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# Litigation & Valuation Report

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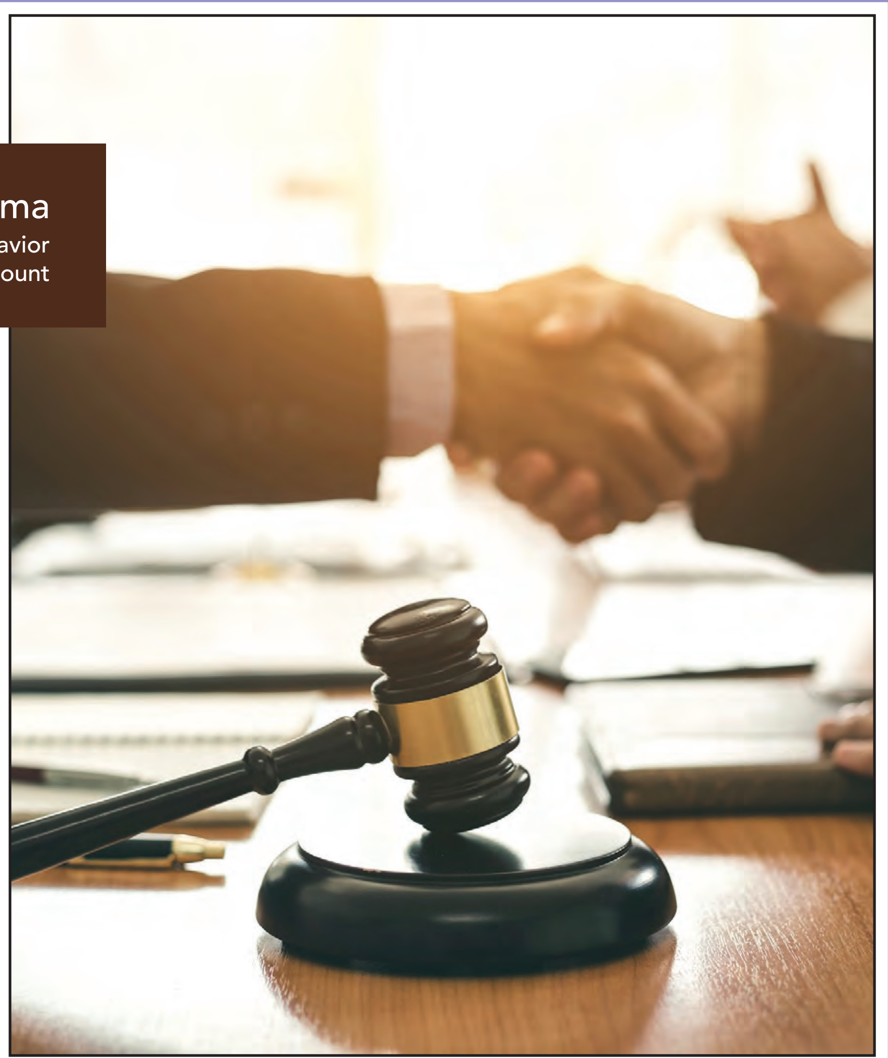

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# DLOM dilemma

## Defendants' bad-faith behavior precluded marketability discount

In *Sipko v. Koger, Inc.*, the New Jersey Supreme Court affirmed the trial court's holding that a buyout of the plaintiff's interests was the appropriate remedy in a shareholder dispute. The court also reversed the appellate court's ruling, which remanded the case to the trial court to determine whether a discount for lack of marketability (DLOM) should apply when valuing the plaintiff's interests. It found that a DLOM was inappropriate, noting the "defendants' bad-faith behavior throughout this 15-year litigation."

### Family dispute leads to business divorce

This case involved several related family businesses owned by a father and his two sons. The father established Koger in 1994, gifting 1.5% interests to each son. In 2002 and 2004, respectively, he formed two subsidiaries — Koger Distributed Solutions (KDS) and Koger Professional Services (KPS) — with each son owning 50% of each company's shares.

A family disagreement led to one son resigning in 2006 and relinquishing his 50% interests in both KDS and KPS. He sued the company, his father and his brother, alleging that he was an oppressed shareholder. He also claimed that he'd signed the documents transferring his KDS and KPS stock under duress.

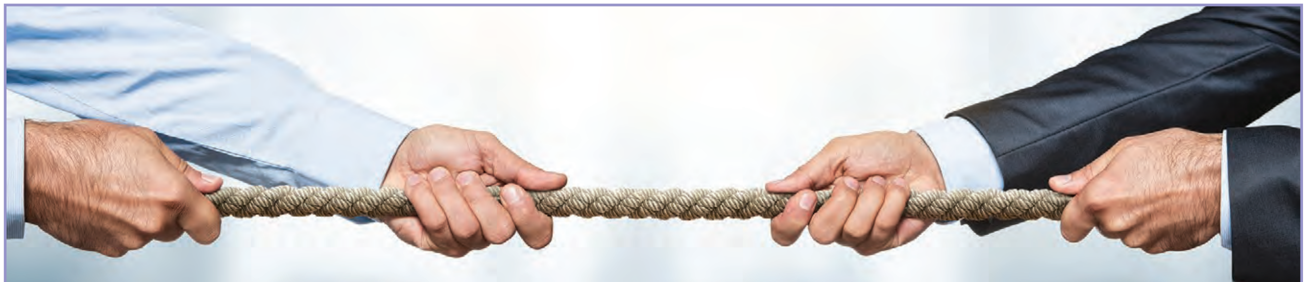
### Defendants behaved badly

After the litigation commenced, the defendants transferred several contracts from the subsidiaries to Koger. According to the trial court, the transfers were "part and parcel of a strategy to render [the plaintiff's] interests in KDS and KPS zero." They also backdated the transfer of stock in KPS, the more valuable of the subsidiaries, from February 2006 to December 2004. This move was designed to deprive the plaintiff of his interests in lucrative contracts he negotiated in 2005.

> ***A DLOM "cannot be used unfairly by the parties whose misconduct and bad faith caused the corporate split to benefit themselves."***

As this case worked its way through the New Jersey courts, the appellate court and supreme court agreed that the plaintiff's transfer of KDS and KPS stock was void for lack of consideration. The higher courts also reversed the trial court's finding that the subsidiaries lacked independent value. Although the supreme court upheld the trial court's finding that the plaintiff failed to demonstrate shareholder oppression, it noted that New Jersey's statute "does not limit the equitable power of the courts to fashion remedies appropriate to an individual case."

On remand, the trial court determined that a buyout of the plaintiff's KDS and KPS stock was



## Is a DLOM appropriate for a controlling interest?

It's widely accepted, among the courts and valuation experts, that a discount for lack of marketability (DLOM) is often appropriate for a *noncontrolling* interest in a privately held company. But what about a controlling interest? Many valuation practitioners apply such discounts, even when valuing a 100% interest in a business, and some courts have accepted them. Generally, DLOMs for controlling interests, if applicable, are much smaller than those for noncontrolling interests. However, the issue remains controversial.

In practice, the DLOM usually reflects two distinct, but related, components:

1. **Marketability.** This refers to the ability to sell an asset in a readily available market at minimal cost.

2. **Liquidity.** This component generally refers to the speed at which an asset can be converted into cash.

Publicly traded stock is marketable (it's readily sold on a stock exchange) and liquid (it can be converted into cash in a matter of days). Minority interests in private companies are generally both unmarketable (there's no readily available market) and illiquid (they can't be converted to cash quickly). The DLOM for such interests is often quantified using restricted stock studies and IPO studies, which measure differences in value between marketable, liquid shares and unmarketable, illiquid shares.

Proponents of DLOMs for controlling interests in private companies note that these interests are marketable but illiquid. Opponents argue that marketability and liquidity issues are already reflected in the risk component of the rate of return used to convert expected cash flows to present value. Even if a DLOM is appropriate, quantifying it can be a challenge. The restricted stock and IPO studies involve minority interests, and there are no similar empirical studies to quantify DLOMs for controlling interests.

an appropriate remedy. It accepted the plaintiff's expert's valuation of his interests, as of the date the complaint was filed, at approximately $18 million. Significantly, though the trial court invited the defendants to present their own expert to value the two subsidiaries, they declined.

### Final chapter

The defendants did, however, file an appeal. In due course, the appellate court upheld the buyout remedy but rejected the trial court's acceptance of the plaintiff's expert's valuation. In particular, the appellate court determined that the trial court had failed to determine whether a DLOM should be applied to the value of his interests in KDS and KPS.

The supreme court reversed. "The guiding principle in such cases," the court explained, "is that a [DLOM] cannot be used unfairly by the parties whose misconduct and bad faith caused the corporate split to benefit themselves to the detriment of the injured parties." Pointing to all of the defendants' conduct to strip the plaintiff's rightful interests of value, the supreme court found that "equity cannot abide imposing a discount to the benefit of defendants." The court deferred to the trial judge's broad discretion to accept or reject expert testimony, "particularly because the trial judge handled this matter for over a decade, presided over the bench trial, heard testimony, asked questions, and had, by far, the best feel for the case." ■

*Redleaf v. Commissioner*

# Cash payments are property settlement, not deductible alimony

In *Redleaf v. Commissioner*, the U.S. Court of Appeals for the Eighth Circuit recently held that $51 million in deferred cash payments made by a husband to his ex-wife pursuant to a marital termination agreement (MTA) weren't deductible as alimony. At the time the payments were made, the federal tax code provided that alimony was deductible by the payor spouse and includable in the recipient spouse's income. This provision was repealed under the Tax Cuts and Jobs Act (TCJA), effective for divorce or separation instruments executed after 2018.

## Sizable property settlement

Executed in 2008, the MTA provided that the wife would receive the family's principal residence and vacation home, as well as most furnishings and artwork in the homes and four of their five vehicles. The husband received a piano, some art, his personal effects, the fifth vehicle and his 84.5% interest in a hedge fund asset management firm.

To account for the wife's interest in the firm as a marital asset, the MTA provided for the husband to pay her approximately $140 million in cash over the next five years. This included around $51 million in payments in 2012 and 2013, which the husband deducted as alimony on his tax returns for those years. The wife treated the payments as nontaxable transfers of property incident to divorce.

The IRS issued separate deficiency notices, informing the husband that the payments weren't deductible as alimony and informing the wife that they were includable in her income as alimony. Both parties petitioned the U.S. Tax Court for redetermination.

The IRS took the position that the payments weren't alimony and, therefore, weren't deductible by the husband or includable in the wife's income. The court agreed, granting summary judgments reversing the wife's deficiency and upholding the husband's deficiency.

## Alimony criteria

The Eighth Circuit affirmed the Tax Court's decision, noting that, to constitute alimony, cash payments must satisfy the following four requirements:

1. The payment is received by or on behalf of a spouse under a divorce or separation instrument,
2. The instrument doesn't designate the payment as excludable from the payee's gross income and nondeductible by the payor,
3. In the case of legal separation, the payor and payee aren't members of the same household, and
4. There's no liability to make any such payment after the payee spouse's death.

The MTA didn't contain a provision specifying whether the payments were includable in the wife's income or deductible by the husband. However, while the MTA didn't expressly state whether the payments would have survived the wife's death, they clearly would have under applicable state law (Minnesota in this case).

The MTA stated that the wife had "adequate income and financial resources from the property settlement to meet her needs," and that each party "waives any right to receive temporary and/or permanent spousal maintenance . . . now or in the future." The Eighth Circuit found that Minnesota law unambiguously established that the MTA was a contractual division of marital property rather than a spousal maintenance agreement. As such, Minnesota law unambiguously provided that the husband's obligation to make the payments would survive the wife's death and, therefore, weren't deductible.

### Factor taxes into settlements

As *Redleaf* demonstrates, it's important to discuss tax issues with a financial professional when executing a divorce or separation agreement. Although the TCJA eliminated the above-the-line deduction for alimony payments, some pre-2019 cases are still making their way through the court system and there are other divorce-related tax pitfalls — for example, related to retirement plans and built-in capital gains tax — that need to be addressed when splitting up the parties' assets. ■

# How to estimate lost profits for a start-up business

Financial experts usually start lost profits calculations with a company's historical performance. However, sometimes the victim of a dispute or breach doesn't have an established track record. Estimates for start-ups and early-stage companies that haven't yet turned a profit require an alternative approach.

### Using the past to predict the future

To estimate lost profits, experts need to project the plaintiff's expected revenue and profit margin numbers. Projected lost revenue is based on certain assumptions and adjusted by appropriate profit margins to reach lost profits.

To project future revenue, experts typically use data from historical company performance, industry, and general economic trends and forecasts. A damaged business's lost revenue is calculated using a variety of techniques, such as the yardstick and before-and-after methods. With a fledgling business, however, an expert may find insufficient performance data, insufficient firm data to correlate with industry trend data or a product so new that no projections have yet been made.

***Experts have alternative forecasting methods that can lead to supportable lost profits claims.***

Similar problems complicate the process of determining profit margins, which requires analysis of a

company's fixed and variable costs. An expert will usually use historical company performance, industry profit margins, and internal forecasts based on projected revenue and cost structures. But a new company may have not yet generated much data for analysis and, if it markets a new product or service, comparable businesses might not exist.

## Applying innovative solutions

Determining accurate lost profits damages for new businesses isn't hopeless, though. Experts have alternative forecasting methods that can lead to supportable lost profits claims. For instance, they can use company projections for future revenue if the available data allows calculation of lost profits with "reasonable certainty" — in other words, the damages aren't merely speculative or overly optimistic. The expert also may apply industry growth rate projections to existing company data and develop multiple sales projections using varied combinations of actual and projected data.

If the multiple projections arrive at similar conclusions, the expert can offer those findings as evidence of lost revenue. After lost revenue is calculated, the expert might use firm-specific data to model the cost structure by determining fixed and variable costs and the cost of goods sold.

Even when no useful firm-specific data can be identified, experts can cull useful information from outside sources. For example, they might look at models and studies of new-product life cycles to obtain market share and penetration estimates useful in projecting revenue.

Internal data and reports, industry forecasts, and other sources can then assist in formulating profit margins. And many governmental agencies, trade associations and research organizations issue regular reports that provide data — including expected demand, price and cost structures — that can be wielded to validate lost profits projections.

Experts also use discount rates. The discount rate applied to lost profits must reflect the riskiness and probability that the business would have realized the projected lost profits. It may be necessary to add a premium to the discount rate to account for overly optimistic internal forecasts. Or, when a company is in an early stage, experts may add an additional premium to the discount rate because lost profits aren't as easily projected as they are for an established business.

## Out-of-the-box thinking

Compared to more mature, stable businesses, start-up ventures seem to disproportionately experience contractual breaches, shareholder disputes and other types of litigation that necessitate lost profits calculations. To make matters worse, new companies often lack the resources to litigate these cases. Hiring an experienced valuation expert to support a claim can help improve your odds of winning in court. ■

# Proposed FRE amendments may affect your expert witnesses

Proposed amendments to the Federal Rules of Evidence (FRE), expected to take effect in late 2023, may affect the admissibility of expert testimony. The proposed amendments to FRE Rule 702 have been approved by the Judicial Conference of the United States. Assuming they're approved by the U.S. Supreme Court and Congress doesn't intervene, they'll take effect on December 1, 2023.

## 2 key changes

Proposed changes to Rule 702 are shown below, with additions in bold and deletions struck through:

A witness who is qualified as an expert by knowledge, skill, experience, training or education may testify in the form of an opinion or otherwise if **the proponent has demonstrated by a preponderance of the evidence that:**

- The expert's scientific, technical or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue,
- The testimony is based on sufficient facts or data,
- The testimony is the product of reliable principles and methods, and
- The ~~expert has reliably applied~~ **expert's opinion reflects a reliable application of** the principles and methods to the facts of the case.

The first change is intended to address conflicting interpretations of Rule 702 among the federal courts. Some have incorrectly concluded that expert testimony is presumed to be admissible. They also view the rule's requirements that the expert rely on sufficient facts or data and apply reliable principles and methods as questions of weight rather than admissibility. By adding the "preponderance of the evidence" standard, the proposed amendments clarify that whether expert testimony meets the reliability requirements is a question of admissibility for the court.

The second change clarifies that the court must determine not only that the expert has reliably applied the principles and methods to the facts of the case, but also that the expert's ultimate opinion flows from such application. In other words, the court is empowered to prevent experts from overstating their opinions or exceeding the bounds of what can reasonably be concluded from a reliable application of their principles and methods.

## Impact of the amendments

The proposed amendments aren't intended to make substantive changes to Rule 702. Instead, they're designed to clarify existing rules regarding the admissibility of expert testimony and address conflicting interpretations of the rule. Practically speaking, however, by emphasizing the courts' gatekeeping role, the changes may make it more difficult to admit expert testimony in certain cases. ■

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