

BCC Advisers Litigation & Valuation Report

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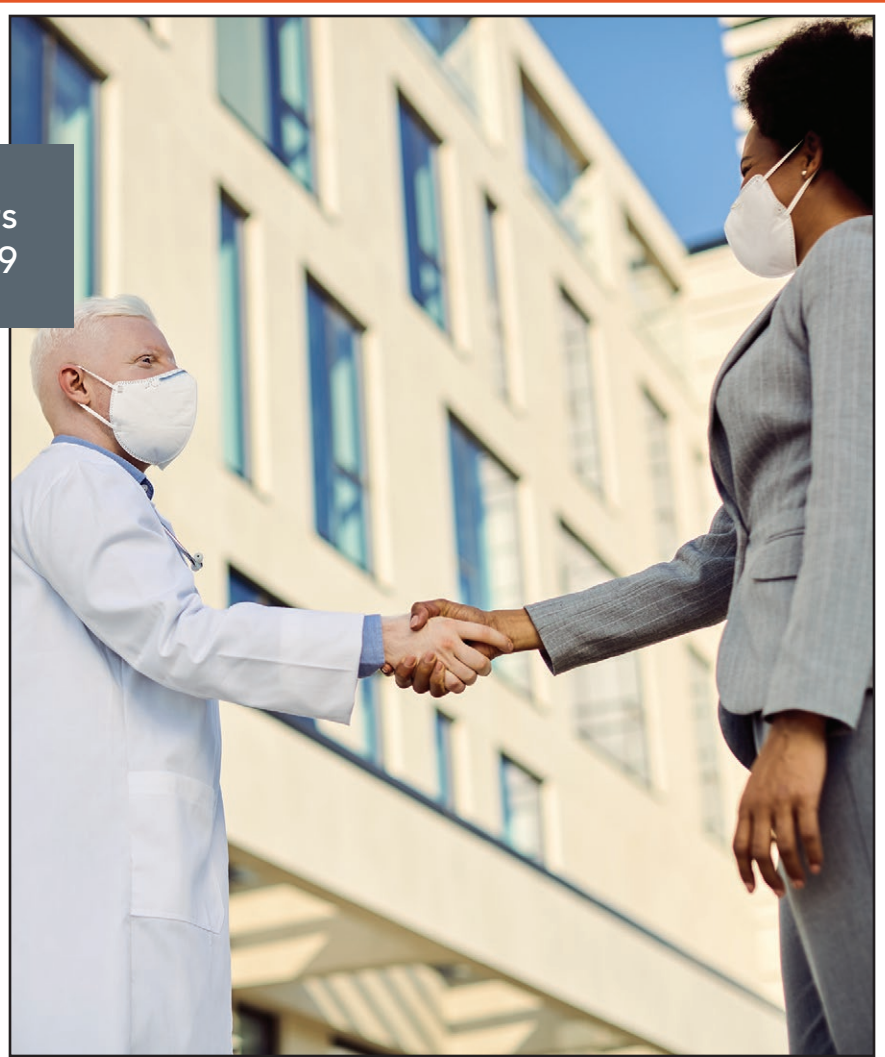
Valuing health care providers
in the age of COVID-19

Badgley v. United States
Entire value of GRAT
includible in grantor's estate

Valuation matters in liquidation

Minority partner buyouts: To
discount or not to discount?

Tennessee appeals court rejects
unspecified discount for lack of control



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Valuing health care providers in the age of COVID-19

Health care valuations have become particularly challenging during the pandemic. Here's an overview of ways business valuation professionals are adjusting their analyses to cope with market disruptions and uncertainty about the future of this industry.

A brave new world

The pandemic has affected health care providers in various ways — some positive, some negative. For example, acute care hospitals and some primary care practices have benefited from increased utilization of their services and higher reimbursement rates for certain COVID-related care. By comparison, those that offer elective or nonessential services, such as dentists, psychologists and plastic surgeons, may report lower revenue, and some have even had to furlough or lay off staff (or rely more on contracted labor).

Myriad other COVID-related factors may affect the value of a health care provider. Notably, providers are spending more on personal protective equipment, cleaning supplies and COVID-19 testing. Many are also experiencing shortages of skilled labor, particularly if staff resist a vaccine mandate.

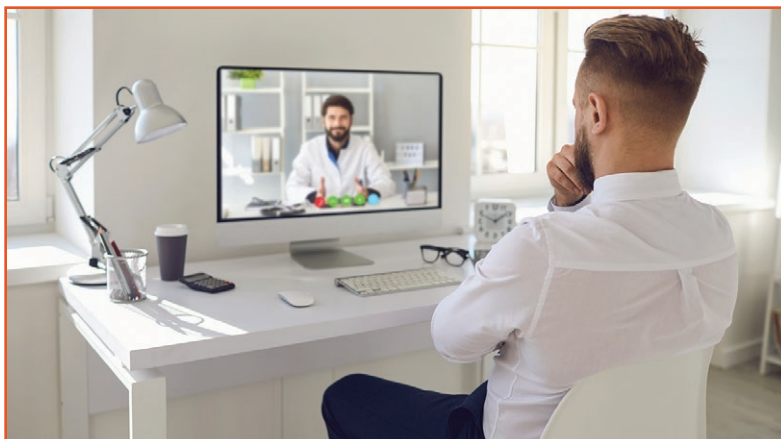
Moreover, hackers may try to exploit weakened internal controls — due to staffing shortages and remote working arrangements — to gain access to a health care provider's network and data. (See "Mounting risk of cyberattacks in health care" on page 3.)

Virtual care

In response to the pandemic, the Centers for Medicare & Medicaid Services:

- ◆ Lifted many restrictions on the use of telemedicine,
- ◆ Expanded it to cover additional services, and
- ◆ Boosted reimbursement for most virtual care services.

These changes benefit providers that are equipped with the technology to provide telemedicine. But they also can expose those providers to higher malpractice risks related to inaccurate diagnoses and inadequate follow-up. Organizations that are unable to provide care virtually (due to the nature of their services or technological limitations) may be at a disadvantage during the pandemic.



It's also unclear whether telemedicine is here to stay — or whether the shift is largely temporary. Providers that see the changes as only transitory may be reluctant to invest in the technology and training to offer services virtually.

Market approach

Historical market data may be less relevant in today's unprecedented conditions. For example, pricing multiples based on public stock prices or comparable private

Mounting risk of cyberattacks in health care

Health care providers' networks hold significant amounts of sensitive personal information on patients and employees. The Cybersecurity and Infrastructure Security Agency, the FBI and the U.S. Department of Health and Human Services recently issued a joint advisory warning of "an increased and imminent cybercrime threat to U.S. hospitals and healthcare providers."

While the sector has been distracted with providing quality care to patients during the pandemic, hackers have launched aggressive attacks — such as phishing and ransomware scams — on providers' networks. Many attacks target remote workers' less-secure home networks or personal devices that connect to provider networks while the owner is onsite. In light of the recent expansion in telemedicine, it might be prudent for health care organizations to invest in measures designed to mitigate financial losses and preserve long-term value.

An outside forensic specialist can help. In addition to assessing networks for vulnerabilities, outside experts can recommend best practices in network security, such as providing staff training, using multifactor authentication, backing up data, implementing network segmentation and limiting who can access sensitive data where possible. It's also important for health care organizations to have business continuity, data recovery and patient response plans in place, in case a cyberattack happens.

business transactions that happened before the start of the pandemic may not provide reliable benchmarks for current market values.

Plus, pricing multiples are typically based on revenue, profits or cash flows. So, to the extent that these earnings streams are temporarily inflated (or suppressed) by market changes during the pandemic, the use of market-based pricing multiples may skew a valuator's conclusion. Adjustments can be made to reflect the increased risk, but it can be difficult to support those adjustments using objective market data.

Income approach

Under the income approach, a company's value is a function of its anticipated economic benefits (in other words, future earnings). But certain methods under the income approach may be more appropriate than others.

Under *normal* market conditions, it may be appropriate to value a mature company with steady earnings

by capitalizing economic benefits for a representative single period. But in today's uncertain marketplace, the discounted cash flow (DCF) method may be more appropriate for most health care providers than the capitalization of earnings method.

Under the DCF method, the present value of future cash flow is calculated using a risk-adjusted discount rate. This method gives the valuator the flexibility to model the subject company's future earnings based on current conditions and assumptions about its eventual return to normal operations over the next several years.

An uncertain future

Determining a health care provider's future earnings requires assumptions about what the industry will look like in the coming years. It's unclear when the industry will return to normal or the extent to which certain changes will be part of a "new normal." Valuators can temper this uncertainty by projecting cash flows under multiple scenarios with probability-weighted outcomes. ■

Badgley v. United States

Entire value of GRAT includible in grantor's estate

The U.S. Court of Appeals for the Ninth Circuit recently held that the full value of a grantor retained annuity trust (GRAT) was properly included in the grantor's gross estate under Internal Revenue Code Section 2036(a)(1). That section provides for inclusion of transferred property if the grantor retains "the possession or enjoyment of, or the right to the income from, the property" for life or "for any period not ascertainable without reference to his death or for any period which does not in fact end before his death."

Strings attached

A GRAT is a popular estate planning tool that families can use to transfer wealth in a tax-efficient manner while maintaining some control over the assets. Typically, a GRAT is structured to pay a fixed annuity to the grantor for a specific term. After the end of the trust's term, the assets remaining in the GRAT are transferred to the beneficiaries. One potential risk is that the grantor will die before the end of the trust term, and then the GRAT assets will be pulled back into his or her estate.

In this case, the decedent ("grantor") transferred a 50% partnership interest — valued at \$2.4 million — to a GRAT established for the benefit of her two daughters. The mother retained the right to a \$300,000 annuity (12.5% of the initial value of the assets in the trust) for 15 years. At the end of the term, the remaining assets would transfer to the beneficiaries.

The grantor died shortly before the 15-year period expired, and her estate tax return reported a gross estate that

included the GRAT's assets. Later, one of grantor's daughters, acting in her capacity as executor, sought a partial refund. She argued that the gross estate should have included only the net present value of the unpaid annuity payments, rather than the GRAT's entire date-of-death value.

The IRS failed to act on the refund claim in a timely fashion, so the executor filed a refund action in federal district court. The court granted the government's motion for summary judgment, ruling that grantor's retained annuity interest constituted both a right to substantial income from and continued enjoyment of the property.

Substance over form

On appeal, the Ninth Circuit explained that to avoid inclusion under Sec. 2036(a)(1), one must "absolutely, unequivocally, without reservations part with all of his title and all of his possession and all of his enjoyment of the transferred property," and the transfer "must be unaffected by whether the grantor lives or dies."



The second requirement means the beneficiaries must receive their interests *before* the grantor's death. The court held that the grantor retained enjoyment of the property for purposes of Sec. 2036(a)(1) because her retained annuity was a "substantial present economic benefit."

If the grantor dies before the end of the trust term, then the GRAT assets will be pulled back into his or her estate.

The estate made several arguments for why Sec. 2036(a)(1) didn't apply, but it failed to convince the court. One argument was that the provision is inapplicable because it doesn't expressly refer to annuities. The court rejected this "form over substance" argument, noting that other courts had applied Sec. 2036(a)(1) to a variety of interests that aren't expressly listed.

The estate also argued that the GRAT's principal exceeded the annuity for much of the 15-year term. That means that the annuity could have been drawn from prior year partnership distributions and the interest earned on them. The court declined to speculate on the annuity's source, but it found the inquiry to be irrelevant. It noted that the partnership interest was the only property in the GRAT. Because the annuity was drawn from the GRAT, the court concluded that the payments received by the grantor "came from the partnership interest."

No surprise

Notably, the court commented that its decision should come as no surprise. The risks associated with GRATs are well known. However, if the grantor survives the trust's term, the potential benefits — which include transferring property to beneficiaries free of estate tax and with low or no gift tax — can be substantial. ■

Valuation matters in liquidation

Unfortunately, many businesses have liquidated assets to generate cash flow, restructured or filed for bankruptcy during the COVID-19 pandemic. Valuation expertise is essential for business clients during the liquidation process and for clients that want to acquire a company in liquidation. An experienced expert can help evaluate a distressed company's future and its current financial picture to maximize liquidation proceeds.

What's liquidation value?

Valuation professionals typically calculate a company's value as a going concern. However, certain financial trends such as recurring net losses, declining sales and severely reduced liquidity may suggest that the business would be more valuable if it were liquidated.

The *International Glossary of Business Valuation Terms* lists the following two types of liquidation value:

- 1. Orderly liquidation.** In this case, assets are sold piecemeal over a reasonable period to maximize proceeds.
- 2. Forced liquidation.** This premise of value assumes assets will be sold as quickly as possible, possibly via auction.

Timing, bankruptcy laws and judicial mandates all help determine what's appropriate for a particular case.

How is value measured?

An expert hired to value a troubled company typically starts with its balance sheet. The book values



of liabilities generally are accurate, but assets may require adjustments to estimate recoverability and current market values. The expert also considers the existence of unrecorded items, such as:

- ◆ Patents,
- ◆ Trademarks,
- ◆ Customer lists,
- ◆ IRS claims,
- ◆ Warranties, and
- ◆ Pending lawsuits.

If a company decides to liquidate, the valuation professional must factor in liquidation expenses, such as lease obligations, severance pay and professional fees. Typically, money is set aside in an escrow account for these incidentals before the company distributes liquidation proceeds to creditors and investors.

How can valuers help?

Liquidation value often serves as a “floor” for business value. It also can help owners decide whether to file for Chapter 7 (liquidation) or Chapter 11 (reorganization) under the Federal Bankruptcy Code. And it helps stakeholders evaluate the viability of spin-offs and mergers, out-of-court loan workouts, management buyouts, and reorganization plans.

Liquidation analyses are just the tip of the iceberg. Valuation experts can advise distressed businesses on such issues as negotiating debt restructuring

with creditors and coordinating bankruptcy filings. They also can provide fairness opinions for management buyouts and third-party acquisitions and help implement reorganization plans.

When creditors file fraudulent conveyance lawsuits, valuers can help determine the facts by performing a solvency analysis. The expert’s subsequent solvency opinion determines whether the allegedly fraudulent transfer has left the company unable

to service its debt obligations or continue normal business operations. Valuation experts also might work with, or serve as, court-appointed receivers and turnaround consultants.

Liquidation value often serves as a “floor” for business value.

On the flipside, they can also help buyers of distressed businesses determine the targets’ strategic value — or value based on the specific buyer’s investment requirements and expectations. For example, a buyer may be willing to pay more than liquidation value for a company that provides synergies and economies of scale with its existing operations.

Experience counts

Valuation plays an essential role in the liquidation process. Yet not every valuation expert is qualified to work on these matters. Select a professional who’s experienced in distressed company engagements and familiar with bankruptcy laws.

In addition to financial expertise, your expert needs the strong presentation skills necessary for persuasive court testimony and negotiations with investors, creditors and other concerned parties. A valuator who is well versed in liquidation matters can help your client emerge from the process in the best possible financial position. ■

Minority partner buyouts: To discount or not to discount?

Tennessee appeals court rejects unspecified discount for lack of control

In *Boesch v. Holeman*, the Court of Appeals of Tennessee at Knoxville addressed the value of a “dissociated” partner’s one-third interest in a whiskey business. The court held that the trial court erred in allowing a discount for the interest’s lack of control. The applicable partnership statute required that value be based on a hypothetical sale of the *entire* business.

Quick distillation of the facts

In 2014, the plaintiff and two others formed a partnership to sell flavored moonshine and whiskey. The plaintiff contributed formulas for various products, as well as providing “sweat equity” with one of the other partners. The third partner provided financing. In December 2015, the plaintiff was dissociated from the partnership.

In 2016, the plaintiff sued the remaining partners on several grounds, including fraud and violation of the Uniform Trade Secrets Act. He also alleged that the defendants breached their fiduciary duties by expelling him from the business and misappropriating his trade secrets.

The trial court dismissed most of the plaintiff’s claims, leaving only one remaining issue: the value of the plaintiff’s interest. The plaintiff’s expert valued the interest at \$258,300 in August 2017. He

didn’t directly determine the value when the plaintiff left the partnership in December 2015, but he did discount his value back to that date.

The opposing expert valued the interest at only \$23,000 as of December 2015. This value incorporated discounts for both lack of control and lack of marketability, but the expert’s report didn’t specify the amount attributable to each discount. The trial court adopted the discounted value.

DLOC was inappropriate

The appellate court rejected all the plaintiff’s arguments on appeal, except for his challenge of the interest’s valuation. The applicable Tennessee statute provides that the buyout price for a dissociated partner is the amount that would be distributable were the partnership assets sold for the greater of liquidation or going concern value. The parties agreed that liquidation value wasn’t appropriate.

Under this standard, the court explained, a discount for lack of marketability as to the entire partnership (rather than plaintiff’s interest) was appropriate, but a discount for lack of control by a minority interest holder wasn’t. The court remanded the case to the trial court to recalculate the buyout price according to the statute.

Bottom line

When buying out a partner who owns a minority (noncontrolling) interest, questions regarding the application of valuation discounts for lack of control and marketability often arise. There is no universal “right” answer. Discuss this matter with your valuation expert to determine what’s appropriate based on the facts of the case, as well as relevant statutes and legal precedent. ■



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