The Financial Expert's Role in Business Interruption Losses — Page 1

By: James A. Gravitt, CPA, CBA, ABV, CFE

Business interruption losses and the resulting insurance claims can sometimes be – no, usually are - complex matters. What roles do financial experts play in these situations?

Protecting a Legacy, Planning for the Future – A Case Study — Page 6

By: Andy Dytrych, Investment Banking Associate

With the right advice, this business owner found not only the best buyer for his business but also peace of mind in deploying the proceeds for a fulfilling retirement.

Court Case Insights — Page 8

Here are some recent court cases involving business valuations and business damages that we found interesting.

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Financial experts are retained by insured businesses, claims adjusters and insurance companies to assist in resolving business interruption claims. The insurance company and the insured party share some common interests: both seek to reduce the loss, return the business to normal as soon as possible, and to resolve the claim with as little delay and controversy as possible. Still, what is a "fair" settlement is in the eye of the beholder. Business interruption claims are a subset of business damages analyses that requires both an understanding of insurance terminology and of financial analysis.

Conceptually, business interruption coverage is simple, measuring lost "profits" stemming from damage to a physical asset by a "covered cause" disrupting the operations of a business. To illustrate, assume that a fire has damaged a food processor's (FoodCo) production line. FoodCo makes a variety of tortilla products that are sold to large grocery chains. The fire just occurred, and it looks like the production lines will be down for several months for repairs. While repairs proceed, it may be possible to restart production to some degree. It has also been on management's "to do" list to upgrade the now damaged plant.

Reviewing the policy and understanding defined terms

FoodCo has business interruption coverage, but hasn't reviewed the policy for quite some time. The first step in any insurance claim (after securing the damaged property) is to thoroughly review the insurance policy. Here are some policy terms that FoodCo's management will soon become all too familiar with:

Profit, referred to as Business Income (BI) is defined in a typical policy as:

(a) Net income (net profit or loss before income taxes) that would have been earned or incurred; plus

(b) Continuing normal operating expenses incurred, including payroll.

Extra expense coverage typically covers (due to the business interruption) (a) operating expenses incurred at a higher rate than the insured normally incurs, and (b) expenses incurred which the insured does not normally incur.

Actual loss sustained is defined as the actual loss of BI due to the "necessary suspension of operations" during the "period of indemnity."

Period of restoration is defined as beginning with the date of the direct physical loss or damage caused by or resulting from any covered cause of loss at the described premises, and ending with the date when the property should be repaired, rebuilt or replaced with reasonable speed, toward premises of similar quality to what existed before the loss. Note this definition follows the principle that insurance covers only the cost of repairing or replacing lost property, not the cost to modify or improve it. Thus, if the time taken to improve or modify exceeds the time it should have reasonably taken to return the property to its "as was" condition, the additional time is not compensable under the policy.

Period of indemnity. Indemnity is a legal term meaning "recompense for loss, damage, or injuries; restitution or reimbursement." A business interruption policy is essentially a contract between the insured and the insurer which indemnifies the insured should a business interruption loss occur due to causes defined in the policy. The policy's "period of indemnity" is the time during which the insurance policy covers the insured's loss. Policy language may state language such as "due to the necessary suspension of your operations during the period of restoration." Not surprisingly, the insured and the carrier can differ on the length of this period.

A company's actual period of loss can be longer than the period of indemnity, and the loss can be permanent and caused by a business interruption, yet not be covered. Assume that FoodCo's period of restoration is three months, during which time a customer of FoodCo permanently switches to a different supplier. Would this customer have eventually been lost anyway? That's arguable, but nevertheless it seems clear that the precipitating factor was the business interruption. Lost profits from the loss of this customer extends beyond the period of indemnity. Although some policies may allow for a limited period of indemnity after physical restoration, to the author's knowledge there is no standard policy that allows for an indefinite period to restore business that was damaged by a covered loss.

Continuing expenses refers to expenses that will continue during the period of restoration, while ***discontinuing expenses*** are those that won't. A shorthand way to think of this concept is that continuing expenses (for example, rent and property taxes) generally don't vary directly with sales, while discontinuing expenses (for example, direct materials or sales commissions) typically do. Discontinuing expenses will generally cease when sales cease due to a business interruption.

There are "gray areas" of expenses, for instance plant maintenance and repairs that are both fixed and variable in nature. Most business financial statements aren't formatted to distinguish between continuing and discontinuing expenses. Differentiating them requires detailed analysis of a company's expenses over time to support their inclusion or exclusion from the claim.

Mitigation refers to the insured's obligation to minimize its loss. In other words, the insured is expected to do exactly what it would do if it were not insured - take steps to minimize the loss. Claims adjusters will often play an active consulting role in mitigating, and this again is an area that is open to interpretation, negotiation and analysis.

Making the claim

Business interruption claims will typically be presented in either of two formats – these are really two different ways of saying the same thing.

1. Net income, plus continuing expenses, plus extra expenses

2. Gross earnings, less discontinuing expenses, plus extra expenses

The example calculation below illustrates these different formats.

Two Methods for Measuring a Business Interruption Loss

	Before (Projected)	After (Actual)	Difference (Loss)
Sales	$ 1,000,000	$ -	$ 1,000,000
Less materials and direct labor	(500,000)	-	(500,000)
Gross earnings	500,000	-	500,000
Operating expenses:			
Officer compensation	27,000	27,000	-
Property taxes	3,000	3,000	-
Extra expenses	-	10,000	(10,000)
All other	410,000		410,000
Total operating expenses	440,000	40,000	400,000
Net income/(loss) before taxes	$ 60,000	$ (40,000)	$ 100,000

Net Income Plus Continuing Expenses:	
Projected net income	$ 60,000
Plus: continuing exps (salary & taxes)	30,000
= Business income loss	90,000
Extra expenses	10,000
= Business income + extra expenses	$ 100,000

Gross Earnings Less Discontinuing Expenses:	
Lost gross earnings	$ 500,000
Less discontinuing expenses	410,000
= Business income loss	90,000
Extra expenses	10,000
= Business income + extra expenses	$ 100,000

Preparing the claim

Business records which may be needed to calculate business interruption losses include the following:

- Tax returns
- Year end and monthly internal income statements
- Sales records
- Leases
- Contractual agreements impacting expenses
- Payroll records
- Other specialized accounting records, for example product costs of goods sold detail

A substantial amount of time is usually spent on estimating lost sales during the period of indemnity. Factors to consider vary widely by type of business, including the company's historical performance, economic and industry conditions, seasonal and cyclical factors, strategic business initiatives, advertising campaigns, and new product introductions. There are no hard and fast rules for how many months or years of historical data to analyze, but it's important to link lost sales to the business interruption versus to other factors. Consider a snow removal business whose equipment is damaged. This year's snow removal sales may be quite different from last year's sales due to the weather, even if the equipment had not been damaged.

"Best practices" for claim preparation from a business owner's perspective include the following:

1. Communicate early and often, maintaining a positive relationship with the carrier's representatives. If possible, get an early idea of the insurance company's expectations, thus saving time by preparing the claim properly the first time. Document meetings and telephone conversations in writing.

2. Identify a "point person" within the company. Claim preparation and management should be supported by someone with the authority to marshal needed resources. This person should have broad knowledge of the business. Typically, someone from risk management or from the accounting/finance area, supported by executive management, will assume this role.

3. Seek outside help as needed. Some policies will pay the cost of retaining an outside expert. The insurance company can be expected to retain professionals to look after its interests, and when potential losses are high, the business owner should match the carrier's efforts with similar expertise. A financial expert who is experienced in claims consulting will be able to:
    a. Provide an independent view of what is reasonable.
    b. Advise as to what is allowable, and ensure the claim is maximized.
    c. Avoid wasted time and effort by preparing a claim that complies with policy requirements, and
    d. Negotiate with the carrier's adjusters and accountants.

4. If possible, obtain a cash advance to allow the business to start its recovery. Insurers will generally agree to such advances, but it is important to clarify that the advance does not constitute a final settlement of the claim.

5. Create a timetable. The claim preparation will likely involve a significant time commitment in addition to time spent by management getting operations back to normal. If not controlled, delays could result in missed policy deadlines or not receiving a timely settlement.

6. Use the company's accounting system to capture extra costs. As noted above, policies often contain coverage for extra expenses that otherwise would not have been incurred. Simplify the claim preparation process by creating accounts that are to be used only for the extra costs related to the loss. Document the reasons extra costs were incurred and how they are related to the business interruption.

7. Prepare a formal claim. The claim will ultimately be reviewed by several parties, some of whom do not understand the business and background of the loss. The claim should be self-contained and easy to understand. Prepare it in anticipation of a dispute and for possible use in litigation.

Don't go it alone

An experienced financial expert serves as a source of technical knowledge in areas where an adjuster or legal counsel may not be comfortable. Adding a financial expert to the team of claim professionals early can go a long way to assure that the policyholder is being properly indemnified for its covered loss under the terms of a business interruption policy.

Protecting a Legacy, Planning for the Future – A Case Study

By: Andy Dytrych, Investment Banking Associate

The owner of a medium-sized manufacturing firm based in the Midwest was ready to retire after a long career and was seeking a fair price for his business. Because the business is located in a small town and was an integral part of the community, the owner was determined to protect employees and ensure that the business continued. Upon making the emotional decision to sell the business, he sought out Hilliard Lyons' team of advisors to guide him through the process of planning his financial future, finding a new owner for the business, and investing the proceeds to ensure that his wife and he could enjoy a retirement of traveling, restoring cars, and serving on local non-profit boards.

Getting past the emotional hurdle

"When you own a business, it's a very emotional decision to transition. But, you're either going to go out feet first, or you can make sure you have a say in how it works," he said. "I think it's a necessary and vital process, but I wanted someone to guide me."

Once engaged, the Hilliard team of over a dozen professionals got to work analyzing and valuing the business, conducting the necessary estate and financial planning, and spending time getting to know the owner and his wife to discover their goals before addressing the market through a limited auction process. Hilliard professionals worked in concert with the couple's outside tax and legal advisers, helping them review their wills and trusts in light of their personal and familial objectives. "Having everyone under one roof made it simple and seamless, and even though I'm not their biggest customer, they really spent the time getting to know us and our goals," the owner said. Hilliard's holistic approach let the owner focus on operating his business through the lengthy disposition process – because it is critical that the business continue to run smoothly while up for sale.

Finding the optimal buyer

The Hilliard team took less than a month to complete its comprehensive analysis and draft confidential marketing materials. "They really did their homework to know the players in my industry," the owner said. "They were selective in who they wanted to market my company to, and they didn't just blanket private equity firms." The Hilliard team immediately began reaching out to strategic buyers in the industry along with a host of private equity firms. Over 20 different entities submitted initial indications of interest, allowing the owner and his wife to choose the best fit. Hilliard believes that true value is established in a competitive environment, such as a limited auction, as it gives the seller more choices and drives more favorable terms.

The final group of eight interested buyers met with the owner and engaged in a deep dive into the business. "We met some really good people – and with others, we knew instantly it wasn't a fit," the owner said. After several rounds of bidding, the owner ultimately accepted an offer from one of the world's leading manufacturers of equipment in his industry. The offer was one of the best, and was deemed the best fit for the community, his employees, and his family. Hilliard's dedicated M&A advisors kept the deal moving along through the often lengthy diligence period, closing the transaction in less than eight months after being retained. "I realized that if I were trying to do it myself, it would not get done," the owner added.

Taking the next step

After the transaction itself closed, Hilliard Lyons extended its continuum of support. Estate planners and strategic wealth advisors from Hilliard Lyons Trust Company continued to advise the seller and his wife, providing the comprehensive resources they needed to navigate the complex market environment.

Before the sale, the owner had a significant majority of the family's wealth tied up in one asset, the business. After the sale, his wife and he had significant assets to deploy, and those assets were much more liquid. "The team from Hilliard Lyons guided me all the way through, but when it came down to it, the final decision was mine," the seller said. "Not only did we come to a successful conclusion, but now I've got some really good friends at the firm." Today, the owner and his wife are enjoying their retirement, and already recommending Hilliard Lyons to other business owners.

Court Case Insights

The following Delaware Chancery fair value case asks "what is the best measure of value – the transaction price or a valuation?"

***Merion Capital L.P. v. Lender Processing Services*, 2016 Del. Ch. LEXIS 189 (Dec. 16, 2016)**

The subject of this litigation was Lender Processing Service Inc. (LPS), a leader in mortgage processing. LPS did well during the financial crisis, but after receiving negative publicity related to its loan practices began reaching out to financial and strategic buyers. It engaged Boston Consulting Group (BCG) to perform an exhaustive strategic review of the company. LPS's financial advisors recommended the company pursue a sale "at an attractive price." The company and a Fidelity-led bidding group negotiated an initial merger agreement of $33.25 per share: 50% would be in cash and 50% in Fidelity stock. The merger with Fidelity closed in early 2014; a rise in Fidelity's stock price in the time between the initial offer and the closing of the deal led to an increase in the deal price to $37.14 per share. Afterwards, two entities objected to the merger and petitioned the Delaware Court of Chancery for a fair value determination.

The suit followed a popular investment strategy known as "appraisal arbitrage," an investment strategy in which hedge funds purchase shares of a target company after the announcement of a cash-out merger with the intention of asserting statutory appraisal rights under Delaware law. In the subsequent appraisal action, the court considers the petitioner's claim that the transaction price was below the "fair value" of the target shares. If the court determines that the target was undervalued, the amount awarded above the transaction price represents the return on the petitioner's investment.

At trial, LPS argued the sales process was sound and the deal price represented fair value. It claimed the final merger consideration set a ceiling for the company's fair value. The Chancery noted the company's board took care to create competition among different types of bidders, "which is critical for promoting competition." This deal, unlike the Dell management buyout, included not only financial sponsors, but also strategic buyers, the court noted. It concluded that, during the pre-signing phase, the company established a dynamic that "generated meaningful price discovery."

The petitioner argued the time gap between the deal announcement and its closing was a reason not to rely on the deal price but to have the court develop its own valuation as of the closing date. The company responded that the absence of a topping bid validated the deal price. It also claimed that, since the company's performance deteriorated during that time and Fidelity's stock traded up, the final merger consideration to the company's stockholders actually exceeded fair value.

The court decided to test the final merger price against the results from post-transaction discounted cash flow (DCF) analyses. Both parties hired noted experts who used the DCF approach to value the company. They arrived at values that varied by just over 50%: The petitioner's expert concluded the company's fair value was $50.46 per share; the company's expert calculated a per-share value of $33.57. The court's analysis borrowed from both experts' inputs. Adopting the inputs of the company's expert, the court arrived at a 9.56% weighted average cost of capital (WACC). Combining the WACC rate with the court's other inputs produced a value of $38.67 per share. The court considered this its best estimate of fair value under the DCF approach.

After surveying the most relevant recent Chancery decisions on valuation methodology in statutory appraisal cases, the court decided in this case it was best to rely entirely on the final merger consideration. Even though there were sound projections that enabled a "meaningful" DCF analysis, the DCF analysis depended too much on assumptions, the court said. "Small changes in the assumptions that drive the DCF analysis, however, generate a range of prices that starts below the merger price and extends far above it." Accordingly, $37.14 per share was the fair value.

The takeaway: You can make money as a bull or as a bear, but not as a pig. In this case, the speculative buyer would have been better off accepting the 12% bump in Fidelity's stock price than challenging the transaction's fair value using post hoc DCF value. Small changes in DCF inputs can result in widely varying valuations.

Distinguishing between non-marital (personal) and marital (business) goodwill is a continuing controversy in divorce cases, as this Tennessee case illustrates.

***Fuller v. Fuller*, 2016 Tenn. App. LEXIS 974 (Dec. 21, 2016)**

The business in this case was a solo financial planning practice. During the parties' marriage, the husband became a certified financial planner and formed his own company, although there were no tangible assets. Besides direct commissions stemming from the sale of financial products, the practice earned "trail" income for managing the funds and accounts he had created for his clients. The trail income made up the majority of the practice's earnings. The question for the appeals court was this: is the value of the trail income akin to professional goodwill, and thus not a divisible marital asset? Or is it a marital asset subject to equitable distribution?

The trial court determined that the trail income was a marital asset, and the husband claimed on appeal that the trail income was no different than the professional goodwill found in a solo practice, which under state law was not a marital asset. The Court of Appeals disagreed. The principle for disallowing professional goodwill to become part of the marital estate is if it could not be separately sold, the court explained. It was valuable to the professional only to the extent that it assured future earnings. As for the trail income in this case, the husband himself testified that it could be sold separately and that there was an accepted method for valuing it. Therefore, it was a marital asset and the trial court, following the formula the husband gave in testimony, valued the trail income properly.

The appeals court brought up a related issue: In determining the husband's income for the purpose of setting child support and alimony, the trial court apparently had included the trail income that it had distributed as a marital asset. This approach ran counter to the applicable statute, the appeals court found. So the Court of Appeals set aside the lower court's support determinations and ordered the trial court to recalculate the husband's income.

The takeaway: In this case, "trail" income from one spouse's financial planning practice was found to have value apart from the underlying business – unlike goodwill. In the divorce context, it was deemed a marital asset subject to distribution.

Samsung and Apple's courtroom battles have resulted in some precedent-setting decisions, but the following U.S. Supreme Court case is likely not among them.

***Samsung Elecs. Co. v. Apple Inc.*, 2016 U.S. LEXIS 7419 (Dec. 6, 2016)**

This litigation has a long and tortured history: After Apple released its original iPhone in 2007, Samsung came out with a series of smartphones whose design features resembled the iPhone. In 2011, Apple successfully alleged Samsung's phones infringed three design patents and was awarded $399 million in damages. Samsung challenged the jury verdict with the Federal Circuit, arguing that, when the design infringement involved a multicomponent product such as a smartphone, the infringer should not have to pay the profits it made on the sale of the entire phone but only on the infringing parts, such as the screen or case. In other words, just as with utility patents, design infringement damages should be apportioned to the infringing components. The court disagreed, based in part on statutory law. Section 289 of the 1952 Patent Act expressly rejects apportionment for design patent infringement and requires that anyone who applies a "patented design … to any article of manufacturer for the purpose of sale" or sells "any article of manufacture to which a (patented) design or colorable imitation has been applied" be liable to the patent holder for "the extent of (the infringer's) total profit, but not less than $250."

According to the Federal Circuit, "article of manufacture" meant the entire phone since the components of Samsung's phones could not be sold apart from the phones' shells. Samsung, with strong backing from the tech industry, asked the Supreme Court to clarify whether the term "article of manufacture" always means the end product sold to the consumer or whether it also could mean a component of that product. In a world of multicomponent high-tech devices, only the latter interpretation makes sense, Samsung contended.

In its decision, the Supreme Court noted that a damages calculation under Section 289 was a two-step process, requiring first identifying the "article of manufacture" and secondly calculating damages based on the total profit made from the article of manufacture. The court stated that the term "article of manufacture" could refer to the product sold to consumers, or to a component of that product. At the same time, the court declined "to go further and resolve whether, for each of the design patents at issue here, the relevant article of manufacture is the smartphone, or a particular smartphone component." Instead, the high court sent the case back to the Federal Circuit to "address any remaining issues."

The takeaway: The court did not provide a test or standard for performing a damages calculation when the parties dispute precisely what the "article of manufacture" is. But this ruling likely cuts down the award Samsung has to pay to Apple, and may open the door to apportionment in design patent infringement cases.

The last case is an estate tax matter that resulted in a loss to the IRS.

***Cavallaro v. Commissioner*, 2016 U.S. App. LEXIS 20713 (Nov. 18, 2016) (Cavallaro II).**

In this matter, the parents owned Knight Tool Co. (Knight), a business that developed an automated liquid dispensing machine. In 1987, the parents' three sons formed a separate company, Camelot, to refine and market the technology. In 1994, the taxpayers hired experienced accountants and lawyers for estate planning advice. The professionals had to decide which entity owned the value of the dispensing machine technology, and arrived at a means to pass the value on to the sons in a way that minimized estate tax liability. They did this by making the assumption that the value of the technology went to Camelot starting with its incorporation, although there was no record to support this version of the facts. A merger of the two companies then took place, based on the premise that no gift tax was due because, in 1995, on the merger date, Camelot already owned the dispensing machine technology. After the IRS became aware of a possible gift tax issue pursuant to the merger, it sued and issued a deficiency notice, claiming that the merger resulted in a $46 million gift from the parents to the sons. The taxpayers petitioned the Tax Court for a redetermination.

At trial, the IRS reduced the gift to $29.6 million based on expert testimony. The expert assumed that Knight owned the technology and found the merged entity was worth $64.5 million. Knight, he decided, owned 65% of the technology's value ($41.9 million), and Camelot owned the rest ($22.6 million). The taxpayers offered two expert appraisals, both assuming that Camelot owned the technology at the time of merger. Both experts used a market approach, and neither offered an appraisal based on Knight's owning the technology.

The taxpayers argued in Tax Court that the IRS's expert valuation was fatally flawed because the expert proceeded from the wrong assumption and his income based analysis had serious methodological flaws. The court concluded that Knight owned the value of the technology on the merger date and that the taxpayers had "the burden of proof to show the proper amount of their tax liability." Since the valuations they offered both were based on an incorrect assumption, they were unable to meet their burden of proof. Therefore, "it is all but immaterial that the Commissioner's expert reached this $29.6 million gift number by an arguably flawed analysis," the Tax Court stated, adopting the IRS expert's valuation. The taxpayers appealed the decision with the U.S. Court of Appeals for the 1st Circuit.

The appeals court found there was legal and factual support for most of the Tax Court's finding, but then sided with the taxpayers on their claim that the Tax Court erred in refusing to consider their critique of the IRS expert's valuation report. According to the court, the taxpayers merely had to show the IRS's determination was "arbitrary and excessive," which they attempted to prove by casting doubt on the IRS's expert valuation. The taxpayers had a right to the Tax Court's assessment of their valuation challenges, the court stated. The case was remanded back to the Tax Court for a decision on whether the IRS's liability determination was arbitrary, and if so, the court was obligated to determine the proper amount. The Court of Appeals also authorized the Tax Court to consider a new expert valuation.

The takeaway: Even with professional guidance, valuing related family-owned businesses for estate tax purposes can face IRS challenges. Families in similar circumstances trying to minimize or avoid gift taxes are well advised to proceed with caution.