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Valuation & Litigation BRIEFING

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Tax-affecting S corp earnings

Courts' varied approaches create confusion

When valuing an S corporation (S corp), is it appropriate to "tax-affect" the company's earnings? In other words, should a valuator reduce earnings by an assumed corporate tax rate, even though S corps don't pay tax at the corporate level? This issue has created confusion — for attorneys, judges and even some valuation professionals — for years.

As illustrated by a recent bankruptcy case, the confusion continues. In *Bank of America, N.A. v. Veluchamy*, the defendant's expert convinced the U.S. Bankruptcy Court for the Northern District of Illinois that it was appropriate to tax-affect an S corp's earnings to reflect the shareholders' personal tax burden. But the court and the expert had different ideas about how to incorporate this principle into the valuation process.

To tax-affect or not?

Traditionally, when using discounted cash flow or other income-based methods to value an S corp, a valuator would reduce the company's projected cash flow or earnings by an assumed corporate income tax rate. Typically, the valuator would use 40% to approximate combined federal and state corporate income taxes. The rationale for tax-affecting was twofold:

1. Even though S corps are not taxed at the corporate level, their income is passed through to shareholders and taxed at their individual rates — a factor considered by hypothetical investors, and
2. Tax-affecting reflects the risk that a hypothetical investor will lose S status.

The U.S. Tax Court rejected tax-affecting in a 1999 case, *Gross v. Commissioner*, and the Sixth U.S. Circuit Court of Appeals upheld the decision. The Tax Court reasoned that corporate-level tax avoidance is an important benefit of S corp status that should be

reflected in a valuation (at least, absent evidence that loss of S status is likely).

Since that time, the Tax Court has continued to reject tax-affecting, although it has indicated that it might revisit the issue in an appropriate case. Other courts have taken a variety of approaches — some allowing full tax-affecting, some disallowing it and others using a hybrid approach.

Perhaps the most notable example of a hybrid approach is the Delaware Chancery Court's 2006 decision in *Delaware Open MRI Radiology Associates v. Kessler*. The court explained that declining to tax-affect an S corp's earnings would overvalue the corporation. On the other hand, the court noted that charging the full corporate rate would undervalue the corporation by failing to recognize the tax advantages of S status. Instead, the court applied an effective 29.4% corporate rate that, when combined with a 15% dividend rate, reflected shareholders' after-tax returns.

Bankruptcy court's approach

In *Veluchamy*, the court was presented with several fraudulent transfer claims. One of those claims required the court to value stock in one of the

debtor's S corps. The bankruptcy estate's expert valued the stock without tax-affecting. The debtor's expert, on the other hand, felt that tax-affecting was appropriate to reflect the individual income taxes a hypothetical buyer would incur on the corporation's income. The way to incorporate these taxes into the valuation, he stated, was "to charge the corporation's income with taxes at a rate reduced by its owners' tax savings."

The bankruptcy court agreed with this approach, but found that the expert's actual calculations didn't follow it. Instead, he simply reduced the corporation's income by the individual owners' marginal rate (which, the court noted, was higher than the effective C corporation tax rate). Rather than correct the expert's calculations, however, the court chose to split the difference between the two experts' cash flow estimates — one tax-affected, one did not.

It's not clear why the court took this middle-ground approach — which may or may not accurately reflect shareholders' after-tax returns — rather than the *Kessler* court's approach.

The Tax Court has continued to reject tax-affecting, although it has indicated that it might revisit the issue in an appropriate case.

Talk to your experts

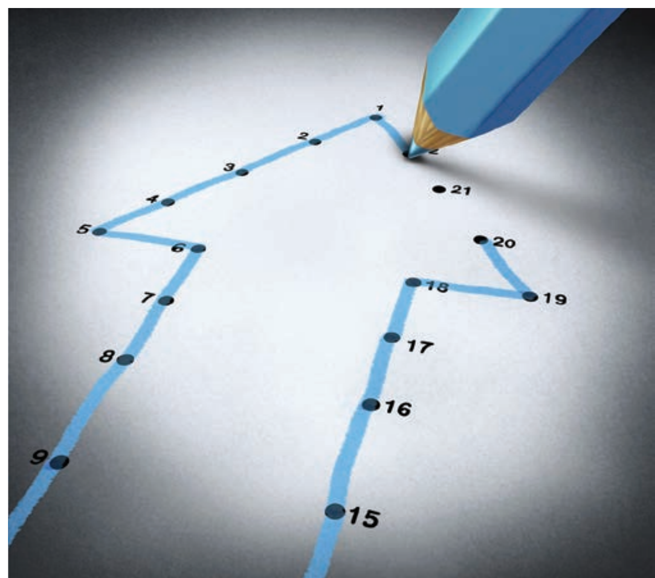
As the *Veluchamy* case demonstrates, confusion over tax-affecting continues. In cases involving S corp valuations, work with your experts to develop a cogent approach to tax-affecting, and be sure you can back it up. ◆

Connecting the dots

Data breach and plaintiff injuries

It seems that hardly a day goes by without a data breach making headlines. And while attacks on the largest companies receive the most attention, businesses of all sizes are vulnerable.

Data breach litigation can be extremely complex, and the law in this area is continuing to evolve. But one thing is certain: Forensic experts, including accountants and IT specialists, are an invaluable part of the litigation team. Although forensic analysis is often associated with damages calculations, forensic experts also can help establish injury and causation. By sifting through enormous amounts of data, these experts can identify trends and patterns, helping connect the dots between data breaches and plaintiff injuries (or help prove that there is no connection).



DATA BREACHES AFFECT MILLIONS

Ponemon Institute is a research center dedicated to privacy, data protection and information security policy. Its recent report *2014: A Year of Mega Breaches* lists the following major breaches from 2014, including the number of people or businesses affected (listed in parentheses).

- eBay (145 million people),
- JPMorgan Chase (76 million households and 7 million small businesses),
- Home Depot (56 million payment cards),
- CHS Community Health Systems (4.5 million people),
- Michaels Stores (2.6 million people),
- Neiman Marcus (1.1 million people), and
- Staples (point-of-sales systems at 115 retail stores).

This list doesn't include the massive data breach at Target in late 2013, which resulted in approximately 40 million lost credit card numbers. Ponemon predicts that 2015 will be as bad or worse.

Establishing injury

One of the biggest hurdles for plaintiffs in data breach cases, especially class actions, is establishing that they were injured by the breach. And the U.S. Supreme Court raised this hurdle even higher in a 2013 decision. In *Clapper v. Amnesty International*, the Court discussed the requirements for proving an "injury in fact" that was sufficient to establish standing. The case didn't involve a data breach — it was a human rights case involving the National Security Agency's wiretapping program. But federal courts have since applied *Clapper*'s principles in dismissing several data breach class actions.

The Court held, among other things, that:

- Mere threatened injury isn't enough — rather, for plaintiffs to have standing, injury must be "certainly impending,"
- Allegations of *possible* future injury are insufficient, and
- Plaintiffs cannot "manufacture" an injury by incurring costs based on their fears of hypothetical future harm.

Following *Clapper*, several federal courts have dismissed data breach cases, reasoning that the *risk* that identity theft or other fraud will be committed using information obtained via data breach is insufficient to establish that injury is "certainly impending." Some courts even have dismissed cases in which plaintiffs had actual fraudulent charges on their credit cards. These courts make a distinction between fraudulent charges, which are readily reversed, and "actual identity theft," which involves use of personal information to open new accounts and can be far more harmful to victims.

An obstacle to recovery in these cases is establishing a connection between the theft of data that includes plaintiffs' information and the actual or imminent use of that information to commit fraud. The mere fact that hackers have possession of certain data doesn't necessarily mean they have the ability or desire to

extract personal information from that data. But in some cases, experts are able to trace breached data to information published, or otherwise stored or transmitted, on the Internet, demonstrating that hackers have indeed extracted plaintiffs' personal information. Even if no fraud has yet been committed, some courts have found that the existence of plaintiffs' names, login credentials, credit card numbers, expiration dates and other information on the Internet is enough to establish that injury is "certainly impending."

Supporting insurance claims

Another area that benefits from forensic expertise is cyber-risk insurance claims. Forensic accountants can sift through large volumes of data to help a company victimized by a data breach identify losses and determine whether they occurred during the relevant coverage periods.

They can also analyze sales data to help ensure that claimed losses are reasonable and accurate. For example, a company that suffers a data breach might lose a significant amount of online sales because customers are hesitant to provide their credit card information. But considering those lost sales alone may overstate the company's losses if some of those customers buy the same products in the company's bricks-and-mortar stores — or simply postpone their online purchases.

Forensic accountants are invaluable in reviewing a company's claimed costs to help determine whether they meet a cyber-risk policy's coverage criteria. For example, it may be necessary to distinguish between costs incurred to investigate and mitigate a data breach and those incurred to improve the company's cyber-security program to prevent future breaches.

Involve experts early

Data breach litigation typically involves enormous quantities of data. Getting experts involved early can help you make sense of the data and establish connections (or the lack thereof) between the breach and claimed injuries. ◆

The importance of site visits in business valuation

In addition to determining such obvious details as the size of the business interest, the effective appraisal date, the standard of value and the most appropriate valuation approach given the circumstances, a valuator needs to get a hands-on feel for the company. The best way to achieve this is by doing the homework: touring the company's facilities and interviewing management before reaching final value conclusions.

Site visit checklist

A site visit provides a firsthand opportunity to learn about business operations. Risk factors a valuator might watch for include operating efficiency and safety, fixed asset condition, physical controls and capacity constraints. A valuator also looks at signage, parking and access, staff morale, attitude and skill level, and hidden liabilities.

Most valuators aren't operations experts or forensic accountants. But they do employ professional skepticism when touring a business's facilities. For example, a valuator will note blatant risk factors — such as unhappy or idle workers, dusty or broken equipment, unlocked doors, or cluttered aisles — in his or her

valuation report and raise these issues with management before concluding the tour.

Value depends on qualitative, subjective factors, such as management depth, dependence on key personnel, planned acquisitions or other growth strategies, competitive advantages or disadvantages, and industry trends, which a valuator simply can't glean from numbers alone. Gaining this type of information is best accomplished via on-site interviews that valuators conduct while touring and inspecting the premises and operations.

An experienced appraiser knows how to set up and conduct interviews in a way designed to preserve the integrity of all parties involved.

Question-and-answer sessions

Interviews that involve discussing concerns, asking questions and clarifying gray areas are essential to effective site visits. Sometimes an appraiser asks to speak to several managers separately for about half an hour each. By speaking with more than one person, the appraiser gains a broader perspective and can corroborate employees' impressions of the company's strengths, weaknesses, opportunities and threats.

Confidentiality is especially important when interviewing managers in an adversarial situation, such as a divorce or shareholder dispute. An experienced appraiser knows how to set up and conduct interviews in a way designed to preserve the integrity of all parties involved.

Interviewing a company's management team is a critical component of the valuation process. But a client's CEO or other top executive may resist these interviews because of time constraints, confidentiality concerns or fear of alerting employees to a major event, such as a sale or bankruptcy. Despite these challenges, it's important to make management interviews happen whenever possible. In some cases, it may be necessary to use depositions to extract the information your valuation expert needs.

The absence of management interviews can even hurt your case when a business is being valued in a litigation context. A court may discount, or even reject, a valuator's assumptions about projected earnings, business or financial risk, asset values and other key factors unless they're backed up by management interviews. A court is also more likely to find a valuation expert credible if he or she conducted interviews, made site visits and took other steps to look beyond the numbers to get the story behind them.

Finish the assignment

To pass the valuation test with flying colors, your valuator needs to do more than scour the books and crunch the numbers. By taking the time to visit a company's facilities and talk to management, a valuator gets a clearer, more well-rounded picture of business operations — which, in turn, leads to a more accurate, complete and useful valuation report. ◆

Is it time to pull the plug on deepening insolvency?

The days of "deepening insolvency" may be numbered. Originally a damages theory, it gained recognition in some courts as an independent cause of action. In recent years, however, a number of courts have repudiated the doctrine.

Deepening insolvency refers to the wrongful prolongation of a company's life, increasing its insolvency and reducing the potential recovery of its creditors and shareholders. The doctrine has been used by shareholders and bankruptcy estates to recover damages from officers, directors and even advisors (such as accountants, attorneys and investment bankers) who played a part in propping the company up. Often it involves the use of fraudulent financial statements to conceal the company's deteriorating health and obtain financing.

No duty of prompt liquidation

Despite deepening insolvency's initial appeal, courts soon began to recognize its logical shortcomings. For example, in *Trenwick America Litigation Trust v. Ernst &Young*, the Delaware Chancery Court rejected deepening insolvency, noting that Delaware law "imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate." Even if a company is insolvent, the court explained, the board is free to pursue good-faith strategies to enhance the company's value, including incurring additional debt. If the strategy fails, the directors are protected by the business judgment rule.

This doesn't mean an insolvent company's management is absolved of responsibility. It simply means that plaintiffs can't recover damages for deepening insolvency by itself. They must be able to prove that officers or directors breached their fiduciary duties or committed fraud.

Judge Posner of the Seventh U.S. Circuit Court of Appeals expressed a similar view in *Fehribach v. Ernst & Young*: "[T]he theory . . . makes no sense when invoked to create a substantive duty of prompt liquidation that would punish corporate management for trying in the exercise of its business judgment to stave off a declaration of bankruptcy, even if there were no indication of fraud."

More recently, in *In re Lemington Home for the Aged*, the Third Circuit denied a petition for rehearing *en banc*, upholding a jury verdict based on deepening insolvency under Pennsylvania law. But in a concurring opinion, one judge observed that the doctrine had been widely repudiated and should be reconsidered in an appropriate case.

Handle with care

Although some jurisdictions continue to recognize deepening insolvency as an independent cause of action, the doctrine appears to be on its last legs. In light of these recent cases, think twice before relying solely on the deepening insolvency doctrine — unless you have evidence of fraud or other wrongdoing. ◆

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