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Information, guidance, and resources from the nation's leading financial forensics experts.

UPCOMING APPEARANCES

FEATURE ARTICLE

Deepening Insolvency is Only Damages Deep

BY PETER KIMANI, CPA, CFA

"A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[1]

With the current economic downturn, it is anticipated that there may be an uptick in cases alleging deepening insolvency as a cause of action and/or a measure of damages. [*Judicial interpretations differ as to whether "deepening insolvency" is a cause of action or measure of damages or both. Ed.*] As creditors seek to recover from companies in bankruptcy, this theory may experience a new lease on life and more courts throughout the United States may be called upon to decide on its validity.

The phrase "deepening insolvency" was first introduced in *Schacht v. Brown,*[2] a case in which the Illinois insurance commissioner alleged that the directors and officers of an insurance company fraudulently concealed its insolvency, thereby allowing continued writing of insurance and further dissipation of assets. In *Kittay v Atlantic Bank of New York*,[3] the court defined deepening insolvency as "…the fraudulent prolongation of a corporation's life beyond insolvency, resulting in damage to the corporation caused by increased debt." The deepening insolvency theory derives from the notion that a corporation is injured when its life is artificially and wrongfully extended past its current state of insolvency. "The premise underlying

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BV FOR THE LITIGATION PRACTITIONER

Discount Rates in the Current Market – Building Up for a Big Fall?

BY MICHAEL S. BLAKE, CFA

Discount rates are frequently an important element in determining damages in commercial litigation, but in current market conditions, the reliability of some established market discount rate data is suspect. In particular, equity risk premium ("ERP") calculations that rely on historical market equity index return data are producing discount rate results that do not seem to be consistent with investor behavior and asset pricing in the current market environment. This was not entirely unexpected. Shannon Pratt, CFA, FASA, ARM, MCBA, CM&AA and Roger Grabowski, ASA published an article earlier this year[1] that saw the issue on the horizon based on historically low 20-year Treasury Bond

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Deepening Insolvency

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the deepening insolvency theory is that even an insolvent company has some value, which could be salvaged if a company is liquidated or restructured in a timely manner."[4]

The theory dates as far back as the late nineteenth century. In *Patterson v. Franklin*,[5] the Supreme Court of Pennsylvania denied recovery in damages resulting from fraudulent misrepresentation by incorporators and shareholders. The court found that the corporation actually benefited from the fraud. This reasoning was upheld by many courts until *Schacht* and *The Official Committee of Unsecured Creditors v. R.F. Lafferty & Co*[6] (*Lafferty*). These cases are noteworthy in that although their findings differed, the hearing courts concurred that not all actions that prolong the lifespan of a corporation are beneficial. In *Schacht*, the court declared that a corporation "…is ineluctably damaged by the deepening of its insolvency." The court further declined to "speculate that the Illinois courts would bar, based on this automatic benefit rule, a corporation from recovering damages resulting from deepening insolvency."[7] Put differently, the *Schacht* court refused to rule out the possibility that deepening insolvency could be used to measure damages.

The theory of deepening insolvency is not universally recognized. There are hardly any state cases that involve deepening insolvency as either a cause of action or as a theory that supports recovery of damages by the aggrieved party. Most deepening insolvency cases originate from federal bankruptcy courts. Although older court decisions recognized deepening insolvency as a cause of action, more recent rulings appear to allow it only as a theory for recovery of damages.

The most influential case appears to be *The Official Committee of Unsecured Creditors v. R.F. Lafferty & Co*[8] (*Lafferty*) decision. This ruling is referenced by nearly all other courts dealing with deepening insolvency. The court in *Lafferty* ruled that the theory of deepening insolvency is essentially sound and "…may give rise to a cognizable injury…" under Pennsylvania law. The court observed that that even when insolvent, corporate property still has value. It further noted that fraudulent increase in debt can damage that value in a number of ways, such as forcing the afflicted company into bankruptcy; placing limitations on corporate operations, undermining the company's corporate relationships, and/or dissipating its assets.

Recent cases have departed from the direct application of *Lafferty's* guidelines on deepening insolvency. In *Trenwick America Litigation Trust v Ernst & Young, LLP*,[9] (*Trenwick),* the Delaware bankruptcy court dismissed deepening insolvency as a valid cause of action but came short of resolving whether it was an appropriate theory of damages. In *re Parmalat Securities Litigation*[10] the court established a test that distinguished "delayed liquidation" from "delayed reorganization," and stated that damages cannot arise for the former but are theoretically possible in cases involving "delayed reorganizations." In *Miller v. McCown (In re Brown Schools)*[11] the Delaware court concurred with *Trenwick* and upheld the ruling that deepening insolvency was not a valid cause of action, but observed that the theory may be used to measure damages in an action for breach of fiduciary duty of loyalty.

Deepening insolvency rests on the premise that a corporation is injured when its life is artificially and wrongfully extended past its current state of insolvency.[12] However, the point at which a company crosses the solvency threshold is ambiguous; in fact some courts have accepted a "zone" of insolvency. Courts have commonly accepted three types of insolvency:

1. Balance sheet insolvency, which occurs when a company's debts

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exceed the fair market value of the sum of its assets.

2. Cash flow insolvency, which arises when a company does not have enough cash on hand to cover its debts as they become due.
3. Low capital insolvency, which occurs when a company's capital is too small to protect it from business downturns and fluctuations.[13]

Generally, since shareholders' interest in a company will be damaged when it is determined to be insolvent, equity holders are not typical plaintiffs in deepening insolvency cases. Shareholders' claims have been deemed valid only when they can prove that there existed some hope of reorganization. In other circumstances a harmed equity holder can argue that a negative equity balance does not necessarily indicate a negative value for a company and that notwithstanding such negative equity, a rational investor may still see some value and may be willing to pay for the company's equity. To reinforce this argument, the equity holder can present examples of startup companies or reorganizing companies which, though with a negative equity balance, may have intangibles and synergies that would not be evident from the balance sheet or cash flow statement.

Most deepening insolvency claims are initiated by creditors' committees of troubled companies and regulators such as state insurance commissioners. Plaintiffs in these cases generally allege that certain actions by the defendants resulted in loss from either additional liability or further erosion of assets of the insolvent company.

Given that deepening insolvency in its most basic form arises from conduct that is alleged to either fraudulently or negligently prolong the life of a company, it follows that parties who are believed to have fiduciary obligations or perceived fiduciary duties of care are likely to end up as defendants in these cases. At the top of this list of potential defendants are company directors and officers. Others are professionals paid to advise the company, including auditors, investment brokers, and attorneys. Another group includes private equity investors and secured lenders who extend new financing during insolvency while simultaneously acquiring additional security for their investments or loans.

Due to lack of case law, plaintiffs are testing different methods in quantifying damages in deepening insolvency litigation. Traditionally, damages are calculated as the decline in equity as a result of a wrongdoing. In deepening insolvency cases, however, pre-damage equity may be less than zero. This brings about a peculiar question: should the measure of damage in deepening insolvency be arrived at by calculating the difference between pre-damage negative equity and post-damage "more negative" equity?

Two damage theories have been presented for companies within the "zone" of insolvency:

a. *Dissipation of assets or increased debt load*. This theory is based on the notion that reduced assets and additional debt decrease the final distribution to unsecured creditors.

b. *Impact on business operations and relationships*. Underlying this theory is the premise that wrongful or tortious conduct diminishes the company's chance to restructure as well as its overall value.[14]

The most common argument by plaintiffs is that damages should be calculated by quantifying **debt load increased** subsequent to harmful conduct. In fact this was the basis suggested by the court in the *Flagship* case:

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Discount Rates

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rates that, even if the published ERP were unchanged, would impact valuations in a way that is hard to reconcile with the market.

Whether applied to lost profits or business value damages, failing to understand how current market conditions distort and potentially discredit ERP data, and by extension, estimated discount rates, leaves the expert vulnerable to debilitating attack in deposition and on the witness stand.

A common approach for developing a discount rate is to estimate the market cost of equity for the subject asset. The cost of equity can be directly applied to cash flows or incorporated into a weighted average cost of capital ("WACC") build up, depending on the nature of the asset and the fact pattern of the assignment. Frequently, experts will apply a "build-up" method to estimate the appropriate cost of equity to be applied to a particular set of forecasted cash flows. Build-up methods estimate cost of equity as a relationship to some risk-free asset (currently, the U.S. Treasury bill is considered risk-free but stay tuned!). As the risk associated with the asset elevates above zero, so does the required return. That required return *premium* is added to the risk-free rate to estimate a required rate of return for a hypothetical buyer for that asset.

The core premium for cost of equity build-ups is the ERP. The ERP is the estimated required expected return to induce investors to forsake risk-free securities to invest in the broad equity securities market.[2] On top of the ERP, experts frequently add premia for industry-specific risk, size specific risk, and company or asset-specific risk.

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Discount Rates

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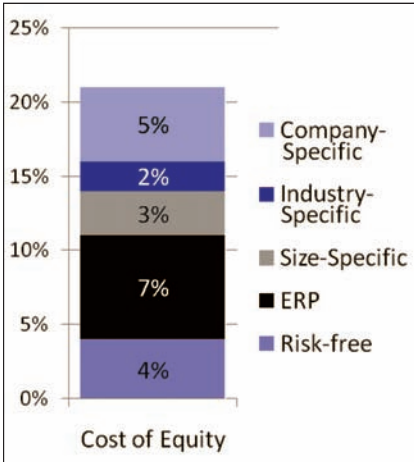
Conceptually, the build-up method looks something like the chart below:



Note that company-specific, industry-specific, or size-specific risk premia could have a negative value, which amounts to a risk discount.

Methodologies similar to the one illustrated above have played an important role in business valuation in terms of estimating discount rates. Typically, the various risk premia are published in numerous sources, with Morningstar/Ibbotson and Duff & Phelps being two of many widely-used sources.

Generally, although many sophisticated practitioners argue the quantitative nuances associated with each data source, build-up methods are widely accepted in the appraisal profession and in expert testimony. As practitioners, we rely heavily on the third party data providers and there is even a sense of anticipation when the next installment is about to be published.

Practitioners felt a heightened sense of anticipation when the 2009 installment was to be published. The equity markets had gone haywire and there was a real risk of a second Depression, with the financial system itself on the verge of collapse. At the risk of rekindling bad memories, recall the market's performance in the last year, especially towards the end of the summer of 2008.

Asset prices, except for a few defensive assets, fell sharply, particularly in September and October, 2008. One would expect that the ERP, the risk of investing in the market, would increase. In times of sharp market corrections, there is flight to quality. If the market corrects itself enough, investors withdraw from the market altogether and invest in commodities or goods to store value. Gold is one such quality haven, although there are many others (notably, crude oil).

As the charts illustrate, although gold prices fell with the broader equity market in September and October (by definition, a market panic means that there is no quality to which to flee), beginning in November 2008, gold prices began a clear upward trend while stock prices continued to fall into March. At roughly the time when gold prices hit a peak in March, the stock market began to climb up from its first bottom. One reasonable interpretation of the gold/equity market price relationship is that as stock prices declined and remained highly volatile, the market sought perceived quality in gold, which means that investors demanded a higher expected return on equities (or ERP) in order to remain in the stock market. Under such conditions, we would expect the ERP to increase because investors are demanding higher returns (above the risk-free rate) to stay in the market as of the end of 2008. However, when Ibbotson published its revised ERP, the risk premium for the market was actually *lower*. At the same time, the risk-free rate, which is added to the ERP for a total expected stock return was also *lower*.[3]

If this data is to be believed, the return required to induce investors to invest in the stock market was 11.6% in 2008, but fell to 9.5%, even as the market is more volatile and there are strong signs of a flight to quality in the asset markets. The implication of the ERP and risk-free return data is that ceteris paribus, stock values should be higher, rather than lower, as they actually are.

The above does not invalidate *Ibbotson's* data, but as experts, we need to be able to either explain how

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Deepening Insolvency

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> *"…even if the Debtor may have been insolvent before the Greenleaf Valuation, the additional debt incurred thereafter, and allegedly as a result of the Defendants' negligence, may provide a measure of damages recoverable by the Trustee."*[15]

In some cases, plaintiffs have argued that the measure of recoverable damages consists of the entire amount of the unpaid debt incurred by the company during the period of its alleged insolvency. However, opponents of the "increased debt" theory have responded that debt is balance sheet neutral. They contend that not only does additional debt increase the liability balance but also results in a corresponding increase in assets. They also argue that unless the borrowed funds are looted, additional debt cannot "deepen" insolvency, certainly not balance sheet insolvency.

Another method measures damages in deepening insolvency as the quantified impact on operations and relationships of the business that necessarily arise from the wrongdoing of the defendants. This is a much more subjective and complex measure of damages, because the plaintiff has to prove that there was value in the insolvent company, and demonstrate that the defendants' actions negatively impacted this value in a manner that would otherwise have been impossible but for the said actions.

It is anticipated that given the current economic climate deepening insolvency will be developed further as a legal concept as more and more courts are called upon to address the issue.

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1 *Bloor v Danske (In re Investors Funding Corp.,* 523 F. Supp. 533 S.D.N.Y. 1980) at 541

2 *Schacht v Brown,711 F.2d 1343 (7th Cir. 1983)*

3 *Kittay v Atlantic Bank of New York (In re Global Service Group LLC)*

4 Phil C. Appenzeller, Ross H. Parker, *Deepening Insolvency Part I A Challenging New Theory or Just the Search for a Deep Pocket?* March 2005

5 *Patterson v Franklin, 176 Pa. 612 (Pa. 1896)*

6 *Official Committee of Unsecured Creditors v R.F. Lafferty & Co., 267 F.3d 340 (3rd Cir. 2001)*

7 TaeRa K Franklin, *Deepening Insolvency: What it is and Why it Should Prevail, NYU Journal of Law and Business,* June 2006., pg. 440

8 *Official Committee of Unsecured Creditors v R.F. Lafferty & Co., 267 F.3d 340 (3rd Cir. 2001)*

9 *Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del.Ch. 2006)*

10 *Bondi v Bank of Am. Corp. (In re Parmalat Sec. Litig.), 383 F. Supp. 2d 587, 601 (S.D.N.Y. 2004)*

11 *Miller v. McCown De Leeuw & Co., Inc., (In re Brown Schools) 386 B.R. 37 (Bankr. D. Del. 2008)*

12 Phil C. Appenzeller, Ross H Parker, *Deepening Insolvency Part I A Challenging New Theory or Just the Search for a Deep Pocket?* March 2005

13 Holem Roberts & Owen, LLP, *Avoiding the Undertow of Deepening Insolvency.* August 12, 2005, p. 2

14 Phil C. Appenzeller, Jr., Esq., Ross H. Parker, Esq., *Deepening Insolvency Part I, A Challenging New Theory or Just the Search for a Deeper Pocket,* TMA 2005 Spring Conference, March 9-12 2005, Part IV

15 *In Re Flagship Healthcare, Inc., 269 B.R. 721(2001)*

Discount Rates

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that data fits our fact set, or adjust the data in a way that is reflective of market reality while at the same time not engineering an answer.

The surprising *Ibbotson* data could be explained by the following theories, and this is not an exhaustive list.

Corporate profits are also down and therefore the impact of lower (or negative) cash flow outweighs the impact of lower discount rates, so asset values are still lower, despite lower discount rates.

The market's correction has led to broader, lower expectations of return, including lower long-term economic growth rates, and stocks are themselves something of a flight to quality when compared with financial derivatives, commodities, real estate, and private equity holdings.

The market's correction has priced in a new level of long term value-adding capacity going forward; the past is in the past, and a 6.5% ERP is simply a new reality in terms of a realistic expectation of broad stock market returns.

The 2009 data is a fluky anomaly based on a system for estimating ERP that is acknowledged in the industry to have limitations, and 2010's data will tell us more about 2009.

The declines in the S&P 500 are heavily concentrated in the financial services sector and asset-intensive industry, such as auto manufacturing, but the rest of the market has not done as badly, and therefore the S&P 500 index currently does not, in fact, represent a true broad market measure.

Of course, it should go without saying that an expert making any of these cases should be prepared to show the research to support these conclu-

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sions – and as literature on the subject is still emerging, the expert should be prepared to conduct original research.

Pratt and Grabowski foresaw many of these issues even before the new ERP data had been released. They largely suggested ignoring year-end 2008 data specifically, and recommended using "long term" (i.e. historically usual) risk-free rates and ERP's. However, with all due respect to two of the giants in business valuation, that recommendation seems hollow. They are probably right, but as experts, we should be prepared to defend those assertions with more than, "because Shannon Pratt and Roger Grabowski" said so. The opportunity for rigorous empirical research and quantitative analysis is both rich and exciting. It would be helpful to see quantitative data to support those recommendations.

The cost of equity data provided by *Ibbotson* and others remains valuable. As experts, we all along have been aware of and been called upon to explain the acknowledged flaws in the calculation methodology. A particular weakness is that conventional ERP analyses may fail to capture the full impact of historically unusual market conditions such as the one in which we even now operate, and especially did back in December, 2008. At a minimum, it seems clear that it would be a mistake to simply accept ERP data from third party sources with the same level of confidence to which we have been accustomed.[4] Professional and academic literature will likely continue to emerge regarding the issue of using conventional methods to calculate costs of equity in the context of the current market conditions. Experts are looked to more than ever to produce thoughtful opinions that, while possibly being based on "standard" valuation data, are ultimately weighed against the realities that attorneys, their clients, judges, and juries can see out of their windows and on television. Attorneys and their financial consultants are becoming increasingly aware of the cost of equity data issues presented by current market conditions. Study, preparation, and questioning of authority now will pay off as great answers in deposition and testimony.

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1 Pratt, Shannon and Grabowski, Roger, "Cost of Capital in Valuation of Stock by the Income Approach: Updated for an Economy in Crisis," *The Value Examiner,* January/February 2009.

2 The broad equity securities market is typically a reference to the S&P 500 Index

3 Source: Ibbotson/Morningstar *Stocks, Bills, Bonds & Inflation,* 2001-2009

4 Grabowski, Roger, *Cost of Capital Estimates in the Current Environment* – Update, Business Valuation E-Letter, February 4, 2009

PRACTICE TIPS

Stock Options and Post-retirement Maintenance Payments

According to the Wisconsin Appeals Court

BY NINA VITEK AND JOHN LEVITSKE

In *Heppner v Heppner* (No. 2008AP2020 Wis. Ct. App. May 5, 2009) [recommended for publication], the Wisconsin Court of Appeals District I evaluated:

a) whether income from the stock options awarded by an employer who also awarded cash bonuses is includable in income for maintenance and support payments, and

b) whether vested "underwater" options earned during the marriage are includable and divisible as property in the marital estate, even if both parties considered the options valueless at the time of the divorce.

In this case, the Court of Appeals concluded that the maintenance order should "encompass income…from the exercise of stock options" (*Heppner*, para. 19) and that the property division must include "[t]he options [that] were earned during the Heppner's [sic] marriage; they are part of the marital estate" (para. 24). In addition, the Court determined

c) whether the maintenance payments should end with the in-

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The Use of Statistics in Expert Reports – Go Figure

BY JAMES A. STAVROS, CPA, CFF

Research shows that the use of statistics by experts has surged in recent years and the reasons vary. One reason was the Supreme Court's 1993 decision in *Daubert v. Merrell Dow*, which clarified the standard for admissibility of scientific evidence. *Daubert* left no doubt that statistics are generally admissible. Other reasons include the publication of many "how to" books for lawyers, experts and judges on calculating damages, where the use of statistics are discussed in specific cases. The use of statistics in expert reports is here to stay.

However, when to use statistics and the selection of the right statistic is a matter of judgment and subjectivity. The role of a damages expert is to be objective in expressing an opinion on damages; the use of a certain statistics can be very subjective, and therein lies the danger. Many experts are using statistics that simply are not objective based on the facts of the case and use of them or sometimes the non-use of them is incorrect. Triers of fact and the public are weary of the sometimes dubious use of statistics.

Mark Twain once said, "There are three types of lies: lies, damn lies, and statistics." I'm sure you may have seen this quote in the past, but its timelessness is striking; we are still skeptical of using statistics today.

The use of what passes as a statistic to be used in a case is always an issue. For example, can you rely on a survey of 100 people taken in New Mexico as opposed to a U.S. Department of Labor study survey of 100,000 people across the country? The quality of data or statistic can always be debated. As a result, statistics can become highly manipulated by choosing the one that gives you the lowest or highest number, and ultimately undermine objectivity.

The decision to use a statistic in lieu of actual data is an issue I want to discuss. I have seen too many times where an expert uses statistics instead of actual data in a loss model.

Objectivity is key. Experts have many decisions to make in preparing an economic loss model. "Do I use the actual data of the claimant to determine a future earnings loss or earnings statistics for their statistical cohort?" I see this choice all the time in calculating damages in personal injury/wrongful death cases. A 20 or more year earning history of an individual will be ignored by some experts, only to use an average earnings statistic to predict the future. Many economists take this approach and they explain it as the concept of "earning capacity" or "earning potential" as being the measure of damages, whereas it is the theoretical capacity that is lost. True, but it is left to the expert to determine how the claimant's earning capacity is best predicted: using actual earnings history of the claimant, which establishes specific patterns or general statistics.

Now in child death cases the use of statistics to determine lost earnings, fringe benefits, personal maintenance, wage growth, etc. is a given, there is no actual history. But the overuse of statistics, especially when there is a long history of actual data, is not being objective. How about when a claimant has only a few years of earnings history, do you use statistics or actual data to determine the future? This question can be answered with a combination of loss scenarios using both actual results and perhaps general earnings statistics, as the facts dictate. It also takes judgment; the expert must ask the questions of what method should be used to most accurately and reliably predict the future?

I have seen too many times, overestimating the damages, the over-use of statistics to determine a loss when actual data and information of the claimant are available. The use of statistics in expert reports is here to stay and have been around for some time. Interestingly, jurors since Twain's time remain skeptical about their reliability and overuse. Nothing could be truer. The expert's use of statistics to determine damages is just one tool they have in determining damages. While the decision to use a statistic, the right statistic, is subjective, it must be done with the overriding goal of objectivity in calculating damages.

I will leave you with one thought, based on a quote from former United States Supreme Court Justice, Louis Brandeis, "I abhor averages. I like the individual case. A man may have six meals one day and none the next, making an average of three meals per day, but that is not a good way to live."

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Stock Options

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come-producing spouse's retirement or should continue for an indefinite term.

The subject decision addresses a) the effect of stock options on income determination for a maintenance order (and the potential for double-counting stock options for both property division and maintenance payment purposes), b) the division of property deemed valueless by the contending parties at the time of the divorce, and c) the term of maintenance payments for the particular case.

In evaluating whether income from the exercise of stock options awarded to a corporate executive in addition to his income from cash bonuses is includable in income for maintenance and support purposes, the Appeals Court distinguished analysis for maintenance purposes from analysis for property division purposes. The Court noted that it "is obligated to consider *all sources of income* when establishing maintenance" (para. 17), and that "Mr. Heppner admitted during his testimony that his W2 forms included income received from his exercise of stock options" (para. 18). In addition, the Court reiterated a prior Wisconsin court's determination that "double counting of an asset for both property division and maintenance … does not apply to *income* from assets awarded in a property division" (para. 18).

Furthermore, in evaluating whether vested "underwater" options earned during marriage are includable and divisible as marital property, the Court determined that "the fact that neither the trial court nor the parties endeavored to give a value to those options … is a neutral consideration" (para. 22). In a footnote, the Court expanded upon this determination and stated, "Were we writing on a clear slate, [sic] we would not accept the conclusion that an underwater option necessarily has no value. Thus, as one respected observer of the financial scene has noted, 'out of the money does not equal worthless. As long as the option has not expired, its potential value gives it value … Indeed, there are various tools to ascertain the value of an out-of-the-money option'" (para. 21, fn 3). The footnote then refers the reader to *In re Zoran Corp. Derivative Litigation*, No. C 06-05503 WHA, 2008 WL 941897, at *6 (N.D. Cal. Apr. 7, 2008) which discusses the Black-Scholes method to value underwater options. In its opinion, the Court reviewed the facts and concluded, "It takes no special insight to recognize that whether the stock rebounds is largely, if not almost wholly, depended on what the economy … does before the options expire. The options were earned during the Heppner's [sic] marriage; they are part of the marital estate …. The trial court erroneously exercised its discretion by excluding the options from division because it erroneously viewed their potential value as being almost solely a function of what Mr. Heppner would do in his business after the divorce, and largely ignored the fact that the options were earned while the Heppners were married" (para. 24).

Moreover, in evaluating the term of the maintenance obligation to Ms. Heppner, the Court determined that "if Ms. Heppner is to be able to enjoy the life she would have enjoyed if the parties had not divorced, as ***Hefty*** [sic] teaches is the rule, she is entitled to maintenance even though Mr. Heppner is retired" (para. 15). The Court further included that "[i]f circumstances change so that the fifty-fifty split of Mr. Heppner's income is no longer fair or warranted, the parties may return to court for a modification" (para. 15).

The case timeline is summarized in the following paragraphs.

John and Susan Heppner were married in May of 1974, and John filed for divorce in September of 2006.

For the marriage of over 33 years, the Trial Court in March of 2008 granted Ms. Heppner limited-term maintenance to end when Mr. Heppner turns sixty on May 30, 2012, irrespective of whether or not he is retired. The Trial Court excluded income from the exercise of stock options Mr. Heppner earned while married to Ms. Heppner in determining Mr. Heppner's maintenance obligation to Ms. Heppner. Similarly, the Trial Court did not include "underwater" (option grant price exceeding underlying stock value) stock options in the divisible marital property since neither contending party assigned the options a value at the time of the divorce.

Ms. Heppner appealed the Trial Court's decisions outlined above, and on May 5, 2009, the Court of Appeals issued an opinion which modified in part, reversed in part and remanded with directions the original order rendered in the spring of 2008.

First, Ms. Heppner contended that the trial court erred in deciding that maintenance payments shall end when Mr. Heppner turns sixty on May 30, 2012. The Court of Appeals agreed with Ms. Heppner and, under Wis. Stat. § 808.09, modified the Trial Court's maintenance order to extend it beyond May 30, 2012, for an indefinite term.

Second, Ms. Heppner argued that the Trial Court improperly excluded the aforesaid stock options from the income pool from which the maintenance obligations would be drawn. The Court of Appeals again agreed with Ms. Heppner and, under Wis. Stat. § 808.09, modified the maintenance order to encompass the income Mr. Heppner received from the exercise of the stock options earned during the marriage.

Last, Ms. Heppner contended that the Trial Court erroneously exercised its discretion in refusing to divide as part of the marital estate those stock options deemed as having no value as

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Stock Options

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of the time of the divorce ("underwater" options). The Court of Appeals found that the Trial Court erroneously viewed the options' potential value as being almost solely a function of Mr. Heppner's performance in his business after the divorce, and the Trial Court largely ignored the fact that the options were earned during the marriage. The Court of Appeals agreed with Ms. Heppner and reversed the Trial Court's judgment and remanded the matter to the Trial Court for an ensuing inclusion of "underwater" options in the marital estate.

Mr. Heppner filed a Motion for Reconsideration ("Motion") of the May 5, 2009 Court of Appeals decision, and Ms. Heppner's counsel filed a formal response to Mr. Heppner's Motion. On June 4, 2009, the Appellate Court issued a judgment on that Motion modifying the section pertaining to the allocation of the percentage split of income for the maintenance obligation.[1] On the same date, Mr. Heppner filed a Petition for Review ("Petition") to the Wisconsin Supreme Court, and Ms. Heppner's counsel followed with a response explaining why the Wisconsin Supreme Court should not accept Mr. Heppner's Petition.

As of the date of this publication, the Wisconsin Supreme Court has yet to decide to review the case. [Recently, the Wisconsin Supreme Court denied review of the appellate court's decision. Ed]

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1 **The language in Paragraph 15 as revised on June 4, 2009, reads as follows – revised language is underlined**: "By ending maintenance on May 30, 2012, the trial court ignored the ***Hefty*** [sic] principles we have discussed, and, accordingly, erroneously exercised its discretion. If Ms. Heppner is to be able to enjoy the life she would have enjoyed if the parties had not divorced, as ***Hefty*** [sic] teaches is the rule, she is entitled to maintenance even though Mr. Heppner is retired. Accordingly, under our authority under WIS. STAT. §808.09 to modify a circuit court order, we modify the trial court's maintenance order to extend beyond May 30, 2012, for an indefinite term. In light of the trial court's setting the fifty-fifty split based on its imposition of the limited-term maintenance, we remand to the trial court for an evaluation whether, consistent with this opinion, the fifty-fifty split should be modified. The parties may, of course, return to court for a modification of whatever maintenance division it ultimately sets. *See* [sic] WIS. STAT. §767.59. Upon remand, the trial court shall enter a revised judgment to conform to our ruling."

PRODUCT/ BOOK REVIEW

The Litigation Valuation Analyst and the Butler Pinkerton Specific Company Risk Calculator

BY PAUL FRENCH III, CPA/ABV, CVA, CFE, BVAL, CDFA, CFFA, CPIM, CM&AA, FCPA, CR.FA, CMEA, ABAR

In the County of Specific Company Risk Premium there is a not so new sheriff in town with the name of the Butler Pinkerton Calculator ™ Total Cost of Equity (TCOE) and Public Company Specific Risk Calculator™ a.k.a.: The BP Calculator or BPC.

We all know that in the litigation environment, the more comprehensive and rational the support for your opinions, the stronger they become. The BP Calculator allows the valuation analyst to determine the Specific Company Risk Premium (SCRP) for guideline public companies in the same or similar industries. The valuation analyst then compares the relevant specific company risk factors of the guideline public companies (available in the annual reports filed with the Securities and Exchange Commission)

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Book Review

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with those of the subject company. The valuation analyst can determine how the subject company's SCRP should compare (i.e.: higher or lower) to the SCRP of each of the guideline public companies.

So instead of saying during direct testimony, "I identified, analyzed, and considered the critical risk factors of the subject company when determining the SCRP"; you will also be able to say, "I compared the risk factors of the subject company to the similar risk factors of five guideline public companies who were operating in the same industry and used that information to help me benchmark the appropriate SCRP for the subject company."

Imagine the cross examination that likely would result for the one valuation analyst in the case who ignored this market based information to provide support for 100% subjectively determine SCRP.

A Cliff's Notes version should provide a good overview of the use of the BP Calculator. Do not confuse this overview with the detailed step by step process. Go to www.bvmarketdata.com and read the excellent collection of articles and FAQS found under the "TCOE/Company-Specific Risk Calculator" link in the website menu on the left hand side of your screen.

I. Identify guideline public companies. Because you are going to identify the differences between your subject company and the individual guideline public companies they do not need to be as comparable as the guideline public companies used in a Market Approach.

a) Input the ticker symbols of the selected guideline public companies, the appropriate risk free rate, a size premium for each guideline public company (using SBBI or a Duff and Phelps), and an Equity Risk Premium (again using SBBI or Duff and Phelps). With this information (and certain other easily obtained information) the BP Calculator will provide the SCRP for each guideline public company you selected.

b) Use the statistical data provided by the BP Calculator to determining the appropriateness of each of the guideline public companies.

c) Determine whether leverage of the guideline public companies require you to do the "unlever thing" that we all enjoy. If so, make the necessary calculations.

d) Obtain the 10K for each guideline public company you selected and identify the specific risk factors faced by that public company.

e) Hopefully the SCRPs determined by the BP Calculator will "bracket" (some larger and some smaller than) the subject company. In situation when the SCRPs of the guideline public companies are all greater than or less than the expected range of the SCRP for the subject company, in the very least, you are provided with a floor or a ceiling and also some solid benchmark market data.

II. Compare the specific company risk factors of the subject company to each guideline public company and decide whether the SCRP for your subject should be larger or smaller than the SCRP of each guideline public company. If as an example, you selected five guideline public companies, you might have the following conclusions:

a) Subject Company (SC) is significantly riskier than guideline public company (GPC) number 1, which has a SCRP of 4% because…

b) SC is somewhat riskier than GPC number 2, which has a SCRP of 5.5% because …

c) And so on.

As you can see, this method still requires PROFESSIONAL JUDGEMENT!

If you are not yet convinced of the great benefit of the BP Calculator, some relevant quotations will be of interest.

"Does such a measure capture the factors that cause company-specific risk? If you thoroughly analyze the risk factors of guideline public companies, the estimate of company-specific risk premium should reflect the market's pricing of these risks. As in any use of guideline public companies as a proxy, you are dependent on the availability of good proxy companies and on the thoroughness of the analysis. This qualitative approach complements a qualitative assessment of the strengths, weaknesses, opportunities, and threats of the subject company compared to its peers by matching the subject company, to the guideline public companies with comparable (not identical) strengths, weaknesses, opportunities, and threats relative to their peers." [1]

"This model will allow us to determine the total cost of equity for our guideline companies. Similar to the application of the guideline company method, the analyst can then adjust the cost

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of equity for the differences between the subject company and the guideline companies. This is clearly a great addition to what we have done in the past."[2]

"We used to use Cost of Capital Quarterly to get an idea of the cost of equity by standard industrial classification code. We would-adjust from there. Now, instead of using the entire industry, we can choose better guideline data as a starting point" [3]

No question there is more analyst work involved to obtain this market date benchmarked result versus what at least one retired Judge has told me off the record is "nothing but a not so scientific wild *apple* guess" (of course he was referring to the other expert).

My friend and worthy adversary, Keith Pinkerton, has demonstrated to me that virtually every public company has its own SCRP. The question then is: why do valuation analysts and noted authors use zero as the starting point for the SCRP in the Build Up Method?

Another interesting by product of the BP Calculator is a tailored, guideline public company specific beta for use in a Capital Asset Pricing Model.

The BP Calculator is available for a limited time offer from www.bvresources.com for new subscribers for $125 a year or $49 for a single search. The regular price is $225 per year.

I'll close with another relevant quote:

"It essentially is a market approach twist to the income approach. In summary, we recommend reviewing public company's Forms 10-K to focus on disclosures related to company-specific factors. Depending on the degree to which your private company faces the same or similar risks, you can place your private company somewhere within, or above or below, the calculated benchmarks. This is no different than selecting an appropriate multiple for a private company from comparison to public benchmarks. In our opinion, this is exactly the type of direct comparison to data that the courts are demanding appraisers perform."[4]

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1 Pratt and Grabowski. *Cost of Capital: Applications and Examples.* 3rd Ed. Hoboken, New Jersey: John Wiley & Sons, Inc., 2008, page 236

2 Trugman, Gary R. *Understanding Business Valuation: A practical Guide to Valuing Small to Medium Sized Businesses.* 3rd Ed. New York, NY: Linda Prentice Cohen, 2008, page 372

3 Ibid.

4 Peter Butler, ASA, CFA and Keith Pinkerton, ASA, CFA. "Using the Butler Pinkerton Model ™- Total Cost of Equity and Public Company Specific Risk Calculator™ Questions from Participants", Business Valuation Resources Webinar, March 6, 2008

TECH TIPS

Protecting Sensitive Data with Whole Disk Encryption (Part 1 of 2)

BY JOSEPH HENDERSON

Encryption of electronic data has received a significant amount of attention in the last few years and justifiably so. Many people do not realize just how vulnerable and unprotected their confidential data may be. One stolen laptop may be enough to put a company out of business. However, data can be protected on computer hard drives though the use of encryption.

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Disk Encryption

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While there are many methods of encryption, including e-mail encryption and file encryption, we will focus on whole disk encryption, its application, and why this method is critical to protect information on laptop computers.

Vulnerability of Laptop Computers

Laptops are increasing in popularity and their portability is essential for business travelers and busy professionals. The number of data breaches caused by stolen laptops is disturbingly high. It is estimated that one in ten laptop computers are stolen each year. Most businesses underestimate the risk involved. First, the number of laptops stolen or misplaced each year is significant. Second, the ease by which data can be acquired from laptops may be considered relatively simple. Third, there are various Federal and State laws that involve mandatory obligations for companies to notify consumers of such a breach of data.

In order to understand the magnitude of the thefts or losses, consider the following statistics:

- Safeware Insurance Agency, a Columbus, Ohio based company that specializes in hardware insurance, indicated that more than 600,000 laptops were reported stolen or lost in 2004, totaling an estimated $5.4 billion in theft of proprietary information. (Source, Safeware Insurance Group, 2004)

- Electronic Data Systems Corporation and Gartner both estimate that 10% of laptops are lost or stolen each year. (Source, Gartner Group, 2002 / Electronic Data Systems Corp.)

- InfoWorld reported, in October 2004, estimates among industry analysts ranging anywhere from 700,000 to 1 million laptops being stolen each year.[1] (Source, InfoWorld, 2004)

- PC World noted in a May 2004 article, based on the 2003 Annual Computer Crime and Security Survey, that the value of the information in an average notebook is $250,000. (Source, PC World, 2004).

In spite of the frequency that laptop computers are misplaced or stolen, most companies have taken little or no efforts to safeguard the information stored on them. If one of your laptops was lost or stolen, how would you determine:

- What data was on the computer?

- The sensitivity or value of the data?

- Whether or not the data was compromised?

- Whether or not you have reporting obligations under State or Federal law?

For most businesses, these are not trivial questions to deal with after a loss. Businesses often install alarm systems to protect physical records but do little or nothing to protect electronic records stored on portable devices.

The Ease in Which Data is Accessed

The ease in which data can be accessed on a stolen computer is alarming. Most individuals feel that simple passwords on their computers operating systems or password protecting files are sufficient. They are mistaken. Consider two simple ways to retrieve information from a laptop where encryption is not installed:

1. Remove the hard drive from the laptop and attach the hard drive to another computer. All of the data is now accessible without having to bypass an account password or equivalent obstacle for that hard drive.

2. Download one of many readily accessible and free utilities from the Internet that resets any password on the computer. Once the password is reset, start the computer and access the data without a password.

Acquiring data using either of these two methods requires very limited computer knowledge. Anyone who has installed a hard drive in a computer or downloaded a utility and created a CD is capable of employing these methods.

Reporting Obligations for Data Compromise

Various State and Federal laws require notification to affected parties if certain types of protected data are believed to be compromised. The laws vary in what is considered “protected” data and specific reporting obligations; however, they all include severe penalties for non-compliance.

Two Federal laws that may dictate a business’s obligations following a breach of data are the Fair Credit Reporting Act and the Gramm-Leach-Bliley Act. Both of these acts have severe criminal and civil sanctions for noncompliance. Most states have similar laws that require compliance. Companies are usually obligated to make immediate notification, offer credit monitoring to consumers for one year, and take corrective action to prevent a similar breach.

The loss of a laptop can be inconsequential when compared to the

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Disk Encryption

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potential damage caused by a data breach. Losses may include damage to a company's reputation, loss of customer confidence, loss of competitive advantage, compromised trade secrets, and impact of stock value. The cost of defending against likely litigation is also a consideration.

It is strongly recommended that you research the applicable data compromise laws in your jurisdiction so that you may prepare contingency plans in the event of data compromise.[2]

Consider the following scenarios:

- Your company, the WIDGET COMPANY, subcontracts services to ACME. An ACME employee loses a laptop with WIDGET COMPANY data that requires notification to WIDGET COMPANY customers, employees and vendors. Who has the legal obligation to notify these parties and who is liable for the compromise?
- The WIDGET COMPANY outsources its e-mail services to the ISP COMPANY. The ISP COMPANY has a compromise which affects WIDGET COMPANY e-mail accounts. Who has the legal obligation to notify affected parties and who is liable for the compromise?

Is there really a need to protect data and report compromises? The answer, obviously, is an emphatic "yes." Certainly, information and data are valuable commodities today and parties interested in paying for information may include competitors, information brokers, and organized criminals.

Whole Disk Encryption as Part of the Solution

Whole disk encryption (WDE) will not solve every data compromise dilemma. For example, it will provide little or no value for a running system that has been exploited by malicious software (malware), trojans, worms, or viruses. However, it is a very useful tool and solution to combat data compromise via theft or loss of computers that are powered down.

With WDE, even if a laptop is lost or stolen, the data is reasonably assured to be safe. While there is still a loss of physical hardware, your data is not compromised and, if you have diligently backed up your data, there will be minimal or no disruption to your business. Part 2 of this article explains, from a conceptual perspective, how whole disk encryption works.

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1 InfoWorld, "ThinkPad with fingerprint reader is introduced", Oct. 4, 2004. http://www.infoworld.com/t/hardware/thinkpad-fingerprint-reader-introduced-327

2 National Conference of State Legislatures: State Security Breach Notification Laws (http://www.ncsl.org/default.aspx?tabid=13489)

VIEW FROM THE BENCH /BAR

Chapter 11 Restructuring 101: (The Financial Expert's Role in the Plan Confirmation Process)

BY ED HARRON, ESQ. AND MICHAEL CIANCI, ESQ.

Financial experts are integral to the Chapter 11 process. Indeed, accountants, analysts, investment bankers, tax advisors, and financial advisors who provide a full range of financial services including business valuation, restructuring analysis, the development of long-range business plans and projections, expert testimony, and various accounting services all are routinely utilized in the bankruptcy context. This article provides a high level summary of the role of financial experts in the context of Chapter 11 restructuring and litigation.

As a company embarks on the Chapter 11 process, the seminal issue almost always is what to do with the company's business. The primary options include restructuring the balance sheet and/or the business or liquidating the company's assets. To make this decision, the company relies heavily on input from its counsel and its financial advisors.

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Restructuring 101

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Step one in the process of determining whether and how best to restructure, is to develop a go-forward business plan. The business plan is fundamental to projecting the company's long-term financial position. Part and parcel to the long term planning process is evaluating how a company can best improve operations. The company and its counsel will rely on the financial advisor to analyze the profitability of the company's business segments and its product/service lines. This process may result in a determination by the company that certain product/service lines are unprofitable and therefore should be eliminated. The financial advisor's expertise in this regard will guide the company through the important considerations of how the company can improve its business and the extent to which the company can generate revenue, profits and cash flow and will answer the ultimate question of whether or not the company can successfully consummate a Chapter 11 reorganization.

Once the operational and strategic aspects of the business plan are addressed, the company looks to its financial advisor to forecast the projected financial performance of the reorganized company. Financial projections are obviously essential for the reorganized company's business plan. These projections generally encompass estimated future revenue, expenses, and the company's ability to service debt. The financial projections will present the proposed capital structure of the reorganized company and determine whether or not the company's proposed reorganization plan is feasible given projected cash flow. If the company's projected cash flow is insufficient, reorganization may not be a viable option.

After the company has developed a business plan and a reorganization strategy, financial experts remain in the forefront of the reorganization process. Investment bankers may be utilized to assist in the marketing and sale of non-core assets. And through the process of educating various parties in interest regarding the viability of the company's business plan, financial advisors often play an essential part in the process of obtaining the lender, vendor and equity holder support that may be necessary to consummate a Chapter 11 reorganization.

On the other hand, if the company, with the advice of its financial advisor and counsel, ultimately determines that reorganization is not a viable option, the company may opt to pursue a sale of all of its assets, either as a going concern or in a "fire sale." Financial advisors (and potentially investment bankers) play a critical role in the decision of whether the company pursues reorganization or a sale.

Expert Testimony

Another predominate role of financial advisors in the Chapter 11 reorganization process is providing expert testimony. "Feasibility" is among the factors a debtor must prove to the satisfaction of the court as a prerequisite to the court confirming its plan of reorganization. The debtor may utilize the expert testimony of its financial advisor to demonstrate to the court that its reorganization will succeed, i.e., that the reorganized company is likely to successfully implement its business plan and, in so doing, will generate sufficient profits and cash flow to meet its obligations under the Chapter 11 plan. The financial advisor may be used to provide testimony to establish the reasonableness of the debtor company's financial projections and the reliability of the assumptions underlying those projections. As with any type of expert testimony, the Court will carefully consider the experience and credibility of the financial expert, and objecting parties may challenge the methodology utilized by the expert in developing his or her expert opinions.

Objecting parties may offer testimony from their own financial experts to oppose the plan of reorganization by demonstrating that the plan is unrealistic and not feasible. In so doing, the objecting parties' financial experts will challenge the debtor's financial projections and assumptions. A good example of such a strategy is discussed in the case of *In re Nellson Nutraceutical* [http://www.deb.uscourts.gov/Opinions/2007/Nellson.pdf]. There, the objecting creditor parties offered the testimony of three financial experts to show that the enterprise value of the company offered by the debtors' expert was unrealistically high. *In re Nellson Nutraceutical, Inc.,* 2007 Bankr. LEXIS 99, at *54 (Bankr. D. Del. Jan. 18, 2007). This testimony highlighted for the court that the Debtors' enterprise valuation did not reflect "management's best and most honest thinking" but rather was an attempt to bolster the perceived value of the company. Id. at *61.

Liquidation

Despite their well-defined roles in the Chapter 11 reorganization process, financial experts' role in the Chapter 11 liquidation context is less settled. For example, when a debtor pursues a sale of its assets through the bankruptcy process, a key issue is whether the consideration paid to the debtor's estate is fair and reasonable. One might assume that the valuation of financial advisors would factor into that determination. To the contrary, courts have held that it is the market, rather than expert financial

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Restructuring 101

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opinion, that is the best indicator of a company's value. *In re SubMicron Sys. Corp.*, 432 F.3d 448 (3d Cir. Del. 2006). Therefore, so long as the market is operating efficiently, it sets the sale or "liquidation" value of the debtor's assets. However, an investment banker can play a key role in marketing a debtor's assets and providing expert testimony on whether the sale process appropriately tested the market.

Conclusion

Financial experts are key professionals in a Chapter 11 case. Whether assisting in a debtor's restructuring strategy, working to market a debtor's asset, or providing expert testimony, he or she adds value to the debtor's professional team.

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