers and Kubota on this issue.

In another allegation of breach of fiduciary duty, the DOL suggested that Bowers, Kubota, and Saakvitne conspired to arrange a sale price of $40 million.

In the opinion, the District Court stated that "the Government's concerns are understandable. The Government was looking at a high sale price that had been shared ahead of time with the ESOP trustee. But knowing what a seller wants does not make a buyer complicit in wrongdoing."[27]

In addition, Saakvitne fought for a favorable interest rate on the loan to the ESOP, an important consideration not reflected in the sale price alone. Once again, the District Court concluded that the DOL did not meet its burden of proof on this issue.

Summary and Conclusion

The *Walsh v. Bowers* judicial decision stands out among the canon of ESOP litigation as the DOL has not lost a major ESOP case on a valuation issue for over a decade.[28]

Many of the DOL complaints relied on the allegation that the fair market value of B+K was significantly overvalued. Naturally, this allegation implied that the ESOP trustee did not conduct due diligence or knowingly relied on an inaccurate appraisal.

However, as the District Court proceeding revealed, neither of the values that the DOL initially based its allegations on—the URS proposal and the December 31, 2012, valuation—accurately reflected a sale price that would occur between a willing buyer and seller with reasonable knowledge of relevant facts.

As a result of the findings related to the fair market value of B+K, the District Court concluded that the sale price did not exceed the fair market value of the company.

In other words, the valuation prepared by the DOL expert did not convince the District Court that the transaction price was inconsistent with the fair market value of the company. Therefore, the plaintiff's fair market values were not relied upon by the District Court.

Like a house of cards, the remaining allegations against Bowers and Kubota fell down largely as a consequence of this foundational blow to the DOL case.

Notes:

1. Walsh v. Bowers, ––– F.Supp.3d –––, 2021 WL 4240365 (D.Hawai'i 2021).
2. Ian C. Rusk and Kenneth Pia, "Landmark ESOP Ruling: Inside the Walsh v. Bowers Case with the DOL," Training Event Transcript, Business Valuation Resources (November 2, 2021): 10.
3. https://www.bowersandkubota.com/about/
4. Walsh v. Bowers, 2021 WL 4240365 at *2.
5. Id. at *4.
6. Id.
7. Id. at *5.
8. Id. at *6.
9. Id.
10. Id. at *7.
11. Id. at *6.
12. Id. at *9.
13. Id. at *8.
14. Id. at *12.
15. Id. at *16-18.
16. Id. at *18–26.
17. "An Inside Look at the Landmark ESOP Valuation Case," *Business Valuation Update* 27, no. 12 (December 2021): 19–21.
18. Walsh v. Bowers, 2021 WL 4240365 at *5.
19. Id. at *12.
20. Id. at *14.
21. Id. at *14–15.
22. Id. at *19–20.
23. Id. at *20–21.
24. Id. at *22.
25. Id.
26. Id. at *23.
27. Id. at *24.
28. "An Inside Look at the Landmark ESOP Valuation Case": 19.

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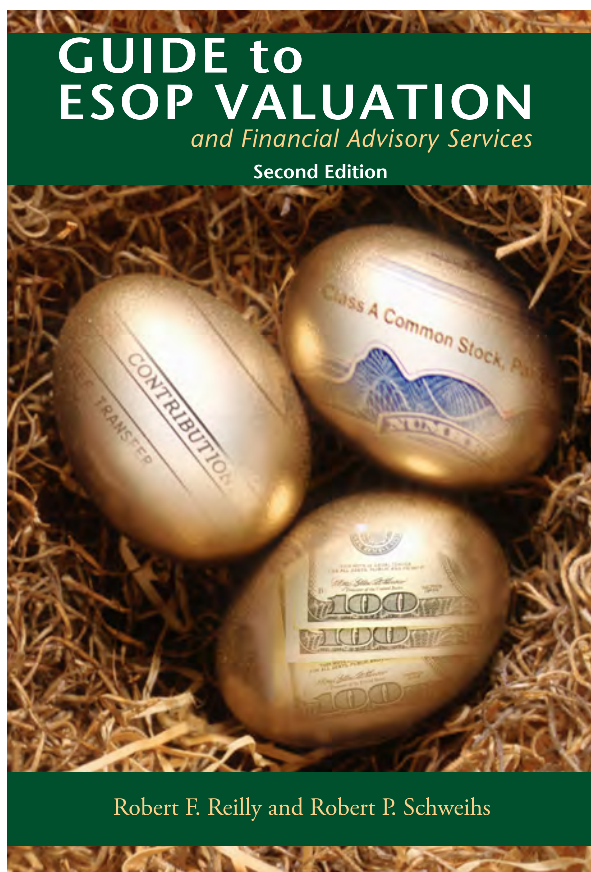

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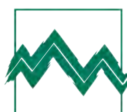

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and Financial Advisory Services

Second Edition

Robert F. Reilly and Robert P. Schweihs

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Damages Analysis and the Cost of Equity Capital Size Premium

Kevin M. Zanni

Damages analysts routinely develop damages measurements that include income projections and apply a present value discount rate. Such damages measurements often include lost profits method analyses. Such damages measurements also include cost to cure method analyses and reasonable royalty rate method analyses. One of the typical components of the discount rate measurement in the damages analysis is the estimation of cost of equity capital. The measurements of many of the cost of equity capital components are typically not controversial in the damages measurement discount rate calculation. The measurement of the size risk premium component of the cost of equity capital can sometimes result in a disagreement among practitioners with regard to the discount rate calculation. This discussion summarizes many of the damages analyst considerations with regard to the measurement of the equity size risk premium. This equity size risk premium is one component of the present value discount rate calculation that is developed as part of the damages measurement analysis.

Introduction

Damages analysts routinely develop damages measurements that include income projections and apply a present value discount rate. Such damages measurements include lost profits method analyses. Such damages measurements also include cost to cure method analyses and reasonable royalty rate method analyses.

One typical component of the discount rate measurement in the damages analysis is the cost of equity capital estimation. The measurements of many of the cost of equity capital components are typically not controversial in the damages measurement discount rate calculation.

The measurement of the size risk premium cost of equity capital component can sometimes result in disagreement with regard to the discount rate calculation. This discussion summarizes the damages analyst considerations with regard to the measurement of the equity size risk premium. This equity size risk premium is one component of the present value discount rate calculation developed as part of the damages measurement analysis.

The cost of equity capital is a foundational component of the present value discount rate used in many lost profits method analyses and many other damages measurement analyses. Some of the generally accepted cost of equity capital estimation models applied in the damages measurement process include the build-up rate model and the modified capital asset pricing model ("MCAPM").[1]

As a component of these generally accepted models, analysts often include a size risk premium—or alpha adjustment factor—as part of the cost of equity estimation procedure.

This discussion considers the following topics:

1. Empirical evidence supporting the size premium adjustment
2. Observations regarding the size premium

3. Observations regarding the Center for Research in Security Prices ("CRSP") size premium 10th decile category
4. Liquidity issues that may account for the size premium

A typical formula for the build-up model ("BUM") to estimate the cost of equity capital follows:

$$K_e = R_f + ERP + IRP + SRP + \alpha$$

where:

K_e = Cost of equity capital
R_f = Risk-free rate of return
ERP = Long-term equity risk premium
IRP = Industry-related equity risk premium
SRP = Size-related equity risk premium
α = Unsystematic equity risk premium

There is a general consensus among damages analysts as to the appropriate risk-free rate of return to use in the BUM. Damages analysts typically select and apply the market yield on the 20-year U.S. Treasury bond as the risk-free rate of return component.

For certain damages analyses, the investment duration may be less than 20 years and an analyst may select a risk-free rate of return with an investment duration commensurate with the specific investment duration.

The selected long-term equity risk premium ("ERP") is not as consistently applied among analysts. Certain damages analysts advocate the use of a more normalized equity risk premium, of say 5 percent. Other analysts elect to use the variables included in the CRSP Decile Size Premium Study published in the *2017 Valuation Handbook – U.S. Guide to Cost of Capital* ("*Valuation Handbook*") in Appendix 3.[2]

The *Valuation Handbook* ERP data are typically cited, providing an estimated ERP premium of around 6 percent.

Other components of the BUM cost of equity estimate often include an industry-related equity risk premium, a size-related equity risk premium, and an unsystematic equity risk premium. By adding an industry-related risk premium, general industry risk is incorporated in the cost of equity.

This general industry risk premium is not specifically addressed in the long-term equity risk premium component. The industry risk component of the build-up cost of equity capital incorporates systematic risk, in much the same way that beta incorporates industry risk in the capital asset pricing model ("CAPM").

The next two components of the BUM are the size-related equity risk premium and the unsystematic equity risk premium. An overview of the size-related equity risk premium is presented later in this discussion.

The unsystematic equity risk premium component is often applied by analysts. This component is used to incorporate risk that is specific to the subject investment—that is, lack of management talent, potential labor issues specific to the damaged party, potential of losing a key client or key personnel, and/or potential cost/risk not identified in financial projections, and so forth.[3]

The basic CAPM formula for estimating the cost of equity capital for publicly traded security analysis follows:[4]

$$K_e = R_f + [\beta \times ERP]$$

where:

K_e = Cost of equity capital
R_f = Risk-free rate of return
β = Industry beta
ERP = Long-term equity risk premium

Damages analysts apply many of the same components in the CAPM formula that are used in the BUM. That is, it is typical for damages analysts to rely on the same risk-free rate of return and long-term equity risk premium component factors when applying both the BUM and the CAPM to estimate the cost of equity. The one distinguishing CAPM factor is beta.[5]

Beta, in general terms, is used to incorporate market risk (general equity risk and industry risk) in an equity cost of capital estimate. As a best practice, it is often important to examine multiple lookback periods and frequencies when determining a beta estimate.

Ultimately, the goal of the damages analyst should be to estimate a beta that fairly represents the systematic risk and stock price variability of the subject company as compared to the broad equity market, over a relevant time period. The damages analyst should keep in mind that the beta estimate is the mean of a statistical distribution that results from a regression analysis.

Some of the factors that a damages analyst may consider when examining multiple beta estimates include the following:

1. The mean of each distribution
2. The relationship between the means of each distribution
3. The dispersion about the mean for each distribution
4. The relationship between the dispersions about the means of each distribution

Further adjustments to CAPM may include:

1. the size-related equity risk premium component and
2. the unsystematic equity risk premium component.

By including these alpha adjustments, the CAPM becomes the MCAPM.

The MCAPM formula for estimating the cost of equity capital for use in an income-related damages measurement analysis is presented as follows:

$$K_e = R_f + [\beta \times ERP] + SRP + \alpha$$

where:

K_e	=	Cost of equity capital
R_f	=	Risk-free rate of return
β	=	Industry beta
ERP	=	Long-term equity risk premium
SRP	=	Size-related equity risk premium
α	=	Unsystematic equity risk premium

The MCAPM and the BUM provide generally consistent and easy to replicate cost of equity capital calculations.

Size Risk Premium and Why It Should Be Applied

Based on empirical observation, it is generally accepted that small companies present a greater investment risk than larger companies do. Therefore, smaller companies typically have a greater cost of capital than do larger companies. In other words, there is a significant (negative) relationship between size and historical equity returns.

It is also generally accepted that small companies have certain risk characteristics that are more prevalent than in larger companies.

These small company risk characteristics include the following:

1. Potential competition issues (it is easier to enter the market and compete with small companies, while larger companies have resources to mitigate competitive challenges)
2. Economic issues and concern (larger companies can better cope with economic downturns than small companies)
3. Limited access to capital (small companies can find it difficult to obtain funding while larger companies typically have more options for funding)
4. Management depth concerns (large companies do not have key employee concerns in the same way that smaller companies do)
5. Customer concentration and product concentration risk (small companies are typically not as diversified in product offerings and are often beholden to a small group of customers)
6. Liquidity concerns and lack of market coverage (small companies do not enjoy the same level of analyst coverage and small company stock is typically less liquid than larger companies)

Rolf Banz, in a 1981 study, is credited and commonly cited for his research focusing on the empirical relationship between equity return and the total market value of NYSE common stocks.

According to Banz, smaller firms have higher risk-adjusted returns, on average, than larger firms. For the approximately 40 years covered in the study, on average, small firms recorded larger risk-adjusted returns than large firms traded on the NYSE. The Banz study found that the size effect did not exhibit linear attributes; however, the size effect was found to be more pronounced in smaller firms.

Another noteworthy finding in the Banz study was that the study suggests no theoretical foundation for the size effect. It concluded no determination as to whether the size effect factor is due to size itself or whether size is just a proxy for one or more true but unknown factors correlated with size. According to Banz, the size effect exists but it is not clear why it exists.

The Kroll—formerly Duff & Phelps—Cost of Capital Navigator is one reference source for measuring the size risk premium adjustment. The Cost of Capital Navigator provides empirical evidence of the size premium phenomena. The Cost of Capital Navigator is a web-based resource that provides certain cost of equity capital components.

The Cost of Capital Navigator defines the size premium as the difference between actual historical excess returns and the excess return predicted by beta (referred to as the "CRSP size premium").[8]

Exhibit 1 presents empirical evidence of the CRSP size premium, as published in the most recent *Valuation Handbook*.[9] As presented in Exhibit 1, the empirical data illustrates stock market returns by size decile for the 1926 to 2020 time period.[10]

Exhibit 1
Current 10 Decile Statistics
As of December 31, 2020

Decile	Market Capitalization (in $ millions)	Geometric Mean (%)	Arithmetic Mean (%)	Standard Deviation (%)
1 - Largest	29,025.8 to 1,966,078.9	9.67	11.39	18.77
2	13,178.7 to 28,808.1	10.73	12.93	21.22
3	6,743.4 to 13,177.8	11.18	13.65	23.06
4	3,861.9 to 6,710.7	10.99	13.85	25.19
5	2,445.7 to 3,836.5	11.44	14.48	25.79
6	1,591.9 to 2,444.7	11.49	14.84	26.72
7	911.6 to 1,591.8	11.82	15.53	28.62
8	452.0 to 911.1	11.43	15.84	32.37
9	190.0 to 451.8	11.67	16.91	36.50
10 - Smallest	2.2 to 189.8	13.3	20.04	41.69

Source: Kroll Cost of Capital Navigator

The annual stock market returns are separated into 10 deciles based on market capitalization. As the deciles get smaller, from 1 to 10, the historical stock market returns increase. The standard deviation of stock return portfolios also increases as the deciles get smaller.[11] This increase in the standard deviation reflects noise in the data.

A review of Exhibit 1 indicates that the most statistical data noise in the 10 decile stratification is in the 10th decile classification.

Other empirical evidence, in support of the small capitalization size premium adjustment, is provided by international equity market data. For example, in the United Kingdom, a study conducted using its equity markets concluded a small capitalization stock premium of around 7 percent.[12]

The U.K. study was conducted using equity market data from 1955 to 1984.

In 2015, an equity risk premium analysis study of small capitalization stocks in 23 global markets was conducted by Dimson, March, and Staunton.[13]

In the 23 global equity markets, small cap stocks outperformed in every market except for Norway, Finland, and the Netherlands. In general, evidence of the small capitalization stock premium is more prevalent in developed markets than in emerging markets.

Size Risk Premium and Certain Factors to Consider

There are several observations regarding the data used to calculate the size risk premium adjustment. A few of these observations include the following:

- The small capitalization premium has disappeared in recent years.
- A premium is unduly influenced by stocks with less than $5 million in market capitalization.
- The supporting data are too noisy to calculate a meaningful size premium estimate due to the evidence of significant standard errors and seasonality.
- There may be other factors than size that contribute to greater small capitalization stock returns compared to large capitalization stock returns, such as:
  - bid/ask spread bias,
  - delisting bias,
  - transaction costs, and
  - liquidity.

It is generally accepted that the small capitalization stock premium was observable prior to 1980. However, it appears that the small capitalization stock premium has decreased since 1981.[14]

The Horwitz study found that during the period of 1963 to 1981, the annualized return difference between small and large firms was greater than 13 percent.[15]

However, the study also found that, during the period of 1981 to 1997, the annualized difference was negative 2 percent.[16]

Perhaps the reason for the small capitalization risk premium decrease is twofold:

1. Market corrections induced by investor understanding of the small capitalization premium phenomena
2. External economic and technological changes in the way the securities are bought and sold

As suggested in the Horowitz study, a trend toward passive investing using index funds that give more weight to large capitalization stocks may be a reason for increases in capital gain performance of large capitalization stocks.[17]

Because small capitalization stock performance as compared to large capitalization stock performance over short-term duration is typically more erratic, measurement over a longer term is preferred. For holding measurement periods of 1 year, 5 years, 10 years, 20 years, and 30 years, small capitalization stocks outperform large capitalization stocks a majority of the time—measured from 1926 to 2016.[18]

As the measurement period increases, so does the likelihood of small capitalization stock outperformance of large capitalization stocks.

Small capitalization stock performance is cyclical, and cyclicality should be expected. Small capitalization stock returns are variable and somewhat volatile. According to one analyst, if small companies always earned more than large companies, then small companies would not be a riskier investment endeavor in the aggregate.[19]

It is also noteworthy that bond prices occasionally outperform equities. In 2014, long-term U.S. government bonds outperformed the S&P 500 Index by 10 percent.[20]

Even over a long period of time, which provides the strongest support for the existence of a small cap premium, the Horowitz study found that removing stocks with less than $5 million in market capitalization causes the small firm effect to vanish.[21]

According to the Horowitz study, the percentage of companies with stock prices of less than $2 per share was greater in the period of 1982 to 1997 than in the period of 1963 to 1981.[22]

In the smallest decile, 11.7 percent of companies traded at prices less than $2 a share between 1963 to 1981. In the 1982 to 1997, the percentage of companies traded at prices less than $2 per share in the smallest decile was 29.7 percent.

In general, historical equity returns exhibit unpredictable variability. Estimates of security risk using historical equity returns reflect noise in the form of large standard errors.[23]

As presented in Exhibit 1, as decile classifications of stock increase—correlated with smaller capitalization stocks—the standard deviation increases. The standard errors by decile class suggest that the small capitalization premium is fragile—almost to the point of lacking statistical significance.[24]

The January effect, seasonality of small capitalization stock returns, is a well-documented phenomenon. The January effect is described as the empirical observation that rates of return for small stocks have, on average, performed better in January than in other months of the year.[25]

In the Horowitz study, the average monthly return in the month of January for small capitalization stocks was 10.20 percent as compared to 0.73 for the average monthly return for February to December.[26]

The Horowitz study calculated the premium using NYSE, AMEX (now NYSE MKT), and Nasdaq stock returns for the period of 1963 to 1997. Other studies have reached similar conclusions. Although the January effect is interesting, it does not disprove that a size premium exists.

It is an unsettled discussion point that the bid/ask spread adds a certain bias to stock returns.[27] This observation is primarily focused on less liquid companies that have larger bid/ask spreads.

Most of the small-size effect studies (such as the SBBI equity study previously prepared by Morningstar, the CRSP equity study previously prepared by Duff & Phelps, and the CRSP equity study now prepared by Kroll) use the CRSP database, which relies on the closing stock price to measure rates of return.

For thinly traded stocks, the ask price is not always a realistic price. Because the small-size effect studies measure size using portfolio returns calculated on a monthly basis, one publication suggests the bid/spread bias issue has only a trivial impact on the small stock risk premium.

Some observers suggest that a delisting bias exists in the Morningstar decile size premium calculations due to its use of the CRSP database without adjustment.[28]

The reason for this possible bias is because the CRSP database information is allegedly missing prices for certain securities in the period immediately after these certain securities are delisted from a stock exchange.

According to the CRSP, as concluded in a CRSP white paper, the so-called delisting bias is greatly exaggerated.[29]

A few observers have suggested that the size effect is not relevant because various studies have ignored transaction costs in measuring rates of return.[30]

The primary observation is that small capitalization stocks often have higher transaction costs than large stocks. Because of the higher transaction costs for small capitalization stocks, it is possible that the historical small-stock-related size risk premium would be reduced if transaction costs and holding periods were factored into the measurement of rates of return.

As published in the *Cost of Capital*, 5th edition, Ashok Abbott prepared a study of transaction costs by decile for securities listed on the NYSE, AMEX, and the Nasdaq from January 1993 to December 2008. The securities trading cost was estimated as the difference between the daily holding return (closing price to closing price) and the daily trading return (ask price from the previous day to the bid price of the current day).

As presented in Exhibit 2, as company size decreases, the average daily trading cost, as a percentage of the trade, increases. The study found that larger firms are traded at lower costs and are subject to less pricing pressure than smaller firms.

Abbott also prepared an analysis of trading costs as differentiated by liquidity. The results of the Abbott study suggest that as company liquidity decreases, trading costs increase. Another notable finding of the Abbott study indicates that the least liquid stocks comprise the smallest market capitalization size-related decile.

Exhibit 3 presents the Abbott study analysis of liquidity and trading costs.

A discussion of stock liquidity and the equity size premium is presented in more detail below.

CRSP Size Premium 10th Decile Category Considerations

The companies that comprise the CRSP size premium 10th decile category have equity market capitalizations that range from $2.2 million to $189.8 million. As of December 31, 2020, the risk premium related to the companies comprising the 10th decile was 5.01 percent.[31]

The companies that comprise the CRSP size premium 10th decile are broken down into subcategories 10a and 10b, as presented in the Cost of Capital Navigator. The companies that comprise the 10a subdecile include companies with market capitalizations between $96.6 million and $189.8 million, and the reported size premium is 3.49 percent.[32]

The companies that comprise the 10b subdecile include companies with market capitalizations between $2.2 million and $95.2 million, and the reported size premium is 8.12 percent.[33]

Within the 10a subdecile and 10b subdecile categories of the 10th decile, the Cost of Capital Navigator presents more subcategories. The 10a subdecile is broken into 10w and 10x subdeciles, while the subdecile 10b is broken into 10y and 10z.

Exhibit 4 presents the Cost of Capital Navigator, CRSP size premium 10th decile subdecile category market capitalizations, and size risk premiums subcategory breakdown.

As presented in Exhibit 4, companies that are classified in the CRSP size premium 10th decile vary considerably in market capitalization and applicable size risk premium. The size risk premium ranges from 2.60 percent to 11.29 percent, a spread of 8.69 percent, or 869 basis points.

As presented in Exhibit 4, as the size of the company increases, its size risk premium decreases. That is why it is important to correctly interpret and apply the size risk premium component of the MCAPM—assuming an analyst applies an equity size risk premium adjustment.

According to the Cost of Capital Navigator, "The CRSP Deciles Size Premia include all companies with no exclusion of speculative (e.g., start-up) or distressed companies whose market capitalization may be small because they are speculative or distressed."[34]

The distressed company issue can be seen through analysis of the 10th decile subcategories of 10y and 10z. For example, the average company in the 10y subcategory typically records a negative net income. In some years, the average of the decile subcategory 10y and 10z companies also recorded negative earnings, before, interest, taxes, depreciation, and amortization ("EBITDA").

Exhibit 5 presents financial statistics related to the CRSP size risk premium 10th decile subcategories 10y and 10z as published in the *Valuation Handbook* for 2014 and 2017, and in the Cost of Capital Navigator for 2020.

As presented in Exhibit 5, the companies that populate subcategory 10y and 10z are, on average, recording negative net income. In many cases, the companies that populate subcategory 10y and 10z are recording negative EBITDA.

Exhibit 2
Average Trading Costs by Market Value of Equity Decile
For the Period of January 1993 to December 2008

Market Value of Equity Portfolio	Average Daily Trading Cost
1 - Largest Companies	0.75489%
2	1.07736%
3	1.33369%
4	1.67466%
5	2.05954%
6	2.50398%
7	3.16594%
8	4.13995%
9	5.57523%
10 - Smallest Companies	9.67356%

Source: *Cost of Capital* , 5th ed., 367.

Exhibit 3
Average Trading Costs Based on Equity Liquidity
For the Period of January 1993 to December 2008

Decile by Liquidity	Average Daily Trading Cost
1 - Most Liquid Companies	1.48241%
2	1.82615%
3	2.02649%
4	2.15579%
5	2.28703%
6	2.47802%
7	2.73914%
8	3.03041%
9	3.73256%
10 - Least Liquid Companies	5.60277%

Source: *Cost of Capital* , 5th ed., 368.

Exhibit 4
10th Decile Subcategories
As of December 31, 2020

10th Decile Subcategory	Market Capitalization	Equity Size Premium
Decile 10w	$138.8 Million to $189.8 Million	2.60%
Decile 10x	$96.6 Million to $137.9 Million	4.65%
Decile 10y	$46.9 Million to $95.2 Million	6.60%
Decile 10z	$2.2 Million to $46.9 Million	11.29%

Source: Kroll Cost of Capital Navigator.

Exhibit 5
10th Decile Subcategories 10y and 10z
Statistics as of September 30, 2013, 2016, and 2019

	Percent of Subcategory	Market Value of Equity (in $ Millions)	Market Value of Invested Capital (in $ Millions)	Sales (in $ Millions)	5-Year Average Net Income (in $ Millions)	5-Year Average EBITDA (in $ Millions)
As of September 30, 2013:	95th Percentile	181.19	566.53	734.63	12.99	80.76
10th Decile Subcategory 10y	75th Percentile	161.62	227.93	233.67	5.47	22.95
Market Value of Equity Range	**50th Percentile**	**138.58**	**175.02**	**74.86**	**(1.71)**	**7.74**
$100.9 Million and $184.9 Million	25th Percentile	116.69	139.05	29.38	(15.95)	(7.13)
	5th Percentile	103.44	110.39	1.42	(71.07)	(30.51)
As of September 30, 2013:	95th Percentile	94.04	210.99	318.61	7.56	27.73
10th Decile Subcategory 10z	75th Percentile	70.49	95.17	78.89	1.81	6.62
Market Value of Equity Range	**50th Percentile**	**44.97**	**64.98**	**31.77**	**(1.42)**	**1.18**
$2.4 Million and $100.8 Million	25th Percentile	25.12	34.97	15.29	(8.25)	(4.43)
	5th Percentile	7.89	11.23	1.03	(33.57)	(17.97)
As of September 30, 2016:	95th Percentile	123.59	694.33	516.09	11.54	69.39
10th Decile Subcategory 10y	75th Percentile	109.94	198.68	151.97	4.86	17.89
Market Value of Equity Range	**50th Percentile**	**96.02**	**121.77**	**51.50**	**(1.50)**	**3.99**
$73.6 Million and $127.3 Million	25th Percentile	82.85	99.80	29.23	(16.28)	(10.61)
	5th Percentile	74.68	77.79	8.28	(37.15)	(22.00)
As of September 30, 2016:	95th Percentile	70.11	176.78	248.60	4.60	22.77
10th Decile Subcategory 10z	75th Percentile	53.10	72.14	67.03	0.71	3.18
Market Value of Equity Range	**50th Percentile**	**34.34**	**46.75**	**25.30**	**(3.96)**	**(1.55)**
$2.5 Million and $73.5 Million	25th Percentile	18.85	25.49	8.09	(13.93)	(9.47)
	5th Percentile	6.66	9.76	1.03	(25.15)	(18.67)
As of September 30, 2019:	95th Percentile	116.97	689.39	1,113.93	12.75	123.17
10th Decile Subcategory 10y	75th Percentile	102.17	172.15	195.92	3.36	17.91
Market Value of Equity Range	**50th Percentile**	**83.92**	**110.30**	**47.49**	**(5.93)**	**(1.30)**
$62.2 Million and $117.0 Million	25th Percentile	70.29	86.48	17.15	(25.52)	(20.22)
	5th Percentile	62.20	64.05	2.33	(48.27)	(38.52)
As of September 30, 2019:	95th Percentile	57.02	241.80	388.96	3.82	23.88
10th Decile Subcategory 10z	75th Percentile	41.79	60.47	66.76	(0.77)	2.43
Market Value of Equity Range	**50th Percentile**	**26.44**	**35.66**	**23.66**	**(6.85)**	**(3.06)**
$4.5 Million and $57.0 Million	25th Percentile	12.21	17.49	6.21	(17.11)	(11.35)
	5th Percentile	4.55	6.89	0.82	(29.79)	23.21

Sources: 2020 Cost of Capital Annual U.S. Guidence and Examples, Kroll Cost of Capital Navigator; *2017 Valuation Handbook: U.S. Guide to Cost of Capital*, Exhibit 4-10; and *2014 Valuation Handbook: Guide to Cost of Capital*, Exhibit 4-9.

Collectively, this information supports the theory that the CRSP size premium 10th decile is comprised of troubled and distressed companies.

According to James Hitchner in *Financial Valuation and Litigation Expert*, "It's important to note that 80 percent of the companies in decile category 10b are from 10z. As such, let's focus on 10z. At the 50th percentile of 10z the operating margin is –1.11 percent. Yes, on average, these companies are losing money. At the 25th percentile the operating margin is –21.27 percent. Furthermore, 62 percent of the companies in 10z are from only three industry sectors: financial services, technology, and healthcare."[35]

As indicated by Hitchner, based on dated information that is still relevant, not only does the CRSP size premium 10th decile include troubled companies, it is skewed by its industry concentration.

A few years back, Morningstar provided some additional detail related to the 10th decile regarding the probability of default of the companies in the 10th decile. Exhibit 6 provides statistics, as published in the *Ibbotson SBBI 2012 Valuation Yearbook* by Morningstar, of the probability of default of companies in the decile 10 subcategories.

As of December 31, 2011, a little less than 20 percent of subcategory 10b had a 25 percent probability of default. As company size decreases, from subcategory 10w to subcategory 10z, the probability of default increases.

As presented in the *Ibbotson SBBI 2013 Valuation Yearbook* published by Morningstar, the 10th decile

Exhibit 6
Probability of Default of the Decile 10 Subcategories
As of December 31, 2011

Probability of Default	10a Percent of Companies	10b Percent of Companies	10w Percent of Companies	10x Percent of Companies	10y Percent of Companies
75%	0	3	0	0	1
50%	2	7	1	3	3
25%	5	17	4	7	12
20%	6	21	4	7	14
15%	8	25	5	10	17
10%	10	31	8	13	22
5%	16	38	15	17	28

Source: *2012 Ibbotson SBBI Valuation Yearbook* , Table 7-15.

was comprised of significantly more companies in the 10b subcategory than the 10a subcategory.[36] As of December 31, 2002, there were 319 companies populating the 10a subcategory and 1,124 companies populating the 10b subcategory.

Furthermore, as of December 31, 2012, the significant majority of the 10b category was comprised of companies in the 10z subcategory—846 companies in 10z compared to 278 companies in 10y.[37]

Of these companies in the 10z subcategory, the majority were financial services businesses.[38]

Also, as presented in the *SBBI 2013 Valuation Yearbook*, Morningstar changed its methodology for determining the likelihood of company default.

The results of the new methodology were similar to the results of the methodology used for the *SBBI 2012 Valuation Yearbook*. Morningstar concluded that financial distressed companies are more likely to be small equity capitalization stocks.[39]

Liquidity May Be More Significant than Size in Assessing Risk

According to Aswath Damodaran, "the notion that market for publicly traded stocks is wide and deep has led to the argument that the net effect of illiquidity on aggregate equity risk premiums should be small."[40]

It is generally accepted that less liquid securities are inherently of a greater risk profile than highly liquid securities and, therefore, investors require greater rates of return to invest in less liquid investments. In fact, a growing body of work investigating the impact of liquidity on returns has emerged.[41]

The cost of illiquidity on security pricing is influenced by macroeconomic direction. Stock illiquidity increases when economies slow down and during periods of crisis, thus exaggerating the effects of both phenomena on the equity risk premium.[42]

Security liquidity has value as discussed in the following example. Consider two assets with the same cash flow and average liquidity, but one asset has much more liquidity risk . . . if the assets had the same price, investors would avoid the one with the high liquidity risk, because they would fear bearing greater losses if they needed to sell it in a liquidity crisis.[43]

For many analysts, the calculation of the cost of equity includes a size risk premium alpha factor developed from the CRSP database. There are numerous theories addressing why small market capitalization stocks provide greater investment returns.

However, there is an increasing amount of interest as to how the CRSP size risk premium decile conclusions may be skewed by an embedded liquidity discount.

Several studies have shown that an embedded stock liquidity discount helps to explain part of the reason that smaller capitalization companies generate higher returns—that is, the investor is compensated for investing in a low liquidity and, therefore, riskier asset.

Exhibit 7 presents liquidity statistics and the impact of liquidity organized by equity market

Exhibit 7
Liquidity Effect on the Size Risk Premium
Based on Quartile Portfolio Classifications for 2020
As Published in the Kroll Cost of Capital Navigator

	Low Liquidity	Mid-Low Liquidity	Mid-High Liquidity	High Liquidity	Liquidity Effect (%)
Micro-Cap					
Geometric Mean (%)	15.44	15.28	9.42	-0.65	16.09
Arithmetic Mean (%)	17.74	18.79	14.47	4.39	13.35
Standard Deviation (%)	22.54	28.36	34.05	32.81	
Average Number of Companies	348	181	122	96	
Small-Cap					
Geometric Mean (%)	15.25	14.22	11.91	5.69	9.56
Arithmetic Mean (%)	16.85	16.67	15.1	9.7	7.15
Standard Deviation (%)	19.19	23.43	26.57	29.72	
Average Number of Companies	198	201	173	175	
Mid-Cap					
Geometric Mean (%)	13.68	13.65	12.74	8.14	5.54
Arithmetic Mean (%)	15.01	15.31	14.8	11.56	3.45
Standard Deviation (%)	17.5	19.51	21.35	27.09	
Average Number of Companies	128	177	204	240	
Large-Cap					
Geometric Mean (%)	11.43	12.33	11.84	8.95	2.48
Arithmetic Mean (%)	12.64	13.45	13.35	11.81	0.83
Standard Deviation (%)	16.17	15.46	17.74	24.31	
Average Number of Companies	73	188	249	237	
Size Effect (%)	4.01	2.95	-2.42	-9.60	

Source: Cost of Capital: Annual U.S. Guidance and Examples, Kroll Cost of Capital Navigator, Exhibit 4.17.

capitalization quartile classification. The analysis corresponds to publicly traded securities in the 1972 to 2019 time frame.

An interesting aspect of the embedded liquidity issue is that market capitalization and illiquidity are not always correlated since there are small, liquid companies and large, illiquid ones in the market.[44]

However, based on the data presented in Exhibit 7, it appears that the smallest capitalization securities are affected by liquidity concerns far more than larger capitalization securities. It is also noteworthy that the subcategory of micro-cap stocks populated with the most companies, on average, was classified as low liquidity securities—a total of 348 companies.

In a research article published in the *Journal of Business Valuation and Economic Loss*, Frank Torchio and Sunita Surana studied the effect of liquidity on size premium calculations ("Torchio study").[45]

According to the Torchio study, a substantial portion of the size premium measurement reflects lack of liquidity. The Torchio study found that the lack of liquidity issue, an embedded liquidity issue, is problematic in certain fair value cases.

It is problematic because the application of the size premium—more specifically the application of the premium in small company valuations—may cause the fair value to be understated and may include an unintended valuation discount.

Exhibit 8
Liquidity Risk Premium Analysis Based on the Torchio Study Using CRSP Data from 1926 to 2010

SBBI Decile Group	Liquidity Level	Liquidity Risk Premium (return in excess of CAPM return) (%)	2011 Ibbotson SBBI Size Risk Premium (%)	Difference between Liquidity Premium and Size Premium (%)
1	High	-1.35	-0.38	**-0.97**
1	Low	0.13		0.51
2	High	-0.16	0.81	**-0.97**
2	Low	2.25		1.44
3	High	-0.05	1.01	**-1.06**
3	Low	2.88		1.87
4	High	0.07	1.20	**-1.13**
4	Low	3.25		2.05
5	High	0.57	1.81	**-1.24**
5	Low	4.01		2.20
6	High	-0.33	1.82	**-2.15**
6	Low	4.90		3.08
7	High	0.06	1.88	**-1.82**
7	Low	4.34		2.46
8	High	0.19	2.65	**-2.46**
8	Low	5.40		2.75
9	High	1.99	2.94	**-0.95**
9	Low	5.25		2.31
10	High	2.46	6.36	**-3.90**
10	Low	11.18		4.82
10w	High	-0.37	3.99	**-4.36**
10w	Low	8.08		4.09
10x	High	4.57	4.96	**-0.39**
10x	Low	10.40		5.44
10y	High	3.34	9.15	**-5.81**
10y	Low	12.85		3.70
10z	High	3.57	12.06	**-8.49**
10z	Low	17.55		5.49

Source: Frank Torchio and Sunita Surana, "Effect of Liquidity on Size Premium and its Implications for Financial Valuations," *Journal of Business Valuation and Economic Loss* 9, no. 1 (2014): Tables 10, 11, and 12.

In order to study the effect of embedded liquidity related to the size risk premium, the Torchio study progressed through several procedures.[46] The three primary procedures are described as follows.

For the first procedure, the Torchio study replicated the Ibbotson SBBI 10 decile analysis using the CRSP database. The study applied the same or similar procedures used by Ibbotson, Duff & Phelps, and now Kroll to replicate the published SBBI 10 decile study results. It also replicated the 10th decile subcategories.

For the second procedure, the Torchio study subdivided the SBBI 10 deciles and 10th decile subcategories into high liquidity and low liquidity categories.

For the final procedure, the liquidity premium is calculated much the same way that the SBBI 10 decile size risk premiums are calculated. The liquidity premium is calculated as the excess return to the predicted CAPM return.

Exhibit 8 presents the Torchio study liquidity risk premium analysis results.[47]

The Torchio study provides empirical evidence of the impact that liquidity has on security rates of return. Based on Exhibit 8, the following conclusions appear to be true:

- The high liquidity level securities (stocks that exhibit trading liquidity above the decile group median) rates of return are significantly lower than the low liquidity level securities at each decile grouping.
- Compared to the size premium statistics presented in the *SBBI 2011 Valuation Yearbook*, the high liquidity group for each decile and subdecile category had much lower rates of return.
- For SBBI deciles 1 through 9, the difference between the high liquidity equity risk premium estimate and the SBBI size risk premium is not as significant as it is for decile 10 and subcategories.

- The liquidity risk premium effect is most pronounced at the 10z subcategory decile.
- The size risk premium is clearly influenced by the low liquidity securities.

According to the Tochio study, the large-size premiums calculated by Ibbotson are the consequence of a disproportionately greater number of low liquidity stocks comprising the small-size portfolios.[48]

For fair value measurements in certain jurisdictions due to the presence of an embedded liquidity discount, the application of an equity size risk premium alpha factor based on the 10th decile or 10th decile subcategories may not be appropriate.

Summary and Conclusion

Damages analysts routinely develop damages measurements that include income projections and apply a present value discount rate. Such damages measurements include lost profits method analyses. Such damages measurements also include cost to cure method analyses and reasonable royalty rate method analyses.

One of the typical components of the damages analysis discount rate is the estimation of cost of equity capital. The measurement of many of the cost of equity capital components are typically not controversial in the damages measurement discount rate calculation. The measurement of the size risk premium component of the cost of equity capital can sometimes result in disagreement with regard to the discount rate calculation.

This discussion summarizes many of the damages analyst considerations with regard to the measurement of the equity size risk premium. This equity size risk premium is one component of the present value discount rate calculation developed as part of the damages measurement analysis.

The focus of this discussion was to provide some background and information on the components related to the measurement of the cost of equity capital. In particular, this discussion focused on the measurement of the size risk premium component.

Dating back to the Banz study, and more recently by way of the Kroll CRSP size risk premium analysis, empirical evidence has been gathered and analyzed in support of the size-related phenomena theory. Small private company investment returns cannot be entirely explained by the standard application of the basic CAPM model for estimating the cost of equity capital.

Because the basic CAPM does not entirely explain small private company investment returns, analysts typically apply the MCAPM to estimate the cost of equity capital in such instances.

There are many observations regarding the size-related phenomena theory and the CRSP size risk premium data used by damages analysts. These observations include the following:

1. The small capitalization premium has disappeared in recent years. The empirical evidence supports varying size-related premium at different points in time. Therefore, in certain time periods, it would not be surprising for small capitalization stocks to provide lower investment returns than larger capitalization stocks.
2. The premium, at the smallest level, is unduly influenced by stocks of less than $5 million in market capitalization and stocks that trade at prices less than $2 per share. The most statistical noise in the CRSP size premium data is in the 10th decile classification and its smaller subcategory classifications. This factor may not be as relevant if the subject matter company is a very small business that is similar to the companies that populate the 10th subcategories of 10y and 10z.
3. Other factors, specifically liquidity or lack thereof, provide important detail that analysts should consider in the decision to use, or not to use, the CRSP size risk premium data.

The application of a size risk premium in the development of the cost of equity capital is considered a generally accepted procedure for many damages measurement methods. However, damages analysts should be aware of the above-described issues related to the application of a size risk premium to develop a discount rate for a damages measurement analysis.

Notes:

1. There are many other cost of equity capital estimation models including (a) the Kroll, Risk Premium Report Model; (b) arbitrage pricing theory model; and (c) Fama-French three factor model.
2. CRSP is an acronym for Center for Research in Security Prices. The *Valuation Handbook* is a continuation of the previously produced *SBBI Valuation Yearbook* by Morningstar. The *Valuation Handbook* is produced by Duff & Phelps (a Kroll business).
3. Unsystematic risk is defined as the portion of total risk that is specific to an individual security and can be avoided through diversification.

Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 1075, Appendix A.

4. CAPM is defined as a model in which the cost of capital for any stock or portfolio of stocks equals a risk-free rate plus a risk premium that is proportionate to the systematic risk of the stock or portfolio. Pratt, *Valuing a Business*, 1070, Appendix A.
5. Beta is defined as a measure of the systematic risk of a stock; the tendency of a stock's price to be correlated with changes in a specific index. Pratt, *Valuing a Business*, 1070, Appendix A.
6. Roger J. Grabowski, "The Size Effect—It Is Still Relevant," *Business Valuation Review* 35, no. 2 (Summer 2016): 63.
7. Rolf W. Banz, "The Relationship between Return and Market Value of Common Stocks," *Journal of Financial Economics* 9 (March 1981): 3–18.
8. The Cost of Capital Navigator is found at: www.kroll.com/en/cost-of-capital.
9. The Cost of Capital Navigator presents an alternative size premium analysis, the Risk Premium Report. The Risk Premium Report is not discussed herein.
10. Annual stock market returns represent the combined annual stock returns of stocks listed on the New York Stock Exchange ("NYSE"), NYSE Euronext, and Nasdaq.
11. The standard deviation is a measure that is used to quantify the amount of variation or dispersion of a set of data values. A low standard deviation indicates that the data points tend to be close to the mean of the set, while a high standard deviation indicates that the data points are spread out over a wider range of values. J.M. Bland and D.G. Altman, "Statistics Notes: Measurement Error," *The BMJ* 312 (7047) (September 1996): 1654.
12. Aswath Damodaran, "Equity Risk Premiums (ERP): Determinants, Estimation and Implications—The 2015 Edition," Stern School of Business whitepaper (March 2015): 37.
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27. Grabowski and Pratt, *Cost of Capital*, 364.
28. Ibid., 365.
29. Ibid.
30. Ibid., 366.
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32. Ibid.
33. Ibid.
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37. Ibid.
38. Ibid., 91.
39. Ibid., 100.
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41. Duff & Phelps, *2017 Valuation Handbook: U.S. Guide to Cost of Capital*, 4–21.
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43. Yakov Amihud, Haim Mendelson, and Lasse Heje Pedersen, *Market Liquidity, Asset Pricing, Risk, and Crises* (Cambridge: Cambridge University Press, 2013), 103.
44. Damodaran, "The Small Cap Premium: Where Is the Beef?"
45. Frank Torchio and Sunita Surana, "Effect of Liquidity on Size Premium and Its Implications for Financial Valuations," *Journal of Business Valuation and Economic Loss* 9, no. 1 (2014): 55–85.
46. The Tochio study was based on monthly stock data provided by the CRSP database for the period of 1926 to 2010.
47. Torchio and Surana, "Effect of Liquidity on Size Premium and its Implications for Financial Valuations": 77–79.
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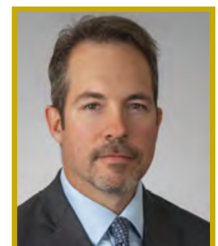

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Commentary on *Lost Profits Damages: Principles, Methods, and Applications*, Second Edition

Robert F. Reilly, CPA

The discussions in Insights *often describe and illustrate the current thought leadership related to the generally accepted damages measurement methodology. One important consideration with regard to damages analysis thought leadership is the professional literature related to this technical discipline. This* Insights *discussion describes—and recommends—a new addition to the professional literature with regard to the development of—and the reporting of—damages measurement analyses in commercial litigation.*

Introduction

It is a pleasure to provide a very favorable commentary related to the recently published second edition of *Lost Profits Damages: Principles, Methods, and Applications*.

The title of this 800-plus page reference book is as fulsome and as comprehensive as the book itself. Therefore, this commentary will adopt a more summarized title: *Lost Profits Damages*.

The shortened book title should not detract from the fact that *Lost Profits Damages* provides an extremely valuable addition to the professional literature related to the damages measurement analysis discipline.

Editors and Authors

Published by Valuation Products and Services, *Lost Profits Damages* is edited by Everett P. Harry III and Jeffrey H. Kinrich.

Everett Harry was the senior partner of the Harry-Torchiana LLP firm. Mr. Harry has over 40 years of experience in forensic accounting and damages analysis related to commercial disputes.

Jeffrey Kinrich is a managing principal of Analysis Group, an economic and financial consulting firm. Mr. Kinrich has practiced as both a damages analyst and a valuation analyst for over 40 years.

In addition to editing the book, Harry and Kinrich authored or co-authored several book chapters. All told, 56 authors contributed to this anthology reference book. These 56 authors include academics, forensic accountants, economists, damages analysts, valuation specialists, lawyers, and judges. Twelve of the 56 authors are new to the second edition of *Lost Profits Damages*.

Purpose and Objective

As with every damages analysis, a damages analysis reference book should have a stated purpose and objective. Everett Harry and Jeffrey Kinrich summarize the purpose and objective of *Lost Profits Damages* in the book's preface.

The purpose of this principles reference book is "to provide a single source for discussion of important topics relevant to determination of lost profits damages."

The objective of this reference principles book—in both its first and its second editions—is to serve as a "reference guide and instructional tool for the analysis of business damages, especially lost profits and lost business value."

Lost Profits Damages accomplishes its stated purpose and objective. The measurement of damages is one component of most commercial disputes. And a damages measurement analysis is a typical component of commercial disputes involving either breach of contract claims or tort claims.

The analysis of lost profits damages is one damages measurement method. Arguably, the analysis of lost profits is the most frequently applied damages measurement method in the quantification of damages related to either breach of contract or tort disputes.

What This Reference Book Provides

As indicated by the subtitle, *Lost Profits Damages* presents comprehensive discussions of:

1. damages analysis principles and concepts,
2. damages measurement methods and procedures, and
3. damages analysis applications and illustrative examples.

This book is a forensic practitioner's reference manual. That is, this book is intended to be used as a desk reference by damages analysts from various technical backgrounds and disciplines. This book is also intended as a reference for legal counsel who rely on and work with damages analysts.

While the audience for this reference book is fairly broad (including economists, forensic accountants, valuation analysts, fraud specialists, and other forensic practitioners), the focus of this book is fairly narrow.

Other reference books provide general discussions of the development of—and the reporting of—the generally accepted methods related to the measurement of dispute-related damages. Such generally accepted damages measurement methods include reasonable royalty, cost to cure, and various other measurement methods. There is an important place in the professional literature for these other books.

In contrast, *Lost Profits Damages* fills a very focused niche. *Lost Profits Damages* provides a deep dive specifically into the defined topic of lost profits damages analysis. This principles-level reference book explains everything that the damages analyst practitioner (and legal counsel) need to know about the development—and the reporting—of the lost profits damages measurement method.

New and Improved Edition

The second edition of *Lost Profits Damages* includes four completely new chapters. These four new chapters relate to:

1. the use of surveys in damages analysis,
2. the measurement of lost profits related to a development stage business,
3. the impact on the damages award measurement of income tax considerations, and
4. the admission of damages analyst expert testimony.

In addition, the 23 chapters of the *Lost Profits Damages* first edition were revised and updated. Most of these first edition chapters include updated professional literature and legal citations, expanded narrative text, and additional illustrative examples.

General Outline of the Book

In addition to the four new chapters, *Lost Profits Damages* includes discussions of the following damages analysis topics:

- Fundamental principles of lost profits damages analysis
- Legal principles of lost profits damages measurement
- Generally accepted lost profits damages measurement methods
- Ex post damages measurement analyses versus ex ante damages measurement analyses
- Generally accepted business valuation approaches and methods
- Comparison of lost profits damages analysis to lost business value damages analysis
- Damages causation considerations
- Economic and industry analysis within the damages measurement
- Application of statistics in damages analysis
- Development of the damaged party revenue projection
- Analysis of damaged party cost behavior
- Damages mitigation considerations
- Cash flow metrics versus accounting income metrics
- Identification of the damages measurement period
- Present value procedures and damages modeling

- Discount rate measurement methods
- Pretax and after-tax damages analysis considerations
- Prejudgment and post-judgment interest calculations
- Developing the damages expert report
- The admission of the damages expert testimony
- Legal challenges to the damages analyst's expert testimony

How Forensic Practitioners Can Use This Reference Book

Lost Profits Damages is an authoritative reference source for forensic analysts. Most readers will start with the table of contents and/or the comprehensive index. That is, most forensic practitioners will come to this book with some form of the question "how do I . . .?" Fortunately, for such forensic practitioners, this book will provide the answer.

Frequently, *Lost Profits Damages* answers the practitioner's questions in several different chapters, written by several different authors—who provide several different perspectives.

What Makes This Book Particularly Useful

While this reference book is directed primarily to damages analysts instead of to legal counsel, several chapters are authored by legal counsel and/or by judicial finders of fact.

These chapters provide important legal guidance (including citations to relevant statutory authority and judicial precedent) to damages analysts. However, these chapters are written to the benefit of damages analysts and, to the extent possible, avoid technical legal jargon.

Related to legal issues, there are important discussions of causation, liability, mitigation, and other concepts that directly or indirectly affect the development of a damages measurement. And there are several important discussions with regard to the admissibility of damages-related expert reports and damages analyst expert testimony.

As would be expected in this damages analysis principles-level book, most of the *Lost Profits Damages* discussions relate to economics, statistical, finance, and accounting topics. Important discussions include industry and economic analysis, competitive analysis and the development of the damaged party revenue projections, various measures of accounting income, damages measurement methodology, and business valuation methodology.

Lost Profits Damages includes important discussions on the many differences between (1) a damages analysis and (2) a valuation analysis. These many differences are both conceptual and practical in nature. And, these differences affect both the development of—and the reporting of—the subject analysis.

As a consideration in any third edition that may be forthcoming, *Lost Profits Damages* may provide a little too much emphasis on business valuation reports and business valuation professional standards. This comment is only relevant from a comparative perspective.

That is, there could be a more balanced discussion of damages analysis (and not business valuation) professional standards. For example, the AICPA *Statement on Standards for Valuation Services* (and various other valuation professional standards) are extensively explored. In contrast, the AICPA *Statement on Standards for Forensic Services* is not explored.

Certainly, such minor omissions can be addressed in future editions of this reference book.

Summary and Conclusion

In conclusion, every economist, forensic accountant, valuation analyst, or fraud specialist who practices in the damages analysis discipline should have—and should use—*Lost Profits Damages*.

As did the first edition, the second edition of *Lost Profits Damages* functions as a forensic practitioner's desk reference. In addition, commercial litigation counsel and judicial finders of fact will benefit from adding *Lost Profits Damages* to their libraries. The legal community will use this reference book as a benchmark by which to evaluate damages measurement expert reports and damages analyst expert testimony.

The stated purpose and objective of *Lost Profits Damages* were mentioned above. If forensic practitioners want to achieve the stated purpose and objective of their damages measurement analyses, then they should keep a well-used copy of *Lost Profits Damages* close at hand.

Lost Profits Damages is published by Valuation Products and Services, and this book may be ordered at www.valuationproducts.com/lost-profits.

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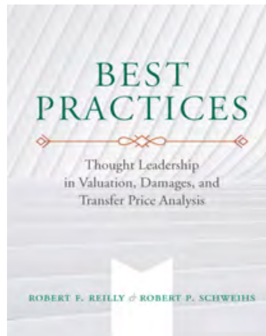
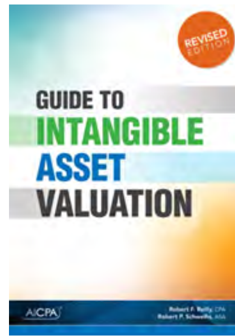
Valuation, Damages, and Transfer Price Textbooks Authored by Willamette Management Associates Authors





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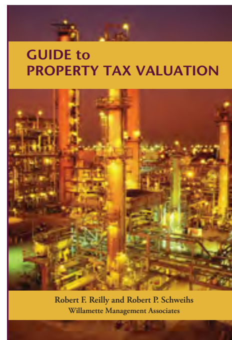

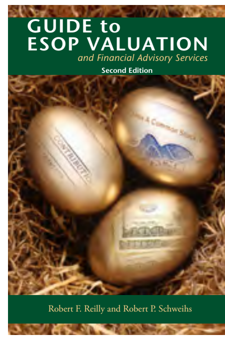

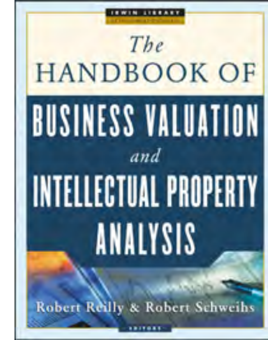

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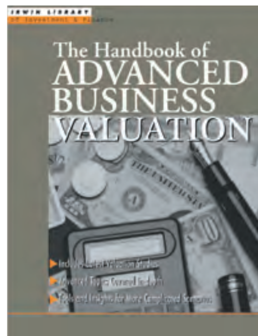

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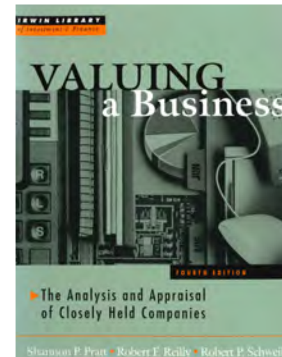

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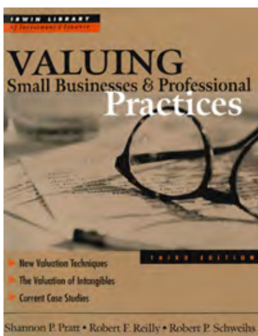

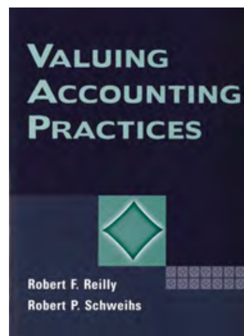

* Authored by Robert Reilly and Israel Shaked, Ph.D.
** Authored with Shannon Pratt
*** Edited by Robert Reilly and Robert Schweihs

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Financial Adviser Due Diligence in a Transactional Fairness Opinion

Justin M. Nielsen

The use of a management-prepared financial projection in the income approach discounted cash flow analysis presents certain issues for the valuation analyst acting as a financial adviser. This statement is certainly true with respect to the independent financial adviser's duties to perform due diligence in a transactional fairness opinion context. While a fairness opinion may be utilized in several contexts, fairness opinions for transactional purposes (i.e., for a merger and acquisition transaction), are typically relied upon by the participating company board of directors. This discussion summarizes fairness opinions in a transactional context and provides insights into the financial adviser's role in utilizing management-prepared financial projections in the income approach discounted cash flow business valuation method.

Introduction

The valuation analyst acting as an independent financial adviser ("adviser") in a merger and acquisition transaction is often asked to provide advisory services to the participating companies. These transaction-related services are typically requested by a participant company board of directors.

Often, the participating company board of directors, acting as fiduciaries, request the adviser to perform the following tasks:

1. Analyze the deal price
2. Analyze the proposed deal structure
3. Provide the fiduciaries with a fairness opinion related to the proposed transaction

A fairness opinion is generally a formal letter prepared by an adviser to the participating company fiduciaries. The fairness opinion typically states whether or not the proposed transaction is fair to the company shareholders.

Fairness is often determined (1) from a financial point of view; (2) as of a specific date in time; and (3) based on certain assumptions, limitations, and analytical procedures.

While fairness opinions are not legally required in merger and acquisition transactions, based, in part, on the Delaware Court of Chancery (the "Chancery court") opinion in *Smith v. Van Gorkam*,[1] participant company board of directors have increasingly requested fairness opinions. Directors request such transaction fairness opinions in order to help ensure compliance with their fiduciary duties.

These fiduciary duties include:

1. the duty of loyalty and
2. the duty of care.

In the development of a transactional fairness opinion, the financial adviser will typically consider

the three generally accepted business valuation approaches:

1. The income approach
2. The market approach
3. The asset-based approach

While an adviser is required to consider all three business valuation approaches when developing a fairness opinion, the income approach is often relied on by advisers.

Such reliance is based on the fundamental understanding that, "in the simplest sense, the theory surrounding the value of an interest in a business depends on the future benefits that will accrue to its owner. The value of the business interest, then, depends upon an estimate of the future benefits and the required rate of return at which those future benefits are discounted back to present value as of the valuation date."[2]

Within the income approach, the discounted cash flow ("DCF") business valuation method is based on the calculation of a current (i.e., present) value of the company's expected future income.

The two principal components of the DCF business valuation method are as follows:

1. The projection of the company's expected future income
2. The estimation of an appropriate risk-adjusted required rate of return used to discount the expected future income to present value

While the measurement of each component is equally important in applying the DCF method, this discussion focuses on the development and the use of management-prepared financial projections as an expectation of a company's future income.

Specifically, this discussion considers the development and application of financial projections within the context of performing a transaction-related fairness opinion for participating company fiduciaries.

The objectives of this discussion are as follows:

1. To describe a fairness opinion and the reasons why the participating company board of directors would obtain a fairness opinions in a merger and acquisition ("M&A") context
2. To describe the function of financial projections within the application of the income approach, DCF method
3. To describe best practices procedures that the adviser can take to ensure the appropriate treatment and reliance on management-prepared financial projections in a fairness opinion context

Fairness Opinions and the Role of Participating Company Fiduciaries

By general definition, a fairness opinion is an advisers' opinion as to whether the price to be paid or received in an M&A transaction is fair to the client's shareholders. Fairness opinions are regularly obtained by boards, special committees, and other fiduciaries.

Fairness opinions are requested in order to:

1. gain a comprehensive understanding of the financial aspects of a transaction and
2. demonstrate that these fiduciaries have agreed to a transaction with due care.

Thomson Reuters defines a fairness opinion as follows:

> An opinion by a company's financial adviser, most often an investment bank, to the company's board of directors in connection with a transaction that would have a material effect on stockholder value or present a potential conflict of interest. The opinion, which is usually written in the form of a letter, generally concludes that a specific transaction's terms are fair to the company's stockholders from a financial standpoint.
>
> While not legally required, the receipt of a fairness opinion can give the board additional comfort that it has satisfied its fiduciary duties in recommending approval of the transaction.
>
> A fairness opinion typically includes:
>
> - A description of the transaction.
> - The due diligence review of the financial adviser.
> - A description of the information the financial adviser relied on in issuing the opinion.[3]

A fairness opinion is typically presented as a formal letter to a participating company fiduciary. The document represents the adviser's opinion

that an M&A transaction, in its entirety, is fair or not fair to the participating company fiduciary shareholders.

In the context of developing a fairness opinion, fairness is determined:

1. from a financial point of view;
2. as of a specific date in time; and
3. based on certain assumptions, limitations, and analytical procedures.

Specifically, a fairness opinion should be based on rigorous financial analysis, including a comparison of the target company value to the proposed purchase price, to assess whether the transaction's economics are fair to participating company shareholders.

This rigorous financial analysis of the target company is generally similar to a business valuation. The adviser will typically value the subject target company equity by considering the three generally accepted business valuation approaches: (1) the income approach, (2) the market approach, and (3) the asset-based approach.

The adviser will then typically conclude a reasonable range of potential transaction equity values based on the sensitivity of certain underlying assumptions to determine if the proposed price of the target company falls within this range.

However, a fairness opinion is a separate and distinct analysis as compared to a business valuation. This is because a fairness opinion does not represent an independent appraisal or valuation of the participating company. Rather, a fairness opinion presents a comparison of a target company's intrinsic value to a proposed transaction price.

This is why the intrinsic value of a target company is typically presented as a range of values rather than a single point estimate in a fairness opinion.

Further, a fairness opinion does not represent an opinion that the proposed transaction price is the best possible price or even the most likely price of a target company, nor does a fairness opinion represent an endorsement or recommendation to enter into a proposed transaction.

Rather, a fairness opinion is simply an opinion that a proposed transaction price is "fair" or "not fair" to the participating company shareholders from a financial point of view.

In certain circumstances, fairness opinions can also address other important fiduciary considerations by a participating company board of directors. However, these considerations are typically not included in a standard fairness opinion.

These additional considerations may include the following:

1. Quantifying how the proposed transaction will increase or decrease shareholder value (including an analysis of proposed synergies)
2. Quantifying how noncash consideration (i.e., equity consideration, seller note consideration, earnout consideration, option consideration) may affect the proposed transaction price
3. Quantifying whether the proposed transaction is accretive or dilutive to current shareholders
4. Quantifying the income tax impact based on the structure of transaction (such as whether the transaction is an asset sale versus an equity sale)

As mentioned, fairness opinions are not legally required in M&A transactions. However, and based in part on the Delaware Court of Chancery[4] opinion in *Smith v. Van Gorkam*, fairness opinions have increasingly become an important tool for participating board of directors.

In *Smith v. Van Gorkam*, the Delaware Court of Chancery stated that:

> Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 Del.C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.[5]

This management of the business affairs creates, in part, the fiduciary duty required of corporate board of directors. Specifically, "In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders."[6]

These fiduciary duties required of a company board of directors are typically known as:

1. the duty of loyalty and
2. the duty of care.

The duty of loyalty generally requires board of directors to act in good faith in advancing the best interests of the corporation, and to refrain from conduct that could potentially injure the company and its shareholders.

Further, the duty of loyalty strictly prohibits board of directors from using their position to fulfill (or advocate for) their own personal interest.

The duty of care requires board of directors to exercise the care that a prudent, reasonable person in a like position would use under similar circumstances.

Specifically, as noted in the *Smith v. Van Gorkam* judicial decision:

> Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty.[7]
>
> . . .
>
> To summarize: we hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) **by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer** [emphasis added].[8]

Based in part on the Delaware Court of Chancery guidance noted above in *Smith v. Van Gorkam*, board of directors of companies participating in M&A transactions have more often looked to fulfill their fiduciary duties through the use of fairness opinions.

To ensure that they have reasonably considered all relevant data and information in determining whether to proceed in an M&A transaction, participating company board of directors have increasingly relied upon fairness opinions to satisfy the duty of loyalty and the duty of care to the participating company stockholders.

In developing a fairness opinion, the financial adviser will apply generally accepted business valuation approaches and methods to analyze the target company. Many times such a valuation analysis includes the application of the income approach and the DCF business valuation method.

The DCF Method and Management-Prepared Financial Projections in a Fairness Opinion Context

Within the income approach, there are a number of generally accepted business valuation methods. Each method is based on the principle that the value of an investment is a function of the economic income that will be generated by that investment over its expected life.

There are several business valuation methods that can be used to estimate value based on this principle (or in the case of a fairness opinion, a value range). Most of these methods are based on the estimation of an investment's future income stream and the application of an appropriate risk-adjusted, present value discount/capitalization rate.

The DCF method is a generally accepted business valuation method used to value companies on a going-concern basis. It has appeal because it directly incorporates the trade-off between risk and expected return, one component to the investment decision and value calculation process.

The DCF business valuation method provides an indication of value by:

1. projecting the expected future income of a business and
2. projecting an appropriate risk-adjusted required rate of return to discount the expected future income to present value.

There are many considerations that a valuation analyst should undertake to estimate a present value discount rate that reflects the related risk associated with the future company income. This discussion focuses on the development and the application of the expected income projection utilized in the DCF method for fairness opinion purposes.

To develop the expected future financial fundamentals of a business, there are several considerations that should be made, including the following:

1. Expected level of dividends or partnership distributions
2. Net cash flow to equity or net cash flow to invested capital (i.e., total market value of company debt and equity)
3. Various accounting financial fundamental measures of income such as net income, net operating income, and other

The valuation analyst, acting as an adviser, has the responsibility when developing the DCF method for a fairness opinion to align the appropriate income measure to the subject interest of the valuation.

Generally, if the subject of the valuation is the value of the company equity, then the appropriate income measure is net cash flow to equity. Similarly, if the subject valuation interest is the business enterprise, then the appropriate income measure is net cash flow to invested capital.

Once the adviser determines the appropriate measure of income to apply in the DCF method, the next step is to project the expected income over a defined future time period. The judicially preferred method (as proffered by the Delaware Court of Chancery) in projecting future income of a target business is to obtain financial projections from company management.

Such financial projections ideally should be generated during the normal course of operations and utilized for general management planning purposes.

While it may seem unimportant, the simple labeling of the expected future income of a business as either a forecast or a projection is a topic of discussion within the valuation profession.

As presented in *Understanding Business Valuation*, the difference between a financial forecast and a financial projection is as follows:

1. Financial Forecast. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows. A financial forecast is based on the responsible party's assumptions reflecting the conditions it expects to exist and the course of action it expects to take.
2. Financial Projection. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as, "What would happen if . . . ?"[9]

According to *Understanding Business Valuation*, the analyst should generally refer to the management-prepared expected future income as a financial forecast. However, there exist a diversity of professional views. For instance, *Valuing a Business*[10] prefers the term *projected* when defining the expected future income of ownership of a business.

Similarly, as noted in *Financial Valuation Applications and Models*,[11] author James Hitchner

applies the term *projection* (*or the formal projection method*) to define estimated future cash flow or economic benefits used in a DCF method analysis.

Therefore, for purposes of this discussion, the term *projection* (rather than the term *forecast*) will encompass all management estimates of future cash flow, earnings, or benefits to be utilized in the income approach DCF method.

It is our opinion that an analyst typically should not use the term *forecast* unless he or she is prepared to be the "responsible party" for all of the financial information used to prepare said forecast.

A projection, however, and again in our opinion, generally means that the analyst is utilizing data that has been provided by the company management (ideally prepared in the normal course of business and not for the specific purpose of estimating the value of the company in anticipation of the transaction),[12] and adjusted, if necessary, by the analyst.

In a fairness opinion context, and considering the participating company board of director's required fiduciary duties of duty of loyalty and duty of care, the adviser should clearly refrain from being the "responsible party" and may refer to the expected future cash flow used in a related DCF method analysis as *projections*.

Independence with regard to a fairness opinion, and the assumptions on which that fairness opinion is based, will greatly assist the participating company board of directors in fulfilling its fiduciary duties.

It is also intuitive that wholesale acceptance of management projections when applying the DCF method in a fairness opinion context eliminates the adviser's objectivity (and similarly the participating companies board of director's objectivity).

If the data provided by company management are simply accepted by the adviser without any due diligence, then a conclusion of value (or opinion with regard to the fairness of a specific transaction) could be influenced by the company management.

This lack of due diligence suggests a lack of impartiality by the analyst (thereby failing the participating companies' board of director's duty of loyalty). This situation may also fail the participating companies' board of director's duty of care.

Adviser who do not perform a diligence analysis of management-prepared financial projections may be providing a fairness opinion that lacks all information reasonably available to them (and relevant to the decision of the board of directors).

Further, additional scrutiny is required, depending on the source of the management-prepared financial projections. For example, if the adviser is performing a fairness opinion for the acquiring corporation and has received projections that were sourced by the acquiring company's management (as opposed to target management-prepared projections that were constructed in the ordinary course of business), the adviser may take care to analyze these projections.

The purpose of this analysis is to ensure that they are not self-serving (which would fail the duty of loyalty fiduciary requirement of a participating company board of directors and open up the possibility of shareholder litigation).

As presented in *Understanding Business Valuation*, there are several factors that the adviser may consider when analyzing management-prepared financial projections, including the following:

1. Company-specific factors
2. Economic conditions
3. Industry trends[13]

These factors are relevant for an adviser to consider in a transactional fairness opinion context. Further, looking at company-specific factors, *PPC's Guide to Business Valuations* suggests several company-specific assumptions related to management-prepared financial projections that the adviser may examine, including the following:

1. Assumptions about revenue and receivables
2. Assumptions about cost of sales and inventory
3. Assumptions about other costs (such as selling, general, and administrative costs)
4. Assumptions about property and equipment, and related depreciation
5. Assumptions about debt and equity
6. Assumptions about income taxes[14]

Similar adviser professional guidance is relevant when performing fairness opinions for employee stock ownership plans. As presented in *Best Practices—Thought Leadership in Valuation, Damages, and Transfer Price Analysis*:

> C. Perform prospective financial statement analysis
>
> 1. Identify important financial variables that drive the company financial performance (e.g., capacity constraints, cost/volume profit relationships, etc.) for prospective results of operations.
> 2. Obtain (if available) and analyze financial projections of prospective results of operations.

3. Assess the reasonableness of all historical management-prepared financial projections relative to historical results of operations.
4. Assess the reasonableness of all historical management-prepared financial projections relative to historical industry data.
5. Assess the reasonableness of all historical management-prepared financial projections relative to current industry data.
6. Obtain and explain alternative management-prepared financial projections covering the same time period.[15]

It is important that the adviser vet the assumptions on which the management-prepared financial projections are based. It is also important that the analyst document and justify any changes made to these management-prepared financial projections.

For purposes of a fairness opinion, and to provide transparency for the participating company board of directors (and ultimately to provide transparency for the participating company shareholders), any changes made to the management-prepared financial projections should be documented and presented in the fairness opinion DCF method analysis.

Based, in part, on the above-referenced guidance, best practices suggest that the analyst assess the reasonableness of management-prepared projections, in a transactional fairness opinion context, by considering if the financial projections meet the following criteria:

1. They are consistent with the company's growth prospects.
2. They are reasonable as compared to the company's historical financial results.
3. They are achievable based on the company's operating capacity and expected future capital expenditures.
4. They are reasonable as compared to the company's client and supplier projected financial results.
5. They are reasonable based on the industry's historical and projected financial results.
6. They are reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy.
7. They are extensively documented and justified if the projections are adjusted or revised by the valuation analyst.
8. They are explainable based on alternative management-prepared financial projections covering the same period (if applicable).

Summary and Conclusion

An analyst acting as an adviser in an M&A transaction may be asked to provide advisory services to the board of directors of the participating companies. These advisory services can include the development of a transaction fairness opinions.

Fairness opinions are formal letters prepared by advisers to the participating company fiduciaries that state whether or not the proposed transaction is fair to the company shareholders.

Board of directors of companies involved in M&A transactions have increasingly requested fairness opinions to ensure the fulfillment of their fiduciary duties, in part due to the judicial decision in the Delaware Court of Chancery case *Smith v. Van Gorkam*.

These fiduciary duties required of participating company board of directors are known as:

1. the duty of loyalty and
2. the duty of care.

The duty of loyalty generally requires a board of directors (1) to act in good faith in advancing the best interests of the corporation and (2) to refrain from conduct that could potentially injure the company and its shareholders (which strictly prohibits boards of directors from using their position to fulfill, or advocate for, their own personal interests).

The duty of care requires board of directors to exercise the care that a prudent, reasonable person in a like position would use under similar circumstances.

In developing a fairness opinion, fairness is determined:

1. from a financial point of view,
2. as of a specific date in time, and
3. based on certain assumptions, limitations, and analytical procedures.

These analytical procedures many times include the application of the income approach DCF business valuation method. The DCF business valuation method provides an indication of value by:

1. projecting the expected future income of a business and

> “[F]inancial projections should be prepared in the normal course of business operations and utilized for general management planning purposes.”

2. applying a risk-adjusted required rate of return to discount the expected future income to present value.

The judicially preferred method (as proffered by the Delaware Court of Chancery) in projecting the future income of a target business (i.e., in a transactional fairness opinion context) is to obtain financial projections from company management.

Ideally, such financial projections should be prepared in the normal course of business operations and utilized for general management planning purposes.

However, the adviser should consider relevant guidance to ensure that the management-prepared financial projections are:

1. consistent with the company’s growth prospects;
2. reasonable as compared to the company’s historical financial results;
3. achievable based on the company’s operating capacity and expected future capital expenditures;
4. reasonable as compared to the company’s client and supplier projected financial results;
5. reasonable based on the industry’s historical and projected financial results;
6. reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy;
7. extensively documented and justified if the projections are adjusted or revised by the valuation analyst; and
8. explainable based on alternative management-prepared financial projections covering the same period (if applicable).

Notes:

1. Smith V. Van Gorkam, 488 A.2d 858 (Del. 1985).
2. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: The McGraw-Hill Companies, 2008), 56.
3. Glossary, 2022 Thomson Reuters, https://content.next.westlaw.com/7-383-2185?__lrTS=20211213094715477&transitionType=Default&contextData=(sc.Default)&firstPage=true. (accessed 1/31/2022).
4. The Chancery court, which decides on matters concerning shareholder equity claims, is generally viewed as the primary forum for ruling on dispute litigation involving matters related to corporate M&A transactions. With its significant influence on valuation matters, attorneys and valuation analysts/advisers alike frequently look to the Chancery court for guidance regarding corporate M&A matters and board of director fiduciary duties.
5. Smith v. Van Gorkam, 488 A.2d 858, 872.
6. Id.
7. Id.
8. Id. at 893.
9. Gary Trugman, *Understanding Business Valuation*, 5th ed. (New York: American Institute of Certified Public Accountants, 2017), 253–254. Also presented in Jay E. Fishman, Shannon P. Pratt, J. James R. Hitchner, J. Clifford Griffith, Stanton L. Meltzer, and Eric G. Lipnicky, *PPC’s Guide to Business Valuations*, 30th ed. (Fort Worth, TX: Thomson Reuters/PPC, 2020).
10. Pratt and Niculita, V*aluing a Business*, 57.
11. James R. Hitchner, *Financial Valuation Application and Models*, 4th ed. (New York: John Wiley & Sons, 2017), 133.
12. Financial projections prepared by company management in the ordinary course of business (and for general management planning purposes) represent the most independent data that can be used in a DCF method analysis. This is because financial projections prepared for other purposes, such as for litigation purposes, transactional purposes, and lending/loan purposes, can many times be tainted based on the goals of the litigation, transaction, or loan acquisition.
13. Trugman, *Understanding Business Valuation*, 255.
14. Fishman, Pratt, Hitchner, Griffith, Meltzer, and Lipnicky, *PPC’s Guide to Business Valuations*, 5–9.
15. Robert F. Reilly and Robert P. Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis* (Ventnor City, NJ: Valuation Products and Services, LLC, 2019), 704.

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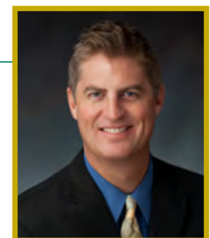

Due Diligence Interviews in a Forensic Analysis

John Sanders Jr. and Dakota Ask

This discussion summarizes forensic analysis best practices related to the conduct of a management due diligence interview. Conducting a successful due diligence interview is not a science. However, it does require a combination of preparation and years of practical experience. In order for the due diligence interview to be successful, the interview should involve (1) sufficient forensic analyst preparation time and (2) ensuring that the forensic analyst interviews the right individuals.

Introduction

A subject entity can be either a plaintiff or a defendant in a litigation matter. A subject entity may become involved in litigation (or other disputed matters) on different occasions.

Forensic analysts are typically retained by legal counsel to a disputing party with regard to one or more of the following issues:

- Valuations
- Damages measurements
- Shareholder disputes
- Bankruptcy
- Mergers and acquisitions
- Transfer pricing disputes
- Tax evasion
- Special investigations

A forensic analyst gathers information from and about the subject entity throughout the due diligence process.

However, a forensic analyst's engagement may not be limited to the above-listed issues. Typically, a forensic analyst may be retained by the subject entity's owner or management (or by its legal counsel) to assist with and render an opinion regarding a forensic investigation. In the context of this discussion, forensic analysts could be accountants, financial consultants, economists, or any other type of consultant.

A forensic analyst may conduct a special investigation for purposes of litigation or other disputed matters.

This discussion summarizes many of the best practices and procedures for due diligence that a forensic analyst may follow. Before discussing the due diligence procedures, it may be helpful to define what due diligence is and is not.

Due diligence is an investigation, audit, or review conducted to ascertain the relevant facts or details pertaining to a subject under investigation.[1]

Due diligence in the financial world entails a comprehensive review of financial records related to pending litigation or other disputed matters. The due diligence process assists the forensic analyst in formulating an unbiased opinion regarding the resolution of litigation or other disputed matters.

Due diligence interviews with management typically provide the forensic analyst with more information than other sources about the subject entity, ownership interest, or the matter.

The forensic analyst may be provided with documents (i.e., financial statements, general ledger transactions, bank statements, and depositions) as additional sources of information in preparation for the due diligence interview.

Frequently, the forensic analyst's information acquisition during the due diligence interview aids in the development, completion, and reporting of the forensic analyst's conclusion. Forensic analysts typically produce an expert report for legal proceedings or expert testimony before a judge or jury.

With regard to internal investigations, the analyst's forensic report is provided to the subject entity's executives or board of directors in many cases. Based on the findings, the forensic analyst is then tasked with formulating recommendations for the subject entity, the ownership interest, or the issue at hand.

Each forensic engagement connected with a lawsuit or other disputed matter may incorporate a due diligence interview. The due diligence interview may help counsel working with the forensic analyst to understand what to expect during the due diligence interview process.

The following issues will be addressed in this discussion:

1. Best practices regarding the due diligence interview process
2. Typical due diligence interview agenda
3. Typical questions that the forensic analyst may ask during the due diligence interview process

An appropriate due diligence has many phases. And, for purposes this discussion, we will consider due diligence best practices related to the "management interview."

The management due diligence interview can provide information to the forensic analyst that cannot be gleaned from document review alone. Engaging with management provides the analyst with context that parties outside the subject entity or industry may not be privy to. The analyst may develop an understanding of the relevant factors for the subject entity and the industry through management interviews.

Additionally, these discussions may reveal issues with the financial statements that may have previously been considered insignificant during the original review. Therefore, the due diligence interview is often useful for the forensic engagement. The forensic analyst can better understand the engagement by planning for and conducting a due diligence interview.

A due diligence interview can be conducted with any employee of the subject entity (typically in person, via phone, Zoom, interrogatories). As a rule, "management" refers to the entire organization, from staff accountants to the board of directors (in the case of a public subject entity).

As part of the due diligence process, the forensic analyst may also speak with third parties (e.g., former employees, independent auditors, counsel, commercial bankers, contractors, clients, suppliers).

Management Due Diligence Interview[2]

There is no one way for a forensic analyst to conduct a management due diligence interview. Each forensic analyst will develop his or her own unique style, refined over time through trial and error.

Some analysts conduct their interviews with a greater or lesser degree of structure, technology, travel, and so on. Whether or not a client can communicate and understand what is being asked of them during an interview depends on whether the forensic analyst can effectively communicates the interview questions.

For a due diligence interview to be successful, the forensic analyst should be adequately prepared to conduct the interview. What does that mean? To the best of his or her abilities, the forensic analyst should examine and interpret all information provided in the engagement document request, all court filings, and all public data regarding the subject entity or the industries in which it operates.

The following best practices may be considered in a forensic analyst's preparation for a due diligence interview:

1. Conduct an in-depth examination of the subject entity's website and any other publicly available data.
2. Conduct a thorough review of all documents provided by the subject entity's management and counsel.
3. Review, examine, and analyze financial statements of the subject entity, both historical and prospective.
4. Examine the subject entity's website and any other publicly accessible data in detail.
5. Prepare a list of specific questions to ask each person interviewed during the management interview process.

After reviewing documents provided by appropriate parties and developing due diligence interview questions, the forensic analyst should identify the subject entity's appropriate individuals to interview.

The individuals the forensic analyst may interview will vary according to the engagement. Senior management and key employees, legal counsel, independent accountants or consultants, suppliers, customers, and former employees are sometimes interviewed.

The primary goal of the due diligence interview is for the forensic analyst to ascertain the truth. As the forensic analyst conducts the due diligence interview, the forensic analyst should filter out any information not relevant to the matter.

The primary goal of the forensic analyst is to ask the interviewee clear and direct questions. If the interviewee does not provide the necessary information or answer the question adequately, the forensic analyst is responsible for asking follow-up questions or obtaining additional documents.

The objective for the forensic analyst is to remain focused so that he or she may formulate a clear and concise conclusion; therefore, unnecessary information should be eliminated.

It is a best practice for the forensic analyst to consider the possible objectives and motives of the interviewee before conducting his or her interview. For instance, management may provide answers about the reliability of their organization's financials that align with the incentives and metrics to which their individual performance is graded, therefore compromising their statements' unbiased nature and validity.

An analyst's responsibility is to use discretion regarding the interviewees' unique motivations in these cases.

During the due diligence interview, it is possible that new or unexpected issues may be discovered, which may or may not have a significant impact on the engagement. The forensic analyst should understand the important issues and how these issues affect the forensic analysis conclusions.

The Due Diligence Interview Agenda

The interview style and process are individual to each case. Ordinary sense, staff availability, and

other circumstantial realities often dictate the logistical practicality of the meeting. The forensic analyst rarely has control over what happens during the interview process.

Senior management is busy running their businesses and is often tied or called to duty during the interview. Before the management due diligence interview, the forensic analyst should communicate and effectively coordinate with the appropriate parties (i.e., senior management, counsel, bankers, accountants) when, where, and what time the due diligence interview is scheduled to take place.

The forensic analyst should review the engagement budget to see what time is allotted, including travel time.

The following list provides a sample agenda for a due diligence interview:

- Tour the entity's facility
- Conduct interviews with the owners and senior management to understand the big picture items of the subject entity or subject interest
- Conduct interviews with financial personnel, line managers, and any other identified personnel to ascertain an understanding and description of the business's critical internal and external components
- Follow up with senior management or other subject entity personnel if there are any unresolved questions or additional questions after the due diligence interview
- Discuss any new or previously unknown issues that may affect the forensic analyst's conclusion with counsel, if any

The forensic analyst should better understand the subject entity or interest when leaving the due diligence interview.

Best Practices regarding Interview Questions

There is no standardized list of due diligence interview questions that a forensic analyst should ask. The list of questions presented in Exhibit 1 is not intended to be comprehensive or all-inclusive. After reviewing the documents received during the initial document request, the forensic analyst should develop his or her own list of questions.

The forensic analyst may consider the following areas when developing due diligence interview questions: (1) background and history, (2) ownership and capital structure, (3) services and product lines, (4) customer and supplier relationships, (5) management and personnel, (6) contractual relationships, (7) competitors and industry overview, (8) financial results and information, (9) contractual relationships, and (10) litigation and other material facts.

Summary and Conclusion

The due diligence interview is one of several components of a forensic analysis in connection with litigation or other disputed matter. As a result, the forensic analyst should be proficient in conducting interviews. The due diligence interview is helpful because the answers provided by the interviewee may directly affect the forensic analyst's conclusion.

When the entity or object of interest presents material issues, the due diligence interview provides an opportunity to resolve them. The primary objective of the due diligence interview is to allow the forensic analyst to ask and receive answers to questions.

In addition, the due diligence interview may elicit information that the forensic analyst is not aware of before the interview. Exhibit 1 presents a list of questions the analyst may consider during a due diligence interview. Exhibit 1 is not an exhaustive list. Rather, it is intended to serve as a reference which forensic analysts may use or modify as they prepare for a due diligence interview.

Each forensic analysis may be different. Therefore, neither the interview question list below nor the information above should replace the forensic analyst's professional judgment.

Notes:

1. "Due Diligence Definition & Uses for Stocks," Investopedia, https://www.investopedia.com/terms/d/duediligence.asp.
2. Robert F. Reilly and Robert P, Schweihs, *Best Practices: Thought Leadership Valuation, Damages, and Transfer Price Analysis* (Ventnor, NJ: Valuation Products and Services, 2019).

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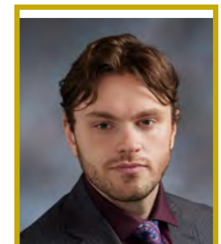

Exhibit 1
Due Diligence Interview Sample Questions

The following is a list of possible interview questions for a due diligence interview. While this is not an exhaustive list of questions that a forensic analyst may ask during the due diligence interview, the following list provides a starting point to prepare for the interview.

Background and History

- When was the subject entity founded, who founded it, and if there has been sufficient ownership change since its inception?
- What are the subject entity's current entity status (e.g., corporation, partnership, limited liability company, sole proprietorship, etc.) and tax status?
- Describe the evolution of the subject entity lines of business since its inception and the subject entity's current lines of business.
- List all related parties that the subject entity does business with. In addition, indicate all names of any divisions or subsidiaries in which the subject entity owns an equity interest.
- Describe each location maintained by the subject entity and its primary activity.
- Describe any restrictions on transferring the subject entity's equity interests (i.e., buy-sell agreements, restricted stock agreements, etc.).
- Discuss any other key dates or events in the subject entity's history.

Product Lines (Services) and Marketing

- Describe the nature of the subject entity's (a) manufactured and/or sold products or (b) provided services.
- Which product line or service offered is the fastest growing and the slowest growing?
- What is the largest product sold or service offered by the subject entity over the last five years, and how has this product mix changed over time?
- Describe the subject entity's markets and how it distributes its products or services. Are subject entity's sales either seasonal or cyclical?
- What is the typical life cycle of the subject entity's products/services?
- What are the advantages/disadvantages of the subject entity's products/services?
- Does the product/service have any rival technology, products, or services that affect future demand?

Customer

- Why do customers want to use or purchase the subject entity's product/services?
- List the top 10 customers by revenue for the last five years.
- Does an annual customer sales exceed 10 percent of revenue? If so, who is that customer? Is there any risk of losing that customer? How does the subject entity intend to mitigate that loss if the customer leaves?
- Does the subject entity have contracts or exclusive vendor agreements with certain customers?
- What does the subject entity's backlog look like? Are there any large contracts pending?
- How does the subject entity set prices? Are there substitutes for either subject entities?

Suppliers

- What raw materials or other supplies are the subject entity dependent on?
- Who are the firm's suppliers?
- What is the subject entity's supplier count?
- Are any of those suppliers the subject entity's sole source of supply?
- How long has the subject entity had a business relationship with each of its key suppliers?
- Are any suppliers the sole (or primary) source of a particular product for the industry?

Exhibit 1 (cont.)
Due Diligence Interview Sample Questions

- Explain how supplies were/are priced.
- What is the current supply-cost trend?
- List and provide copies of any long-term supply contracts or other special purchasing arrangements with suppliers that you have in place.
- How much notice does the subject entity or the supplier need to end the business relationship? Could the subject entity change suppliers without hurting the business? If so, why or why not?
- If the subject entity needed to find a new supplier for a critical supply, (1) could it do so and (2) how long would it take?

Management and Employees

- Provide a copy of the most current organization chart and resumes for key management team members.
- How long has the subject entity employed the key members of the management team?
- Do any of the key members of the management team have known health issues, or are any of the key members of the management team close to retirement age?
- Provide the total compensation for each subject entity management team member, including perquisites.
- What unions represent the subject entity's employees, and when do the contracts expire?
- Collective bargaining agreements cover how many employees?
- Has the subject entity experienced any work stoppages due to a strike?
- What is the total number of employees in each organizational area: executive management, operating/service delivery, marketing/sales, accounting, and administration/personnel? What are the most critical skills and backgrounds needed to develop, produce, and distribute the subject entity's products/services?
- List the members of the subject entity's board of directors and describe each member's background.

Subject Entity Outlook

- Describe the subject entity's advantages, disadvantages, opportunities, and threats.
- What are the expected annual growth in revenue, operating profit, and net profit over the next five years?
- How is it possible that the actual financial results will far outperform the projected financial results?
- What level of capital investment is required to support the projected growth?
- Is the annual budget or forecast regarded as conservative, standard, or aggressive? How do the projected growth rates and profit margins compare to the historical rates and profit margins?
- Is the subject entity planning to change its ownership in the future (via share buybacks or share issuance)?

Industry and Economy

- What national or regional economic factors influence the subject entity's sales (for example, interest rates, inflation, disposable income, and so on)?
- What distinguishes the subject entity from other companies in the industry?
- How has the subject entity fared during recent downturns? During a good economic period?
- Is government regulation an issue in the industry? If so, how so?
- In what stage of the industry life cycle is the subject entity industry (introduction, growth, maturity, or decline)?
- What are the most recent significant developments or trends in the industry?
- How many companies in the industry are the approximate size (e.g., revenue within plus or minus 50%)?
- Is the industry dominated by small "mom-and-pop" businesses or large multi-national corporations?
- Describe the entry barriers in the industry.
- How has the industry's size changed in the last five or the next five years?

Exhibit 1 (cont.)
Due Diligence Interview Sample Questions

- Is the subject entity's technology considered (1) outdated, (2) current, or (3) cutting-edge in comparison to the industry standard?
- What trade associations are the subject entity a member of?

Competition

- Who are the subject entity's most significant competitors? List both publicly traded and privately owned competitors.
- In terms of revenue, how big are the competitors?
- Where can I find competitors?
- What is the subject entity's estimated competitor market share for each of its products and services?
- What are the main advantages and disadvantages of competitors compared to the subject entity?
- What factors drive competition in this industry (e.g., price, quality, service, technology, or some other factor)?
- Do the competitors of the subject entity have greater or lesser economies of scale than the subject entity?
- How has competition changed in the last five years (new competitors, regulatory changes affecting competition, pricing power erosion, etc.)?
- How intense is the competition among companies in the industry?

Historical Financial Results

- Provide a copy of the auditor's letters to management for the previous five years, if applicable.
- Describe the subject entity's accounting principles (e.g., revenue recognition methods, cash versus accrual basis, and inventory accounting methods).
- Have accounting principles changed in the development of financial statements over the last five years?
- Explain any significant year-over-year changes in the financial statement accounts (for example, the interviewee should explain changes such as (1) a 50 percent annual increase in accounts payable, (2) a 15 percent annual decrease in sales, or (3) the gross margin improved from 30 percent to 40 percent of sales).
- Describe any nonrecurring or unusual income or expenses you have had in the last five years.
- What capital expenditure plans does the subject entity have for the next 12 months?
- Are there any stockholders who are guarantors of corporate loans? If so, please explain.
- Describe the short- and long-term credit sources, as well as how you used them over the last five years.
- Is the current capital structure (1) sustainable and (2) likely to change in the next five years?
- Discuss the dividend history of the subject entity and the outlook for future dividend payments.
- Summarize any assets owned by the subject entity that are (1) nonoperating assets or (2) excess assets. That is, are there any assets that do not contribute to the subject entity's primary operations (e.g., cash and cash equivalents are not needed for future working capital or capital expenditures)? Describe any assets or liabilities of the subject entity that are not recorded on the subject entity balance sheet.

Source: Robert F. Reilly and Robert P. Schweihs, *Best Practices: Thought Leadership Valuation, Damages, and Transfer Price Analysis* (Ventnor, NJ: Valuation Products and Services, 2019).

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GUIDE TO PROPERTY TAX VALUATION

Robert F. Reilly and Robert P. Schweihs

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Best Practices Discussion

Best Practices Related to Equity Incentive Compensation Programs

Robert F. Reilly, CPA

Private companies (and particularly early-stage private companies) may use equity incentives to attract and/or retain talented employees. This employee compensation practice has become more common during periods of labor shortages and low unemployment rates. However, equity incentive compensation plans have income tax consequences—both to the employee recipient and to the employer company. This discussion summarizes the taxation issues and the security valuation issues related to the implementation of private company equity incentive compensation programs.

Introduction

With the labor shortages currently affecting many industries and with the low national unemployment rate, many private companies are considering some form of equity compensation incentives to attract and retain high quality employees. For years, private companies have developed and implemented equity incentive compensation plans for senior executives and for other key employees.

In the current economic environment, many private companies are expanding those equity incentive plans to include all management levels and, in certain cases, some of their rank-and-file employees, as well.

For purposes of this discussion, the term private company includes a corporation (both C corporation and S corporation), a limited liability company ("LLC"), or a partnership. For purposes of this discussion, equity incentive compensation plans include stock (or LLC unit) awards, stock (or LLC unit) options, and partnership profits interests.

With regard to the grant of equity incentives, this discussion considers some of the uncertainties related to the fair market value valuation of private company equity interests. In particular, this discussion considers the compensation related to the valuation of early-stage private company equity interests.

This discussion focuses on both the taxation aspects and the valuation aspects of implementing an equity incentive compensation plan at a private company. In this discussion, the assumed purpose of such a plan is to assist the private company to attract and retain the best employees. This discussion is not intended to provide legal, accounting, or taxation advice.

This discussion focuses on all private companies, including closely held private companies. This discussion is particularly relevant to early-stage and development-stage private companies (including start-up companies). In a competitive labor market, smaller, more thinly capitalized companies may face a greater need to use equity incentive plans to attract and retain high-quality employees.

And, newer, smaller, and more thinly capitalized companies will experience more valuation uncertainty with regard to both the grant and the taxation of their equity incentive alternatives.

Business owners often do not research or consider all of the taxation aspects of implementing an equity incentive compensation plan. The business owner's decision to implement such a compensation

plan may have to be made quickly in order to hire or retain a key employee. The taxation considerations of an employment offer that includes equity incentives may be an afterthought.

In addition, the professional valuation of the equity instruments encompassed in the newly created plan may also be an afterthought. The retention of an independent valuation analyst ("analyst") may occur after the equity incentives have been offered—and accepted.

Such analysts may not be familiar with all of the taxation consequences related to the grant of equity incentive awards.

The implementation of an equity incentive plan will have taxation consequences both to the employee recipient and to the private company. These taxation considerations may be particularly material to an early-stage company. Many of these taxation considerations relate directly to the valuation of the equity instruments included in the compensation plan.

Typically, there is a greater level of uncertainty in the valuation of an early-stage private company than there is in the valuation of a larger, established, better-capitalized private company.

This discussion summarizes the least that business owners and analysts—and their tax (and other professional) advisers—need to know about the implementation of an equity incentive compensation plan. Again, the scope of this discussion is limited to stock awards, stock options, and partnership profits interests.

Uncertainty in the Early-Stage Company Valuation

There is some uncertainty with regard to the fair market value valuation of any private company business enterprise. There is greater uncertainty with regard to the valuation of the nonmarketable, noncontrolling equity instruments of a private company.

There is greater uncertainty still with regard to the valuation of the nonmarketable, noncontrolling equity instruments of an early-stage or development-stage private company.

For purposes of this discussion, this uncertainty relates to the probability that the estimated fair market value of the equity will turn out to be different than the actual fair market value of the equity.

For purposes of this discussion, the estimated fair market value is the amount concluded in an independent valuation prepared by a valuation specialist.

For purposes of this discussion, the actual fair market value is the price that is actually paid in an arm's-length transaction between a wiling buyer and a willing seller. This probability that the estimated value is different than the actual value is sometimes referred to as valuation risk.

Valuation risk may be considered as the risk that the independent valuation conclusion will understate or overstate the actual transaction price of a private company equity interest.

Business owners, tax counsel, and other professional advisers should understand that there is some uncertainty—or valuation risk—in every security valuation that is prepared for equity incentive plan purposes. And, there is greater uncertainty—or valuation risk—in every early-stage company security valuation that is prepared for equity incentive plan purposes.

In all private company valuations, analysts exercise professional judgment in the selection and application of the generally accepted business valuation approaches. Analysts exercise professional judgment in the selection and application of the individual business valuation methods applied within each generally accepted valuation approach.

Analysts exercise professional judgment in the selection and application of the specific valuation procedures within each business valuation method. And, analysts apply professional judgment in the selection and application of the quantitative valuation variables (i.e., the actual numbers) that are considered in the selected valuation procedures.

When the subject private company is in its early or development stages, these professional judgements are often more difficult to make and more difficult to support. Often, the analyst's valuation judgments regarding the early-stage company may be difficult to support due to data constraints.

The subject company may not have a long history of financial results of operations. The historical financial results of operations may look materially different year to year—as the subject company matures.

The subject company may not have audited financial statements. The historical financial statements may be influenced by the company's change in accounting policies over time. The historical financial statements may be influenced by the company's debt/equity recapitalizations.

The company may have not yet achieved a stabilized (also called normalized) level of operating income. This lack of stabilized income may limit the analyst's ability to apply the direct capitalization method to the private company security valuation.

In addition, the early-stage company may not have prospective financial statements—that is, financial projections. If the company does have financial projections, the analyst may not be able to assess whether those prospective financial statements are credible.

That is, the analyst may not be able to perform the typical due diligence procedures with regard to those financial projections. For example, due to the company's limited history, the analyst may not be able to compare previous period financial projections to previous period actual results of operations. Such a comparison often allows the analyst to assess management's ability to develop reliable financial projections.

Another valuation data constraint may involve transactional data that would allow the analyst to apply market approach security valuation methods.

For example, there may not be any publicly traded companies that are sufficiently comparable to the subject early-stage company to provide meaningful valuation guidance. In that case, the analyst may not be able to apply the guideline publicly traded company valuation method.

Likewise, there may not be any completed merger and acquisition transactions that are sufficiently comparable to the subject early-stage company to provide meaningful valuation guidance. In that case, the analyst may not be able to apply the guideline merged and acquired company (or guideline transaction) valuation method.

The above-listed data constraints may affect the analyst's judgments with respect to the private company security valuation. There may also be data constraints that affect the analyst's valuation of the options to buy the private company securities.

Many stock option valuation methods involve analyses that are typically called option pricing models. These options pricing models incorporate valuation variables that may also be influenced by the analyst's judgment.

Many option pricing models include consideration of the expected future variability in the private company stock value. And, many option pricing models include consideration of the expected future growth rate (rate of appreciation) in the private company stock value.

However, the analyst may not have adequate data with regard to historical company stock value variability or historical company stock value growth rates. Such data constraints may cause uncertainty in the analyst's private company stock option valuation analyses and conclusions.

Stock Awards and Valuation

Internal Revenue Code Section 83 provides the income recognition rules for an employee's receipt of stock or LLC units (collectively, "stock") with respect to that employee's performance of services.

Section 83(a) provides that the employee's receipt of such stock is taxable income to the extent that (1) the fair market value of the stock exceeds (2) the price (if any) paid for the stock.

The fair market value of the stock is measured at the time that the stock award vests.

Section 83(b) allows the employee to make an election. That election allows the employee to recognize taxable income on the stock grant date, regardless of when the stock award ultimately vests. The amount of the taxable income equals the excess of:

1. the fair market value of the stock over
2. the price (if any) paid for the stock.

When the employee makes the Section 83(b) election, the stock fair market value is estimated without regard to any award restriction that will lapse in the future.

Whether Section 83(a) or 83(b) applies, the amount by which the stock's fair market value exceeds the amount (if any) paid for the stock represents:

1. taxable income to the employee and
2. a tax deduction to the employer company.

If the stock subject to grant is undervalued, then there may be a potential tax liability to the employee. That is, the Internal Revenue Service (the "Service") may claim:

1. the actual fair market value is greater than the amount that was reported by the employee and
2. the employee underreported his or her taxable income.

In addition, if the stock is undervalued, then the employer company will not benefit from the income tax deduction associated with that value understatement.

If the stock subject to the grant is overvalued, then the employee will recognize more taxable income than the Service would have required. In addition, the Service may disallow the employer company's tax deduction for the alleged stock value overstatement.

Stock Options and Valuation

Of course, stock options are typically subject to greater valuation risk than are private company stock awards. This is because, often, there is more analyst judgment involved in the valuation of stock options than there is in the valuation of private company stock.

Nonqualified stock options are more typically granted in private companies (particularly in early-stage companies) than are incentive stock options. This is because nonqualified stock options are generally subject to fewer taxation requirements and restrictions than are incentive stock options.

Unless certain requirements are met, nonqualified stock options may fall within the Section 409A requirements. For purposes of this discussion, the most relevant Section 409A-related taxation requirement is as follows: "the exercise price may never be less than the fair market value of the underlying stock . . . on the date the option is granted." This fair market value requirement is provided in Regulation 1.409A-1(b)5(k)(A)(1).

Section 409A provides for a 20 percent additional tax (plus interest) on the amounts to which it is applied. Therefore, taxpayers (and their tax advisers) want to make sure that any stock options are issued with a strike price at or above the fair market value of the employer company's stock.

In the *Sutardja* decision,[1] the Service applied the provisions of Section 409A to discontinued stock options. The Service claimed that the taxpayer's exercise of the employer company's stock option was from a nonqualified deferred compensation plan under Section 409A(d).

Dr. Sehat Sutardja and his wife Weili Dei were employed by his company, Marvell Technology Group Limited. Dr. Sutardja exercised a stock option that was granted by Marvell. Upon audit, the Service applied the additional 20 percent tax provided by Section 409A(a)(1)(B)(i)(II). At trial before the Court of Federal Claims, both the taxpayer, Dr. Sutardja, and the Service agreed that the stock option did have a readily determinable fair market value as of the grant date. Based on that agreement, the taxpayer could not convince the court that the nonqualified stock option was not issued at a strike price below fair market value.

Partnership Profits Interests and Valuation

Many private companies operate as either a C corporation or an S corporation. In recent years, many early-stage companies have elected the LLC form of organization. These LLCs typically elect to be taxed as partnerships. Currently, the Biden administration has proposed the return of higher federal income tax rates for C corporations. In the event that such a fiscal policy initiative can make its way through Congress and be passed into law, the LLC organization structure may become even more popular—particularly for start-up companies.

Like early-stage corporations, early-stage LLCs often use equity incentive plans to attract and retain talented employees. For LLCs (taxed as partnerships), one possible compensation alternative is profits interests. In such a compensation arrangement, the employee becomes a partner of the firm—but a partner who can only share in the future appreciation of the company. Revenue Procedures 2001-43 and 93-27 provide safe harbor provisions under which the Service will treat the employee's receipt of a partnership profits interest as a nontaxable event.

In Revenue Procedure 93-27, the Service defined a partnership profits interest as any "partnership interest other than a capital interest." At its grant date, a partnership capital interest "would give the holder a share if the proceeds of the partnership's assets were sold at fair market value." Therefore, the fair market value valuation of the profits interest is an important consideration.

The safe harbor provisions in the above-mentioned revenue procedures only apply in instances that the Service considers to be a true profits interest. The question of what provisions qualify as a partnership profits interest has been litigated. See, for example, *Crescent Holdings, LLC*.[2] If the partnership interest is issued "in the money," then the Service may recast the profits interest as a capital interest. The grant of a capital interest would be considered taxable compensation to the employee on the grant date. In other words, the Service will treat the grant of a capital interest just like the grant of a stock (or an LLC unit) award.

Such a Service challenge to a partnership profits interest is particularly important to an employee who has made the Section 83(b) election. In that situation, if the Service recasts the profits interest as a capital interest, then the employee will have to recognize taxable income equal to the fair market value of the (recast) capital interest on the grant date.

Valuation Challenges

When business owners implement any of the above-mentioned equity incentive programs, tax counsel and other advisers often recommend that the

company retain specialist professionals to estimate the fair market value of the employer company and of the subject equity interests. These specialists prepare these fair market value security valuations as of a specifically identified valuation date. That date is typically the equity incentive grant date. Such security valuations are typically prepared by analysts with specialized valuation credentials. And, such security valuations are typically developed in compliance with generally accepted valuation professional standards.

Nonetheless, as discussed above, such security valuations are influenced by the individual analyst's professional judgments. And, such analyst judgment is influenced by the company, industry, economic, and capital market information that is known or knowable to the analyst as of the specified valuation date.

When the Service reviews the company's equity incentive compensation program years after the fact, the Service has the benefit of hindsight. Particularly for an early-stage private company, the actual company results, competitive conditions, and economic trends may turn out differently from what was projected by the company management or by the valuation analyst.

This sometimes-called hindsight advantage often affects the Service's challenge of security valuations prepared for income tax, estate tax, or gift tax purposes. In the *Estate of Jung*,[3] the Tax Court opined that "if a prospective . . . buyer and seller were likely to have foreseen [a future sale], and the other activities leading to the liquidation, then those later-occurring events could affect what a willing buyer would pay and what a willing seller would demand as of [the valuation date]."

In other words, the courts sometimes agree that the Service can consider certain post-valuation-date events to assess the credibility of an independent valuation analysis. The question is typically disputed about whether such post-valuation-date events were actively known—or could have been knowable—as of the specific valuation date.

The possibility of this hindsight lookback on the part of the Service may influence how the employer company approaches the valuation of the equity ownership interest. Business owners are typically advised not to undervalue the equity incentive award if there may be a near-term stock sale, company sale, or company capitalization event that will provide the Service with post-valuation-date security pricing benchmarks.

Of course, for private companies, valuation uncertainty—or valuation risk—cannot be eliminated entirely. This conclusion is particularly true in the case of an early-stage or development-stage company.

As discussed above, such security valuations—however professionally prepared—are often influenced by the limited availability of both historical data and prospective data. Of course, the business owner's reliance on a professional analyst's independent valuation helps the taxpayers to comply with various Section 409A safe harbors. And, such reliance—and such safe harbors—shift the burden of proof on any equity incentive valuation challenges from the taxpayer to the Service.

With a professionally supported equity interest valuation in place, the business owner can more confidentially use the equity incentive compensation plan to attract and retain talented employees.

Making the Section 83(b) Election

The Section 83(b) election is an employee election, not an employer company election. First, the employee receives from the employer company one of the equity incentives described above. Second, the employee makes the Section 83(b) election. This election allows the employee to recognize the income tax consequences of the equity incentive at the time of the incentive grant—rather than at the time that the equity incentive is vested.

Presumably, for a successful employer company with an appreciating equity value, the amount of compensation income that the employee will have to recognize is much lower on the current grant date than it will be on the future vesting date.

More generous private companies may pay for a tax adviser (or some other expert) to advise the employee recipient regarding the decision to make the Section 83(b) election. The principal purpose of implementing an equity incentive compensation plan is to attract and return talented employees.

The business owners want to keep the company's best employees happy. Company employees who are faced with unfavorable or unexpected income tax consequences—or who missed an opportunity to enjoy a favorable income tax treatment—generally will not be happy employees.

The *Alves* Decision

The Tax Court's decision in *Alves*[4] illustrates the negative consequences of an employee not making a timely Section 83(b) election with regard to an equity incentive award. In this case, the taxpayer was an employee of an early-stage private company, General Digital Corporation.

The employee, Lawrence Alves, was granted the right to company common stock at 10 cents per share, the then fair market value of the stock. In fact, employee Mr. Alves purchased the stock for a price equal to fair market value. Upon audit, the Service never challenged the fair market value pricing determination.

The issue is that the employee still owned the stock at the end of the vesting period, and the private company stock had appreciated materially between the grant date and the vesting date. In the year of the vesting date, the employee did not report that appreciation as compensation income on his income tax return.

The Service audited Lawrence Alves. The Service issued an adjustment and assessed additional tax on the amount of the stock value appreciation between the purchase date and the vesting date. Again, employee Alves had paid an undisputed fair market value price for the new corporation's stock on the grant date.

But, Mr. Alves did not make the Section 83(b) election. Therefore, the Service claimed that the stock value appreciation was ordinary income to the employee under Section 83(a).

Alves brought suit in the Tax Court. Based on these facts, the Tax Court agreed with the Service. In its decision, the Tax Court stated "it is unfortunate that the petitioner did not elect the provisions of Section 93(b)." However, the court upheld the Service's position.

Lawrence Alves appealed to the U.S. Court of Appeals. In its decision in *Alves*,[5] the Ninth Circuit upheld the Tax Court's decision. The Appeals Court also noted how unfortunate this result was for the taxpayer employee.

The Appeals Court stated, "the tax laws often make an affirmative election necessary. Section 83(b) is but one example of a provision requiring taxpayers to act or suffer less attractive tax consequences." While the Ninth Circuit recognized how inequitable this result may seem to Mr. Alves, this court also upheld the Service's position.

In the *Alves* matter, if the taxpayer had simply made the Section 83(b) election, he would have escaped the taxation on ordinary income related to the General Digital Corporation stock appreciation between the purchase date and the vesting date.

In addition, in this case, there would have been no tax cost to Mr. Alves to make the Section 83(b) election. This is because, at the time of the early-stage company stock purchase, the "excess" of the stock's fair market value over the stock's purchase price was zero. This would have been the result because Mr. Alves had paid the full fair market value for the General Digital Corporation stock.

Other Section 83(b) Election Issues

It is noteworthy that making the Section 83(b) election also starts the statutory clock running with regard to any Service challenge to the equity incentive transaction. That is, the tax year in which the employee makes the election starts the statutory limit on the amount of time during which the Service can challenge the valuation of the equity incentive award.

Both grants and awards subject to vesting provide the Service with several opportunities to challenge the valuation of the equity incentive. The Service can challenge the initial equity valuation and any subsequent equity valuations during the various vesting dates.

Therefore, it may be in the employee's interest to make an election that begins to limit the time period during which the Service can challenge the equity valuations.

Employee recipients (and employer companies) should be aware that there is some financial risk to making the Section 83(b) election. The risk is that the employee may ultimately forfeit the equity incentive award or grant after the election is made.

Employees (and employers) should realize that the private company shares (or the LLC units) often are not legally vested when the election is made. Those shares (or units) typically can be forfeited if the employee leaves the employer company for any reason before vesting occurs.

Section 83(b)(1) states the following: "if such election is made . . . and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture."

That is, if the employee leaves the employer company and forfeits the equity incentive, the employee will not get a tax deduction for the grant date income that was recognized at the time the Section 83(b) election was made.

Employee (and employers) should note that forfeiting the equity incentive stock (or units) has different income tax consequences than disposing (say, in a liquidation) of the stock (or units). In a disposal (say, liquidation) scenario, the employee will have a tax basis in the stock (or the units) that are being disposed.

This tax basis was created when the employee made the Section 83(b) election and recognized taxable income at that time. If the liquidation

proceeds (if any) are less than the employee's basis in the shares or units, then the employee can claim a capital loss on the disposal of the equity interest.

The point is that there are both risks and rewards to the employee recipient who makes the Section 83(b) election. The previous paragraphs illustrated a couple of the risks. However, employee recipients (and employer companies) should consider that the rewards of the election generally outweigh the risks of the election.

If the private company is successful, then the employee could expect that the stock or units will appreciate over time. And, the employee would expect to ultimately sell the stock or units (whether back to the employer company or to another buyer) at a price much higher than the price the employee originally paid for the equity interest.

If the employee had made a valid Section 83(b) election, then all of that appreciation would have been taxed as a long-term capital gain—rather than as ordinary income.

Summary and Conclusion

Business owners (whether of early-stage companies or seasoned companies) are often in competition to attract and retain talented employees. This statement is particularly true when the national (or industry) unemployment rate is at a historically low level. And, this statement is particularly true when the better employees believe that it may be a good time to jump ship and find (what they perceive to be) a better opportunity.

Early-stage and development-stage companies may find it more difficult to recruit the most talented employees. Rightly or wrongly, such employees may perceive more risk and less opportunities associated with smaller employer companies.

In order to incentivize and retain high quality employees (and, particularly, key position employees), many private companies offer a variety of equity incentive compensation programs.

This discussion considered stock grants, stock options, and partnership profits interests as three typical examples of such compensation programs. These types of equity incentive programs are fairly typical in early-stage and development-stage companies.

Employees in such companies often believe that they deserve such equity incentives. Such employees often remind the business owners that "they came in on the ground floor" and that "they helped the company to achieve its success." In such situations, these employees sometimes believe that they have earned a share of the company's value appreciation.

In addition to compensation advisers, business owners should consult with tax advisers and valuation specialists before implementing an equity incentive compensation program. Such programs bring income tax consequences to both the employee recipients and to the employer company.

Valuation specialists should be aware of such consequences and should be aware of how their fair market value security valuations may affect those consequences.

In particular, all parties to an equity incentive program should be aware of the uncertainty associated with the valuation of private company securities—and particularly early-stage company securities.

The parties should understand that the Service is less subject to this so-called valuation risk when it challenges these private company security valuations. That is because the Service may be applying hindsight when it reviews such transactions years after the grant date or the vesting date.

Business owners should consider all of the taxation consequences of implementing an equity incentive program. Business owners should also consider the practical consequences of implementing such a program.

For example, if the company employee does not have the available liquidity to exercise a stock option or to pay the income tax on a stock award, then such a program could prove to be an employee disincentive rather than an employee incentive.

Finally, both employees and employers should consider the costs and the benefits of all of the tax elections—and other tax strategies—related to the equity incentive compensation awards.

Notes:

1. Sutardja v. United States, 109 Fed.Cl. 358 (2013).
2. Crescent Holdings, LLC v. Commissioner, 141 T.C. 477 (2013).
3. Estate of Jung v. Commissioner, 101 T.C. 412 (1993).
4. Alves v. Commissioner of Internal Revenue, 79 T.C. 864 (1982).
5. Alves v. Commissioner of Internal Revenue, 734 F.2d 428 (9th Cir., 1984).

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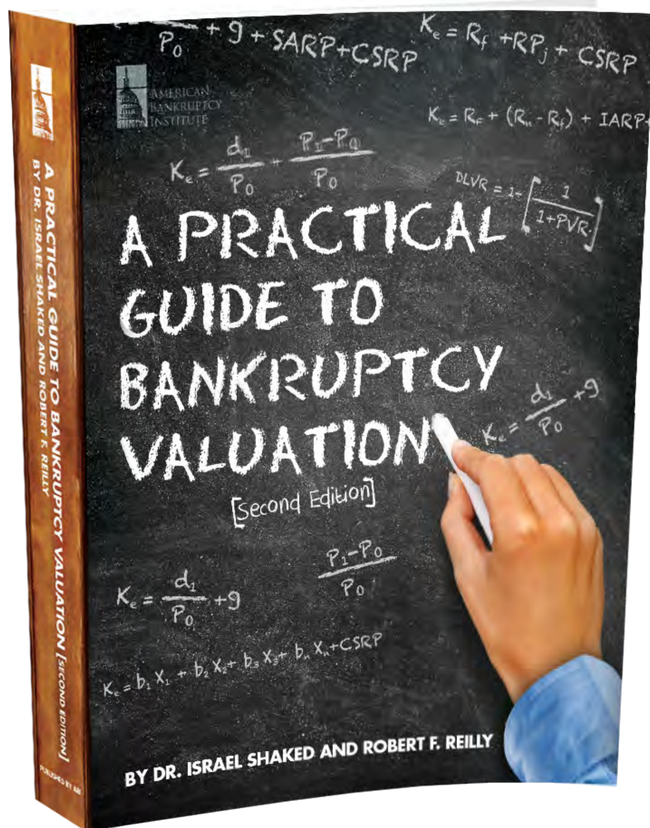

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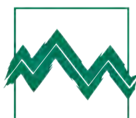

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Dr. Israel Shaked and Robert F. Reilly

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Glossary

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Valuation Reporting Requirements for Charitable Contribution Tax Deductions

Weston C. Kirk and Christopher T. Chafin

This discussion summarizes what the valuation analyst, tax counsel, and taxpayer need to know with respect to the valuation reporting requirements for charitable contribution income tax deductions. This discussion specifically focuses on the charitable contribution income tax valuation reporting requirements related to the noncash contribution of private company stock.

Charitable Contribution Income Tax Deduction Overview

Affluent households, that is, households with a net worth of $1 million or more (excluding the value of their personal residence) and/or annual household income of $200,000 or more, provide the largest share of charitable donations in the United States. In 2020, 88.1 percent of affluent households gave to charity, as compared with only 48.4 percent of the general population.

Affluent households on average gave $43,195 to charity in 2020 as compared to the general population of $2,581. About 59 percent of affluent donors reported that giving was motivated in part by the income tax benefit; whereas, about 41 percent reported that giving was never a motivation to their charitable philanthropy.[1]

The majority of affluent households (79.1 percent) gave directly to charity in 2020 from their personal assets and income; whereas, one in five (20.1 percent) gave to charity through a charitable trust, donor-advised fund, family foundation, or other charitable giving vehicle.

Approximately 7.4 percent of the affluent donors in the survey noted that either a family-owned business or a company that they started were the source of their net worth.[2]

One avenue for making a charitable contribution to a qualified charity, charitable trust, donor-advised fund, family foundation, or other charitable giving vehicle is to contribute shares of a private company rather than giving cash alone. The shares of the private company may be equally valuable to that of the cash the taxpayer may be interested in giving to charity, but if the stock has a lower cost basis, the after-sale net proceeds would be lower than if the taxpayer had simply transferred the appreciated private company shares.

The charity would then be able to liquidate the private company stock (e.g., a redemption by the private company) without incurring the same taxation that the taxpayer would otherwise be required to pay.

Many affluent households use private company stock to make annual charitable gifts. However, this type of asset is considered to be a noncash charitable contribution that requires additional documentation by the Internal Revenue Service (the "Service").

Unlike publicly traded stock, an independent valuation is required by the Internal Revenue Code (the "Code") to secure a charitable tax deduction from the private company stock charitable gift.

If documented properly, and in most instances, an income tax deduction of the fair market value of the private company stock would apply to the

taxpayers' adjusted gross income ("AGI"). In general, contributions to charitable organizations may be deducted up to 50 percent of AGI (computed without regard to net operating loss carrybacks). Contributions to certain private foundations, veteran organizations, fraternal societies, and cemetery organizations are limited to 30 percent of AGI (computed without regard to net operating loss carrybacks).[3]

From time to time, the Service encourages more charitable giving by temporarily suspending the limits on charitable contribution deductions, such as was the case in 2020 and 2021 where deductions were adjusted to 100 percent of AGI for those tax years.

The purpose of this discussion is to present (1) the valuation reporting requirements under the Code for noncash charitable contribution deductions, (2) the valuation professional organization ("VPO") standards that apply directly to charitable income tax reporting compliance, and (3) the valuation analyst ("analyst") and taxpayer penalties that may apply for both substantial and gross valuation misstatements for charitable contributions.

Charitable Contribution Income Tax Deduction Requirements

According to the Section 170(a)(1), noncash charitable contributions to qualified organizations are deductible by individuals and corporations for income tax reporting purposes.

The analyst, tax counsel, and taxpayer should be aware of and comply with the specific valuation reporting requirements for noncash charitable income tax deductions, which are different than those that apply for estate and gift tax valuation reporting purposes under the Code.

To claim any deduction for any charitable contribution of $250 or more in value,[4] the taxpayer needs to substantiate the gift with a contemporaneous written acknowledgement of the charitable contribution with the following information:[5]

1. The amount of cash and a description (but not value) of any property other than cash contributed
2. Whether the donee organization provided any goods or services in consideration, in whole or in part, for any property described in one above
3. A description and good faith estimate of the value of any goods or services referred to in number two above or, if such goods or services consist solely of intangible religious benefits, a statement to that effect

To claim a charitable deduction of more than $5,000 under Section 170(f)(11)(C), the taxpayer must obtain a qualified appraisal report for the donated property and attach that appraisal report with Form 8283 to claim an income tax deduction.

According to Section 170(f)(11)(D), no charitable contribution deduction is allowed for charitable gifts by an individual or corporation for which a deduction of more than $500,000 is claimed unless the taxpayer attaches a qualified appraisal of the property to his or her income tax return.

Form 8283 should also be signed by the qualified appraiser responsible for the qualified appraisal of the donated property.

For noncash charitable gifts that (1) do not have a market quotation that is readily available or (2) are certain exempt assets (such as certain annuity contracts), the value of noncash charitable gifts is appraised under the "fair market value" standard of value.

Fair market value is defined as the price that property would sell for in the open market. That is, the price at which property would change hands between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

If the donor imposes a restriction on the use of property donated, then the fair market value should reflect that restriction.[6]

Furthermore, noncash charitable income tax gifts are limited to the net amount contributed to charity. That is, noncash charitable contributions are determined as the difference between (1) the fair market value of the charitable gift and (2) the fair market value of anything received in return.

Qualified Appraisals for Noncash Charitable Income Tax Deductions

According to Section 170(f)(11)(E)(i), the term qualified appraisal means an appraisal that is conducted by a qualified appraiser and in accordance with generally accepted appraisal standards.

The definition for a qualified appraiser is defined under Section 170(f)(11)(E)(ii) as an individual who: (1) has earned an appraisal designation from a recognized VPO or has otherwise met minimum education and experience requirements outlined in regulations prescribed by the Service, (2) regularly performs appraisals for which the individual receives compensation, and (3) meets such other

requirements as may be prescribed by the Service in regulations or other guidance.

In addition, an appraiser is not considered to be qualified unless (1) he or she demonstrates verifiable education and experience in valuing the type of property valued and (2) he or she has not been prohibited from practicing before the Service by the Secretary under Section 330(c) at any time during the three-year period ending on the date of the donated property valuation.

The following individuals cannot be a qualified appraiser with respect to the donated property:[7]

1. The donor of the property or the taxpayer who claims the deduction.
2. The donee of the property.
3. A party to the transaction in which the donor acquired the property being appraised, unless the property is donated within two months of the date of acquisition and its appraised value is not more than its acquisition price. This requirement applies to the person who sold, exchanged, or gave the property to the donor, or any person who acted as an agent for the transferor or donor in the transaction.
4. Any person employed by any of the above persons. For example, if the donor acquired a painting from an art dealer, neither the dealer nor persons employed by the dealer can be qualified appraisers for that painting.
5. Any person related under Section 267(b) to any of the above persons or married to a person related under Section 267(b) to any of the above persons.
6. An appraiser who appraises regularly for a person in requirements 1, 2, or 3 above, and who does not perform a majority of his or her appraisals made during his or her tax year for other persons.
7. An individual who receives a prohibited appraisal fee for the appraisal of the donated property.
8. An individual who is prohibited from practicing before the Service under Section 330(c) at any time during the three-year period ending on the date the appraisal is signed by the individual.

In addition, an individual is not a qualified appraiser for a particular donation if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser to falsely overstate the value of the donated property.

For example, if the donor and the appraiser make an agreement concerning the amount at which the property will be valued, and the donor knows that amount is more than the fair market value of the property, the appraiser is not a qualified appraiser for the donation.

Generally accepted appraisal standards are defined in Section 170(a)(17)(a)(2) as the substance and principles of the *Uniform Standards of Professional Appraisal Practice*, as developed by the Appraisal Standards Board of the Appraisal Foundation.

The minimum information requirements outlined in Section 170(a)(17)(a)(3) for a qualified appraisal include the following:

1. **Description of Donated Property**. Every appraisal report should include in sufficient detail a description of key aspects of the donated property; this includes the relevant characteristics of the donated property that are relevant to the type and definition of value as well as key aspects that were relevant for determining the selected valuation method.
2. **Physical Condition of the Tangible Property**. If the donated property being valued is real property or tangible personal property then the appraiser should include details of the physical condition of the property in the appraisal report.
3. **Date of the Charitable Contribution**. The date (or the expected date) of the charitable contribution should be included by the appraiser in the appraisal report.
4. **Terms and Agreements of Charitable Donations**. The terms of any agreement entered into that relates to the use, sale, or other disposition of the property donated should be included by the appraiser in the appraisal report.

   This description should include (a) temporary or permanent restrictions on the donee's right to use or dispose of the donated property, (b) earmarks for the specific use of the donated property, or (c) reserves to, or confers upon, anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having the income, possession, or right to acquire the property.

5. **Appraiser's Identification**. The name, address, and taxpayer identification number of the qualified appraiser's firm Federal Employment Identification Number, if conducted on behalf of the firm, or if the valuation is conducted individually, the appraiser's social security number should be included in the appraisal report.
6. **Appraiser's Qualifications**. The qualifications of the appraiser who conducts the valuation should be included in the valuation report. This would include the appraiser's work experience, education, and any professional memberships to any appraisal associations.
7. **Appraiser's Signature and Date**. The appraiser must also sign the report and express the date the appraisal was signed.
8. **Appraiser's Declaration**. An appraisal report performed in connection with a noncash charitable contribution should include the following disclosure:

   > I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if there is a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund that is based on my appraisal, I may be subject to a penalty under Section 6695A, as well as other applicable penalties. I affirm that I have not been at any time in the three-year period ending on the date of the appraisal barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to Section 330(c).

9. **Appraisal Statement**. A statement that the appraisal was prepared for income tax purposes should be included.
10. **Valuation Date**. The date that the donated property was valued should also be included by the appraiser in the appraisal report. Additionally, an appraiser may also define the date of the valuation as both (a) the "valuation date" and (b) the "effective date of contribution."
11. **Valuation Approaches**. The valuation approaches applied to estimate the fair market value of the donated property should be included by the appraiser in the appraisal report. Generally, the valuation approaches would include an income approach, a market approach, or an asset-based approach. The fair market value of the donated property as of the date valued should be included by the appraiser in the appraisal report.
12. **Basis of the Valuation**. The specific basis for the valuation, such as any specific comparable sales transactions, should be included by the appraiser in the appraisal report.[8]

Additionally, according to Section 170(a)(13)(3), a qualified appraisal should:

1. be prepared, signed, and dated by the appraiser;
2. meet the relevant information requirements of Section 170(a)(17)(a);
3. be dated no earlier than 60 days before the date of the contribution and no later than the date of the contribution; and
4. not involve a prohibited appraisal fee.

A prohibited appraisal fee is a fee arrangement for an appraiser that is based on a percentage of the appraised value of the property.

For property with a value of $5,000 or more contributed to charity with the intent of the taxpayer to take a charitable income tax deduction, the appraiser must complete the Declaration of Appraiser section on Form 8283 to be filed with the taxpayers tax returns.

More than one appraiser may value the property, provided that each complies with the requirements, including signing the qualified appraisal and the Declaration of Appraiser section on Form 8283.[9]

The appraiser should understand the purpose of the appraisal assignment and articulate it clearly in the appraisal report that it will be used for charitable income tax reporting purposes.

An appraiser who fails to accurately define the assignment in the appraisal report and include the items listed above can risk having the appraisal disregarded for income tax purposes and potentially incur penalties under Section 6695A if the value indication results in a valuation misstatement.

As described below, both the appraiser and the taxpayer may be subject to penalties as stated under Section 6695A for both substantial and gross valuation misrepresentation.

Potential Appraiser Penalties

As stated in Section 6695A, an appraiser who prepares an incorrect appraisal report may be required to pay a penalty if the appraiser knows or reasonably should have known that the appraisal would be

used in connection with a return or claim for refund that resulted in a valuation misstatement of the donated property.

The penalty imposed on the appraiser under Section 6695A is equal to the greater of $1,000 or 10 percent of the amount of tax attributable to the substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income received by the analyst.

Additionally, the appraiser who falsely or fraudulently overstates the value of property on Form 8283 that the appraiser has signed may be subject to a civil penalty for aiding and abetting and may have the appraisal disregarded by the tax courts.

The appraiser may also be prohibited from submitting another appraisal report to be used by a taxpayer for up to three years.

Potential Taxpayer Penalties

According to Section 6662, taxpayers may be subject to accuracy-related penalties for both "substantial" and "gross" valuation misstatements of donated property.

Section 6662 defines a substantial valuation misstatement as when the value of the donated property claimed is 150 percent or more of the amount determined to be the correct value of such property. The penalty to the donor in the case of a substantial valuation misstatement is equal to 20 percent of the correct value determined.

Similarly, a gross valuation misstatement is when the value of the donated property claimed is 200 percent or more of the amount determined to be the correct value of such property. In this case, the penalty to the donor of a gross valuation misstatement is equal to 40 percent of the correct value determined by the Service.

These penalties do not apply to the donor if (1) the claimed value of the property was based on a qualified appraisal written by a qualified appraiser and (2) the taxpayer made a good-faith investigation of the value of the donated property.

An appraisal is not a qualified appraisal for a particular contribution if the donor either failed to disclose or misrepresented facts and a reasonable person would expect that this failure or misrepresentation would cause the appraiser to misstate the value of the contributed property.

Summary and Conclusion

The requirements outlined in Section 170(f)(11) provides the valuation requirements for reporting noncash charitable contribution deductions.

The appraiser and the taxpayer that fail to follow the aforementioned requirements, as outlined in the Code, may be subject to both financial and civil penalties by the Service and/or the courts. The appraiser(s) responsible for a valuation misstatement may have the appraisal disregarded and be subject to penalties under Section 6695A.

Similarly, a taxpayer responsible for a valuation misstatement may also incur penalties under Section 6662. However, the taxpayer is protected to the extent that the valuation misstatement is attributable to an error by the appraiser.

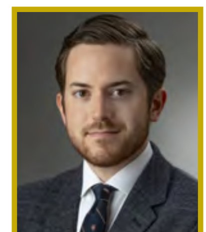
A taxpayer's filing to the Service for a charitable contribution deduction necessitates a complex documentation process, which includes (1) the contemporaneous acknowledgement of the contributed property, (2) a qualified appraisal issued by a qualified appraiser, and (3) a completed Form 8283 signed by both the qualified appraiser(s) and the taxpayer.

The appraiser, taxpayer, and tax counsel should understand the procedural steps and requirements necessary to support the value of the contributed property. Doing so will ensure that the charitable intent of the taxpayer is accomplished without unnecessary hardship.

We make a living by what we get, but we make a life by what we give. – Sir Winston Churchill

Notes:

1. The 2021 Bank of America Study of Philanthropy: Charitable Giving by Affluent Households, Indiana University Lilly Family School of Philanthropy, September 2021.
2. Ibid.
3. https://www.irs.gov/charities-non-profits/charitable-organizations/charitable-contribution-deductions
4. Section 170(8)(A).
5. Section 170(8)(B).
6. Publication 561 (01/2022), Determining the Value of Donated Property, irs.gov, revised January 2022, https://www.irs.gov/publications/p561#en_US_202109_publink1000257999.
7. Ibid.
8. Ibid.
9. Ibid.



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Look into the Sun (Powered Industry)

Forrest E. Lind III, Esq.

From lighting fires through Greek burning glass[1] to powering NASA satellites during the space race,[2] solar energy has made possible some of mankind's greatest achievements. Therefore, it should come as no surprise that we are increasingly turning to solar energy to meet our electricity needs. This discussion explores the expansion of the commercial solar industry and how the industry players are meeting the increasing demand for electricity. This discussion summarizes the recent trends in the world of solar industry financing.

The Solar Industry Shines on the United States

In 2021, solar energy accounted for 54 percent of the new electric generating capacity added to the U.S. grid.[3]

This marks the first time in the history of the United States that solar energy has accounted for over 50 percent of new generating capacity.[4] It is also a significant increase from the previous year's record of 44 percent of new capacity.[5]

Even with pandemic-induced supply chain issues, a record 19.2 Gigawatts of solar generation were installed in 2020.[6] Based on market estimates conducted in December of 2021, that record was likely broken again in 2021.[7]

So, what is driving this increasing demand for photovoltaic generation facilities ("PV facilities")? There are several key factors driving this growth: industry trends toward larger utility-scale PV facilities, an increasing number of state incentives and programs, the federal Solar Investment Tax Credit[8] ("SITC"), government-guaranteed loans for PV facilities, and re-powering operating PV facilities for increased capacity.

However, it costs money to build PV facilities that can take advantage of these opportunities. Accordingly, developers look to lenders and investors to provide funding for new and renovated PV facilities.

Funding the Future with Income Tax Incentives That Compel Equity Investors

PV facilities are financed in much the same way as any other revenue-generating business with tangible assets. PV facility developers procure loans from lenders and equity-based capital contributions from investors. The investor capital contributions for most PV facilities are linked to tax credits created under the SITC and various state programs.

These investors are known in the industry as "tax equity investors" and the SITC is a 26 percent income tax credit ("ITC").[9]

The SITC is planned to phase down in amount from 26 percent in 2022 to 22 percent in 2023 and 10 percent for commercial projects in 2024.[10]

The tax credit can currently be generated by qualifying PV facilities that range in size from small to utility-scale projects.[11]

Both lenders and tax equity investors will perform their due diligence process on the project and prepare transaction documents tailored to the organizational and tax structure of the entities that will own and operate the PV facility. Tax equity investors and lenders do not always enter into the transaction at the same time and may, therefore, have slightly different diligence concerns. However, most of the lender's and tax equity investor's diligence items will be the same.

Both parties want to make sure that the PV facility:

1. has been properly approved by the various level of government agencies with authority over the construction and operation of the project and
2. is engineered to meet forecasted financial goals.

From a documentation standpoint, lenders are focused more on their security instruments and ensuring that their collateral is being delivered with the appropriate priority of interests. tax equity investors are more concerned about the documents governing ownership and tax structure of the entities that own the PV facility. Depending on the structure, these documents can include master leases, master-tenant and landlord operating agreements, and PV facility equipment leases.

Tax equity investors represented by knowledgeable counsel will often require the lender to enter into a nondisturbance agreement, forbearance agreement, or interparty agreement, depending on the structure and construction stage of the project.

These agreements place restrictions on the remedies a lender can exercise in the event of a default under the loan agreement between the lender and the entity that owns the PV facility ("Project Company").

Lenders accept some form of these restrictions because tax equity investor capital contributions are as critical to the development of large PV facilities as a construction or permanent loan.

Further, these restrictions should only be in place for the durations of the tax equity investor's compliance period under the SITC rules.

At the conclusion of that compliance period, the tax equity investor often exits the deal and the restrictions on the lender's remedies for an event of default under the loan agreement are lifted. Of course, not every project requires or involves a tax equity investor.

If a project is smaller, being refinanced after the tax equity investor has exited the transaction, or the Project Company owner desires to take the tax credits themselves, a project will not have a tax equity investor.

As implied above, however, the involvement of a tax equity investor helps ease loan-to-value concerns for a PV facility. A tax equity investor will contribute capital at various stages of the deal which enables the PV facility owner to procure a permanent loan that is less than the construction loan.

These contributions, therefore, reduce the developer's need for loan funding by the time the construction loan is ready to convert to a permanent loan. Projects are often ready for permanent loan financing and receipt of tax equity investor capital contributions at a construction milestone known as "substantial completion," which allows the PV facility to be placed in service.[12]

Construction and permanent loan lenders are sometimes different institutions, but the same lender will often make both loans.

Having a single lender is more efficient because the project will undergo a single review process and the lender will be more familiar with the project at the permanent loan closing. A lender issuing both loans can make separate loans or a construction loan that converts to a permanent loan.

Financing a Nationwide Solar Industry

When people think about solar markets in the United States, California is often the first state to come to mind. However, the solar industry in the United States has rapidly expanded over the last decade and is a true nationwide industry.[13]

From Hawaii to the Carolinas, from Florida to New York, and Oregon to southern California, the solar industry has made inroads in every state.[14]

Florida and Texas account for the largest market advances outside California, but even northern states like New York, Massachusetts, and Minnesota have seen substantial gains in the last few years.[15]

States have promoted solar energy development through capacity-percentage mandates for utilities, various incentives, and innovative programs like community solar.[16]

Lenders, tax equity investors, PV facility developers, and their counsel have, therefore, had to acclimate themselves to regional and state requirements for PV facilities. The nomenclature of various notice instruments, such as a memorandum of lease and notice of lease, can change from state to state.[17]

Security instruments will also vary. Some states allow lenders to record a deed of trust against the PV facility real estate collateral, and others only allow lenders to record a mortgage.[18]

Even the foreclosure terminology used in a deed of trust may change from one state to another.[19] As one might imagine, the regulatory landscape can also differ wildly as one moves across the county.

States like Vermont, New York, North Carolina, and even Texas have a comprehensive state-level regulatory scheme for PV facilities. Other states leave regulatory processes to the federal government, counties, and municipalities.

The municipal and county authorities in one state may have little or no permitting requirements, while the same authorities in another state may have several. Even the involvement of the federal government does not guarantee conformity. The United States Department of Agriculture ("USDA") guarantees loans for PV facilities that meet certain conditions.[20]

Lenders and PV facility developers will often apply for one of the USDA loan guaranty programs because they offer several financial advantages. However, the USDA issues the conditional commitments and loan note guarantees through state-level offices. The USDA requirements for loan documents and diligence can, therefore, vary from state to state.

Lenders that select counsel who have dealt with these USDA offices will often experience a smoother transaction because their counsel will be able to predict the document provisions and diligence requirements at the outset of the transaction. This allows the lender to communicate requirements and set expectations with the Project Company owner early in the process.

The regulatory schemes in some states may require more time to complete than others, so it is important for lenders and tax equity investors to communicate the diligence items they will expect from the PV facility developer as early as possible.

The Tangible Property Valuation of a Solar Business

A tangible property appraisal of the value of a PV facility is one of the most important diligence items for both lenders and tax equity investors. Lenders need the appraisal to confirm, among other things, that their loan-to-value requirements are going to be met.

Likewise, investors need the appraisal to forecast the tax incentives that will be generated by the PV facility. The appraisal can also be used for acquisition purposes.

There are several definitions of value related to the valuation of a PV facility, including book value, fair market value ("FMV"), fair value, investment value, and market value.

Revenue Ruling 59-60 defines FMV as the "price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."[21]

The FMV standard is required for federal income tax purposes. FMV is, therefore, the typical standard of value for valuing PV facilities.[22]

There are three generally accepted property valuation approaches to estimate FMV for PV facilities:

1. The cost approach
2. The income approach
3. The market approach

The cost approach seeks to estimate the hypothetical cost to replace the property being valued. In the solar industry, this is the cost of creating a new PV facility identical to the one being valued.

The problem with the cost approach is that it may not account for potential variances in one of the most important PV facility documents, the power purchase agreement ("PPA"). The PPA is the PV facility's revenue document, and the PPA is sometimes accompanied by a renewable energy certificate sales contract.

The market approach may suffer from a problem similar to that of the cost approach. The market approach to FMV relies on comparative sales of similar PV facilities and, therefore, does not clearly account for potential variances in the PPA or other incentives available to the project being valued.

The income approach, on the other hand, provides the means to evaluate the revenue contracts specific to the PV facility being valued. This approach relies on the expected earnings of the PV facility to estimate FMV and is, therefore, better suited to a property that will generate income under a PPA for an extended period of time.[23]

For PV facilities, the income approach typically involves the application of a discounted cash flow model.[24]

Trends in Solar Financing

The commercial solar industry has changed since the early 2000s in several ways. Since the SITC was enacted in 2006, the U.S. solar industry has increased 10,000 percent.[25]

As the solar market has increased, PV facility developers have begun developing larger PV facilities, industry pioneers have started new companies, energy storage systems have become more common, states have enacted solar incentive programs, and the federal government has developed a loan guaranty program. PV facility developers have also begun refinancing and re-powering PV facilities after the expiration of the tax equity investor's compliance period under the SITC.

As the capacity of PV facilities increase, they become more expensive to construct. Due to legal lending limits and various banks' appetite for risk, it has become more common for lenders to syndicate loans with other lenders. This process involves two or more banks entering into a syndication agreement whereby they allocate risk, obligations, and profits from the loan or loans.

These syndication agreements can be effective during a construction loan, bridge loan, permanent loan, or all of the above. For efficiency reasons, the lead lender will usually be the point of contact for all documents, diligence review, and negotiation with the PV facility developer.

PV facility developers have also taken equity- and facility-based approaches to financing these larger projects. North-Carolina-based Pine Gate Renewables, for example, has recently completed a capital raise and procured a $500 million credit facility.[26]

Cypress Creek Renewables, on the other hand, was recently acquired by EQT Infrastructure which has vertically integrated the solar developer into its energy portfolio.[27]

However, like any other business, these developers are taking multi-pronged approaches to raising funding. For example, Cypress Creek Renewables has sold several portions of its project portfolio, most recently in Massachusetts.[28]

Pine Gate Renewables, on the other hand, acquired Horne Brothers Construction and then separated its previously internal construction arm into a separate business.[29]

Although these developers are executing different strategies to increase their share of the solar market, they are all turning to their lender and investor partners to finance these transactions.

The trend towards large projects should not, however, be read to imply that the solar industry

is trending towards consolidation. Several industry pioneers have separated from previous institutions to forge their own path. The former senior vice president of solar development for Gardner Capital is now the founder and president of Renewable Properties, based out of San Francisco, California.[30]

He is joined by a former director on the project finance team at Cypress Creek Renewables and former senior manager in the project finance group at SunEdison.[31]

The former chief financial officer of Cypress Creek Renewables has also set out on his own with FCM Renewables.[32]

Yet another example is the former vice president of development at Cypress Creek Renewables, who founded White Pine Renewables.[33]

These industry pioneers and their peers who have continued to innovate in their space show that the solar industry is ripe with opportunity. As these professionals branch out, they have relied on relationships with lenders and investors to facilitate the growth of their companies and the solar industry.

Battery storage is a recent development in the solar industry, and it understandably pairs well with energy generation facilities that only work when the sun is shining. In 2019, approximately 4 percent of new PV facilities incorporated a battery storage system.[34]

Nearly 6 percent of new PV facilities constructed in 2020 incorporated a battery storage system.[35] The Solar Energy Industries Association expects this trend to continue, and forecasts that by 2025, nearly a quarter of all PV facilities will incorporate a battery storage system.[36]

For lenders and tax equity investors, this means increased construction costs and potential revenue sources that will need to be accounted for.

State incentive programs generally fall into three categories: grants, capacity-percentage mandates for utility providers, and community solar programs. Grants, such as the New York NYSERDA awards program, allocate funds for PV facility developers who meet certain criteria.[37]

Capacity-percentage mandates, sometimes known as "Renewable Portfolio Standards," require utility providers to meet a state's energy needs with a minimum percentage of electricity produced by PV facilities.[38]

These mandates often escalate the required percentage year-over-year, which incentivizes the construction of additional PV facilities.[39]

The utility providers can either construct their own PV facilities or purchase electricity generated from privately owned PV facilities. Many utility providers choose the latter, and enter into power purchase agreements with project companies.

Community solar programs are a somewhat recent development in the industry. States like Massachusetts and Minnesota have created elaborate community solar programs wherein utility customers can purchase a percentage of the capacity of a PV facility through subscription agreements.[40]

The structure of the programs varies from state to state, but subscribers are usually given credits toward their electricity bills based on their subscribed output from the PV facility.[41]

As the SITC phases down over the next few years, these state incentives will likely influence the location of new PV facilities. State incentive programs are, therefore, strong factors in the future growth of the solar industry.

As noted above, the federal government of the United States has incentivized the construction of PV facilities through the enactment of the SITC. It also provides financial support for PV facilities through USDA-guaranteed loans. The USDA provides loan guarantees to qualifying PV facility developers under its Rural Energy for America Program ("REAP") and its Business and Industry program ("B&I").[42]

Many PV facilities mounted directly on the ground are constructed in rural areas, and are often eligible under the REAP program.[43]

The B&I program applies more broadly, but it can be less advantageous for PV facility developers depending on the financials of the project.[44]

Although the solar industry took some time to evolve around the SITC, by 2015, the industry was experiencing strong investor-fueled growth.[45]

As tax equity investors exit the transactions of that era, they are leaving operating projects in the hands of the developers. These PV facilities have an expected useful life of between 21.5 to 32.5 years,[46] so refinancing them is a common strategy at the tax equity investor's exit.

Developers have also begun re-powering old projects by installing new equipment that increases the capacity of the projects. Refinancing deals are attractive to lenders because the projects have been operating for at least five years, and many see it as a growing source of business.

Walking into the Sunset

Knowing where the solar industry has been and where it is now begs the question, where it is going? The income tax credit and production tax credit[47] have driven the growth of the solar industry.

Unfortunately, the production tax credit expired for all renewable energy technologies that commenced construction after December 31, 2021, and the SITC will be phased down over the next two years.[48]

The ITC phase down schedule under the SITC was protracted in 2020,[49] but tax equity investors, lenders, and developers should not assume that it will be extended again. Given the expected phase down to 10 percent in 2024, many developers will likely do what they did at the last phase down event; they will "safe harbor" projects by "beginning construction" of these projects in 2023.[50]

The Internal Revenue Service has previously allowed developers to satisfy its safe harbor requirement via two tests: the Continuous Construction Test and the Continuous Efforts Test.[51]

The continuous construction test requires developers to provide proof of physical construction and continuance of that work.[52]

The continuous efforts test, also known as the five percent safe harbor test, requires developers to provide proof that they are making a continuous effort to construct a project.[53]

Developers pursuing this method typically show that they are entering into contracts, procuring permits, or incurring construction costs related to the project.

The SITC is expected to phase down, but the reduction in federal credits will be offset in part by state incentives. State incentives will likely not make up for the loss in federal credits by themselves, but they are a strong sign that the demand for solar power in the United States is only increasing.

As incentives for solar development decrease in one category and increase in another, the cost of PV facilities has also ebbed and flowed. Prior to the pandemic, the cost of installing PV facilities had been decreasing. Even through the first quarter of 2021, the cost to install a PV facility had decreased by 2 percent to 4 percent depending on the scale of the project.[54]

Conversely, by the second quarter of 2021, the cost of installing a PV facility had increased by 3 percent to 12 percent.[55]

PV facilities are, therefore, subject to the same inflation as all other manufactured goods in the current economic climate. There is some hope on the horizon, however. By the third quarter of 2021, these price increases had moderated to less than 3 percent.[56]

Assuming the supply chain woes and public policies creating them dissipate in the future, that trend of decreasing costs should return and provide another opportunity for growth in the solar industry.

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On Our Website

Recent Articles and Presentations

Robert F. Reilly, a managing director of our firm, authored a five-part article that appeared in the December 8, 2021, December 15, 2021, January 5, 2022, January 12, 2022, and January 19, 2022, issues of the NACVA publication *QuickRead*. The title of Robert's article is "Intellectual Property Valuations: The Relief from Royalty Method."

This is a five-part article series that focuses on what valuation analysts (analysts) and owner/operators need to know about one category of intangible property: intellectual property. There are generally accepted cost approach, market approach, and income approach methods that may be used to value intellectual property. Robert's article focuses on the application of the market approach. It specifically focuses on one market approach valuation method: the RFR method. Part I of Robert's article presents an overview of the RFR method and discusses the various categories of intellectual property. Part II of Robert's article summarizes the typical elements of the intellectual property valuation analysis. This part of the discussion focuses on benchmarking and the use of research databases. Part III describes the application of the RFR method. Part IV presents an illustrative example of the practical application of the RFR method. Finally, Part V presents valuation analyst caveats and reporting best practices related to the intellectual property valuation.

Robert Reilly also authored a two-part article that appeared in the February 16, 2022, and February 23, 2022, issues of *QuickRead.* The title of Robert's article is "Analyst Noncompete Agreement Considerations in Corporate Acquisitions."

This is a two-part article that focuses on the a transaction where the target company is a private corporation, and the sellers are employee/shareholders. Robert's article summarizes the taxation and valuation considerations related to a transaction where employee/shareholders are selling the private C corporation stock to a C corporation acquirer. The principal focus of his article is on valuation and taxation guidance related to the employee/shareholders' sale of a closely held corporation. Valuation analysts are not expected to be M&A transaction tax advisors or deal structuring experts. However, valuation analysts who practice in the M&A transaction arena are expected to work with the transaction principal's legal counsel, tax accountants, and other professional advisors. Valuation analysts who practice in the M&A discipline are expected to understand the basics of how intangible asset identification and valuation influence the taxation aspects of the transaction.

Robert Reilly also authored a four-part article that appeared in the October 13, 2021, October 20, 2021, October 27, 2021, and November 3, 2021, issues of *QuickRead*. The title of Robert's article is "Cost Approach to Intellectual Property Valuation."

This four-part article series focuses on the conceptual principles and the practical applications of the cost approach in the development of intellectual property valuations. Part I of Robert's article focuses on the conceptual principles that support the application of the cost approach to intellectual property valuation. Part II describes the generally accepted cost approach valuation methods. Part III examines the practical measurement procedures related to intellectual property cost metrics and obsolescence metrics. Finally, Part IV presents several illustrative examples of the application of the cost approach in hypothetical intellectual property valuation scenarios.

Robert F. Reilly delivered a presentation at the National Association of Certified Valuators and Analysts (NACVA) Minnesota Chapter Conference, which was held on September 29, 2021, in Plymouth, Minnesota. The title of Robert's presentation was "Asset-Based Approach to Business Valuation: Conceptual Foundations and Practical Applications."

The presentation slides for Robert's presentation are available on our website..

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Communiqué

In Print

Robert Reilly, Chicago office managing director, authored an article that appeared in the February 2022 issue of *Practical Tax Strategies*. The title of Robert's article is "Intellectual Property Valuations for Property Tax Purposes."

Robert Reilly authored an article that was published in the March 2022 issue of *The Practical Tax Lawyer*. The title of Robert's article is "The F Reorganization as Part of the S Corporation Acquisition Transaction Structure."

Robert Reilly and Portland office manager Connor Thurman authored an article that appeared in the March 2022 issue of *The Practical Tax Lawyer*. The title of that article is "What Legal Counsel Need to Know about Cost of Capital Calculations in Valuation and Damages Disputes."

Robert Reilly authored an article that appeared in the November/December 2021 issue of the *Journal of Multistate Taxation and Incentives*. The title of Robert's article is "Intellectual Property Valuations and Unit Valuation Principle Assessments."

Robert Reilly also authored a two-part article that appeared in the National Association of Certified Valuators and Analysts ("NACVA") online publication at www.quickreadbuzz.com. The title of the article is "Analyst's Noncompete Agreement Considerations in Corporate Acquisitions." Part I was posted on February 16, 2022. Part II of this two-part article was posted on February 23, 2022.

Robert Reilly authored a five-part article that also appeared in NACVA's online publication at www.quickreadbuzz.com. The five parts of the article are titled "Intellectual Property Valuations" and were published as follows:

1. "The Relief from Royalty Method (Part I of V)" was published on December 8, 2021
2. "Elements of the Valuation Analysis (Part II of V)" was published on December 15, 2021
3. "Elements of the Valuation Analysis (Part III of V)" was published on January 5, 2022
4. "Illustrative Example of the Relief from Royalty Method (Part IV of V)" was published on January 12, 2022
5. "Analyst Caveats and Reporting Guidelines (Part V of V)" was published on January 19, 2022.

Kevin Zanni, Chicago office managing director, contributed to the recent American Institute of Certified Public Accountants ("AICPA") publication titled "A Bridge from the AICPA Statement on Standards for Valuation Services—Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset to the International Valuation Standards." This AICPA publication is intended to provide a framework and provide professional guidance to analysts related to preparing business valuations that comply with the International Valuation Standards.

In Person

Robert Reilly delivered a presentation on February 21, 2022, on the National Association of Certified Valuators and Analysts ("NACVA") Around the Valuation World webcast. The topic of Robert's NACVA webcast was "Applications of the Cost Approach to Intellectual Property Valuation."

Robert Reilly will present a four-hour workshop sponsored by Business Valuation Resources on May 26, 2022. The title of the workshop will be "Valuation of Intangible Assets as Part of the Asset-Based Approach to Business Valuation." This workshop will focus on both intangible asset valuation topics and asset-based approach business valuation topics that are explored in the textbook *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis*. *Best Practices* is co-authored by managing directors Robert Reilly and Robert Schweihs.

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