SEPTEMBER/OCTOBER 2020

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Discounted cash flow vs. deal price

Chancery Court relies on DCF in appraisal action

When calculating fair value in appraisal actions, Delaware courts in recent years have demonstrated a strong preference for market-based metrics, such as a company's unaffected trading price or the deal price after an appropriate market check. In a recent departure from this trend, the Delaware Chancery Court in *Manichaean Capital* relied on a discounted cash flow (DCF) analysis to determine the company's fair value.

But the court was clear that its divergent approach reflected the specific circumstances — not a categorical rejection of market-based indicators of value. It also stressed the critical role of credibility in fair value presentations.

Disputed transaction

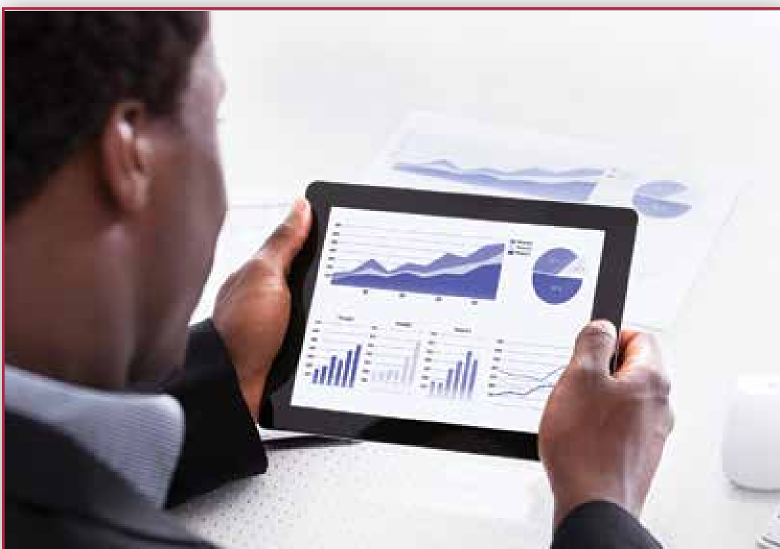
The case required the valuation of a privately held company that executed a series of transactions, converting certain minority stockholders into owners of a limited liability company (LLC). The transactions led to a three-party business combination, with the company becoming a publicly traded company.

Some minority shareholders exercised their appraisal rights under Delaware state law. They sought appraisal of 10,304 shares of common stock that were converted into membership units in the LLC.

Chancery Court decision

Based on guidance from the Delaware Supreme Court, the Chancery Court typically begins appraisals by focusing on market-based evidence. However, the court concluded that circumstances in this case rendered market evidence unreliable when determining fair value.

The court explained that the lack of a formal negotiating process undermined any reliance on deal price as an indicator of fair value. For example, it noted that the company didn't hold any board of directors meetings to consider the business combination or solicit any offers from third parties.



The court pointed out, too, that, as a private company, the business's equity wasn't traded in an efficient market. Its unaffected market price, therefore, also was an unreliable indicator of fair value.

Experts matter

Without reliable market evidence of value, the parties are left with traditional valuation methods. According to the Chancery Court, this case was a "quintessential

Chancery Court questions usefulness of DCF approach

In a recent appraisal action, the Delaware Chancery Court explained why it has come to doubt whether the discounted cash flow (DCF) method is appropriate for determining the fair value. While the court has made exceptions (see main article), it largely has followed the Delaware Supreme Court's lead in favoring deal price as the proper evidence of fair value in appraisal rights cases.

For example, *In re Appraisal of Columbia Pipeline Grp., Inc.* involves a publicly traded company that owned and operated natural gas pipelines, storage and related assets. The deal price was $25.50 per share. But the petitioners' expert valued the shares at $32.47, using the DCF method.

The Chancery Court rejected the DCF-based value. It cited three decisions where the Delaware Supreme Court endorsed using the deal price in an arm's-length transaction to determine the fair value of minority shares. In each, the court found that the perceived objectivity of deal price outweighed the shortcomings in the deal process. It concluded that Columbia Pipeline's deal price was a reliable indicator of value. Specifically, the merger was an arm's-length transaction with a third party, and the board of directors had no conflicts of interest. The company negotiated multiple price increases. And no bidders emerged in the postsigning phase.

This case is yet another example of the direction in which Delaware courts are moving on fair value. The reliance on DCF analysis increasingly is becoming the exception, not the rule.

'battle of the experts,'" which produced conclusions that were "solar systems apart." After considering the credibility of the parties' presentations, the court determined that the company's presentation lacked credibility for multiple reasons.

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For example, the company disagreed with its own expert over which revenue projections to use in the DCF analysis and took a different position than its expert on the company's fair value. The company's expert, as well as the shareholders' expert, used 5% growth projections that the company had relied on when working with its auditor, financial advisors and debt rating agencies in the period before the business combination.

The company, however, argued for projections that showed 2.2% growth for valuation purposes. The court found that the company's willingness to continue to argue for those projections, even when its expert rejected them, made its overall presentation "substantially less credible."

In addition, the Chancery Court faulted the company's expert for taking a "bespoke approach" to calculating beta (a measure of a stock's volatility compared with the overall market and therefore its systematic risk). The court found the expert's approach methodologically novel, which "raised serious questions about the credibility of his entire valuation analysis."

Lessons learned

Though the Chancery Court turned to the DCF method in *Manichaean Capital*, the court left little doubt that it continues to prefer market-based evidence. Moreover, this case highlights the importance of credibility when it comes to valuation — regardless of the method ultimately applied. ■

How to value a distressed business

The COVID-19 pandemic has caused many businesses around the globe to struggle financially. Distressed businesses present challenges during the valuation process. But an experienced business valuation professional can apply lessons learned during the Great Recession of 2007–2009 to today's market conditions and tailor his or her analysis accordingly.

Valuation methods

Regardless of whether a business is healthy or distressed, experts must consider the following three general approaches to value it:

1. Cost approach. Under this technique, all assets and liabilities (including off-balance sheet, intangible and contingent) are adjusted to their fair market values.

2. Market approach. Methods under this approach derive value from pricing multiples (such as price-to-revenue and price-to-operating cash flow) by comparing the subject business to similar businesses that have been sold within a reasonable time period.

3. Income approach. Here, value is estimated by converting anticipated economic benefits (earnings) into a present single amount, using a discount or capitalization rate that's based on the risk of the investment.

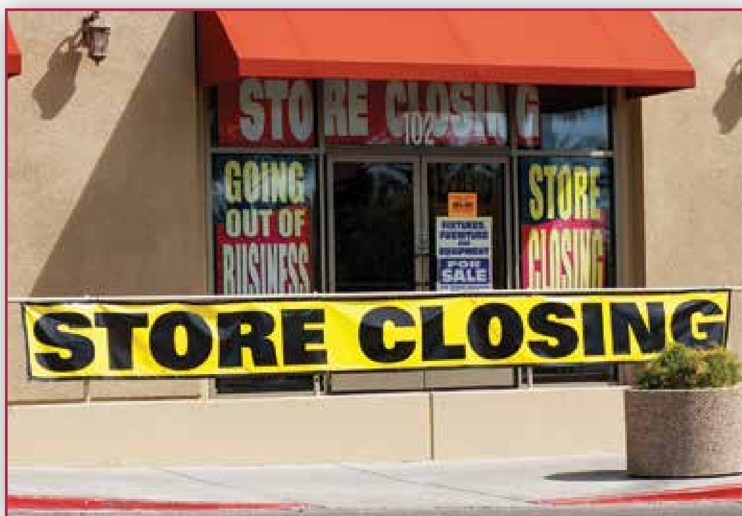
When a business is under financial distress, historical financial statements may not reflect future earnings capacity. Management may need to prepare financial forecasts to reflect expected future earnings, including any plans to turn around performance, pursue new market opportunities or divest unprofitable business segments.

Some distressed businesses may not generate enough operating cash flow to justify keeping the business open in its current state. The business may need to reorganize or liquidate under the U.S. Bankruptcy Code. In these cases, the cost approach may serve as a "floor" for the company's value.

Orderly vs. forced liquidation

Certain financial trends — such as recurring net losses, declining sales and severely reduced liquidity — may suggest that the business is no longer a viable going concern and, therefore, should be liquidated. There are two types of liquidation value:

1. Orderly liquidation. In these situations, assets are sold piecemeal over a reasonable period of time to maximize proceeds.



2. Forced liquidation. This type of value assumes assets will be sold as quickly as possible, possibly at an auction.

When estimating liquidation value, business valuation experts typically start with the balance sheet. The book values of recorded liabilities generally are accurate, but assets may require adjustments to estimate recoverability and current market values.

Experts also must consider the existence of unrecorded items. Examples include internally generated patents,

trademarks and customer lists, along with warranty claims and pending lawsuits. An expert also must factor in liquidation expenses, such as severance pay and professional fees. An escrow account may be set up for these incidentals before the company distributes liquidation proceeds to creditors and investors.

Third-party sale

Distressed businesses have a third alternative, beyond reorganization and liquidation. Some find a strategic buyer who'll pay more than the fair market value under the cost approach to acquire the business or its assets. Potential strategic buyers may include:

- Competitors looking to expand market share,
- Supply chain partners who want to become more vertically integrated, and
- Venture capital firms that specialize in the company's industry.

Strategic value is based on a *specific* buyer's investment requirements and expectations. For example, a buyer may be willing to pay a premium above fair market value for a company that provides synergies or economies of scale to that *specific* buyer. Typically, strategic value is based on discounted cash flow analyses that consider buyer-specific cost-saving and revenue-generating synergies.

Extra attention

Distressed businesses often need more assistance than a simple valuation report. An experienced business valuation professional can help throughout the bankruptcy or reorganization process. For example, experts can help restructure debt, perform solvency analyses and work with court-appointed receivers.

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They can also provide guidance to distressed business owners who would prefer to sell to a strategic buyer. Beyond setting an offer price, experts can help identify potential strategic buyers and structure deals to minimize adverse tax consequences.

Need help?

Many businesses are struggling in today's uncertain marketplace. A valuation professional can help evaluate the options — including liquidation, reorganization and sale — for improving lackluster performance. ■

New ACFE study highlights the high cost of white-collar crime

Every two years, the Association of Certified Fraud Examiners (ACFE) publishes a study detailing the latest costs, schemes, perpetrators and victims of occupational fraud. *Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse* was released earlier this year.

Consistent with previous versions of this study, the 2020 report estimates that U.S. businesses typically lose 5% of revenue each year to fraud. This can have a significant negative impact on business value.

Assessing fraud risks

Valuation experts must consider fraud risks when estimating future income and discount rates. Small businesses generally lose more to fraud than large businesses. Globally, the median loss caused by the

frauds in the 2020 study was $125,000. However, the median loss for organizations with fewer than 100 employees was $150,000, roughly 20% higher than the overall median.

Size also may determine the schemes to which a company is most vulnerable. For example, companies with fewer than 100 employees are *two* times more likely to be victims of billing and payroll scams and *four* times more likely to experience check and payment tampering than large ones. Conversely, corruption and theft of noncash assets are more common at larger organizations.

Mitigating risk

Internal controls over financial reporting (ICFR) are a company's first line of defense against employee theft and financial misstatement. Unfortunately, the study found that 43% of the victim-organizations with fewer than 100 employees lacked effective internal controls, compared to 28% of larger victim-organizations. An ineffective internal control system increases the potential risk of fraud.

The ACFE has identified the following controls as effective means of reducing fraud losses:

Antifraud control	**Percent reduction in fraud losses**
Code of conduct	51%
Internal audit department	50%
Management certification of financial statements	50%
External audit of ICFR	50%
Management review	50%
Reporting hotline	49%
External audit of financial statements	46%
Employee fraud training	38%

Investors and lenders generally perceive companies that have implemented these controls as less risky than other organizations with fewer or less effective antifraud controls in place.

Adjusting for fraud

Business valuations typically aren't designed to unearth fraud. However, valuation experts rely on financial statements to estimate value. If financial statements contain fraud, a business valuation will be inaccurate, unless properly adjusted.

During the valuation process, an expert could unearth red flags of fraud. In these situations, the expert might ask a client to expand the scope of the engagement to include forensic accounting services. This expert can help make the requisite adjustments to accurately value the business and build a fraud case, if necessary.

Risky business

Fraud can unexpectedly strike any business, large or small. But certain situations — such as shareholder disputes and divorces — can create motives to hide assets and downplay income. Experts are particularly mindful of fraud risks when valuing a business for these purposes.

Likewise, valuators must be diligent about fraud risks during the COVID-19 crisis. Financial distress and market uncertainty can motivate employees to steal or falsify statements — and liberalized management oversight while employees work remotely may compromise a company's ICFR. This can create opportunities to misstate financial results. If you suspect fraud, discuss it with your valuation professional or a forensic accountant. ■

Subchapter V: New reorganization rules for small businesses

The COVID-19 crisis is prompting many struggling business owners to seek relief through bankruptcy. Recent changes to the bankruptcy law, as well as a provision in the Coronavirus Aid, Relief and Economic Security (CARES) Act, may allow certain small businesses to avoid Chapter 7 liquidation and, instead, opt for a new, more affordable type of Chapter 11 reorganization. Here's an overview of what's changed.

Updating the Bankruptcy Code

Chapter 11 has often proven too costly for small businesses to pursue. Effective as of February 19, the Small Business Reorganization Act (SBRA) aims to help owners of privately held businesses survive bankruptcy and retain control over their operations.

The SBRA creates a new subchapter of the U.S. Bankruptcy Code. Notably, Subchapter V requires fewer expenses than typical Chapter 11 filings. For example, a committee of creditors won't be appointed unless ordered by the bankruptcy court for cause. Under traditional Chapter 11, a committee can hire its own professionals, and the debtor must pay for them.

Subchapter V is generally available to debtors whose total debt doesn't exceed $2,725,625 (subject to adjustment every three years). However, the CARES Act expands Subchapter V availability by raising the eligibility limit to $7.5 million for new Subchapter V cases filed after March 28, 2020. But this is a limited time offer: The debt limit will revert to $2,725,625 after March 27, 2021.

Plotting the course

Valuation professionals can help business owners who are contemplating bankruptcy evaluate whether liquidation (Chapter 7) or reorganization (Chapter 11) makes sense. If the company's going concern value exceeds its liquidation value, reorganization is generally the preferred route. Here, experts can help navigate the financial aspects of filing for bankruptcy under Subchapter V. For example, they can help "sell" a reorganization plan to creditors and appraise assets when renegotiating working capital covenants.

When creditors or minority shareholders protest plans to divest business segments, valuators can provide fairness opinions. These reports confirm whether the terms of a proposed transaction are "fair" from a financial perspective. Conversely, when creditors and minority shareholders approve of a sale, a valuator can aid in the search for buyers, help evaluate offers and structure the deal in a tax-smart manner.

Rough waters ahead

COVID-19 may cause some struggling business owners to throw in the towel. Fortunately, recent changes in the law may offer a lifeline to many small businesses and increase their odds of survival. The key is to seek financial expertise as soon as possible. ■

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