

A detailed, grayscale microscopic image of a virus, likely a coronavirus, showing its characteristic spherical shape and numerous spike-like projections extending from its surface. The background is dark with some blurred light spots.

Litigation & Financial Considerations During COVID: How It Started, How It's Going

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Presenters



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Agenda

- Introduction
- Impact of COVID-19 on financial analysis, business valuations and family law matters
- Wrap-up, Q&A



Objectives

- Recognize the impact COVID-19 has had on actual financial results versus the impact it will have on projected financial results.
- Learn about other damage calculation, valuation and income considerations.

The top portion of the slide features a grayscale photograph of the United States flag waving on the left, with the dome of the United States Capitol building visible in the background on the right. Below the photograph is a solid green horizontal bar.

**Impact of COVID-19 on Financial
Analysis and Business
Valuations**

How It Started.....

When will we get a vaccine?

What aid will there be for businesses?

What aid will there be for individuals?

Will we ever go to the office again?

How many months/years will this go on?

What does recovery look like?

Will I ever have to wear a suit again?

How It's Going.....

When do we get back to normal?

What are the long-term implications for business?

How does all this aid impact future taxes?

What's the future for commercial real estate? What about business travel?

How has COVID changed the way we do business?

What does recovery look like?

Will I ever have to wear a suit again?

What Are The Issues When It Comes to Valuation?

- Forward looking nature of valuation
- The valuation date dilemma and the “known or knowable” argument
- Equitable issues as it relates to divorce

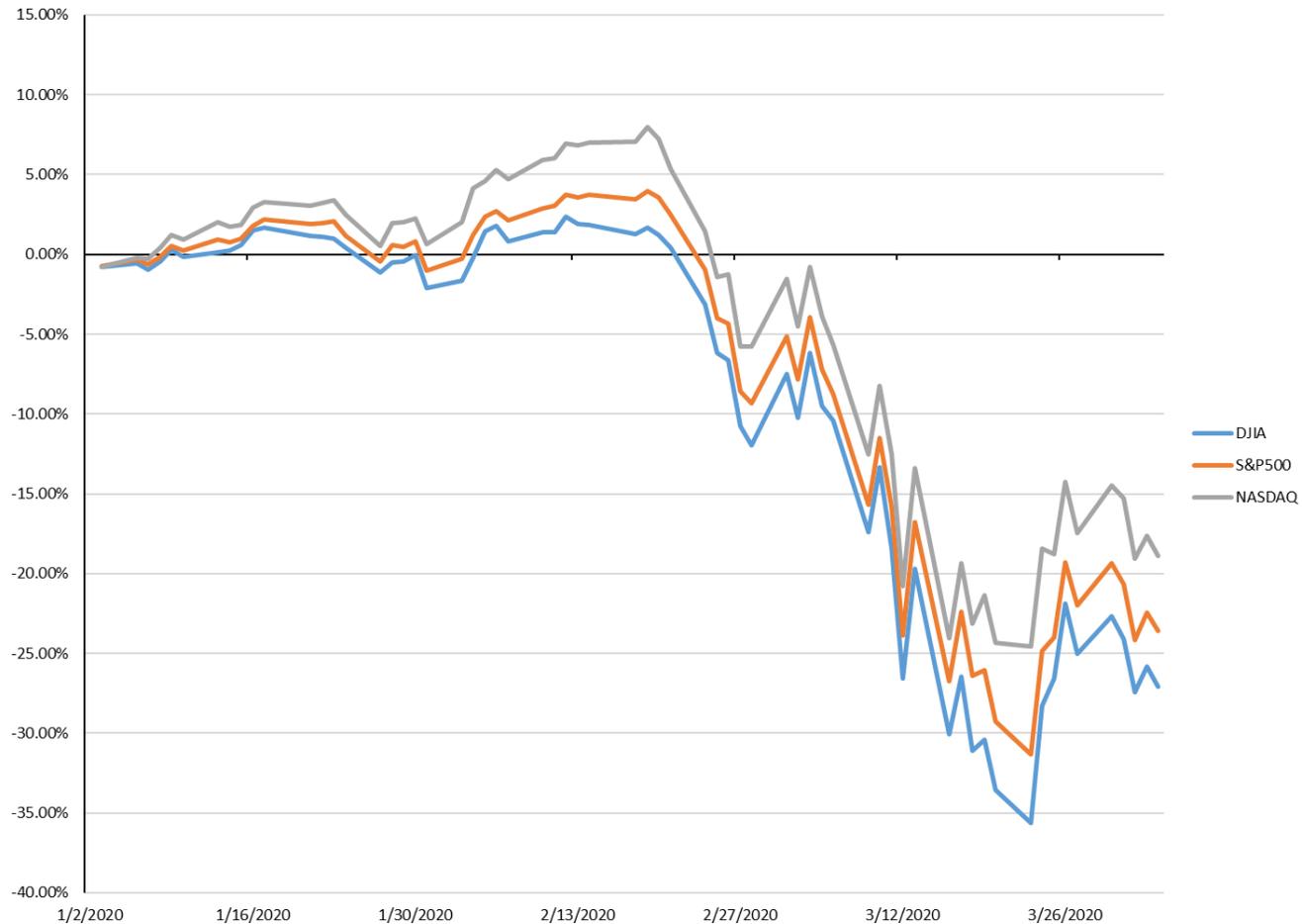


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**Forward Looking Nature of
Valuation**

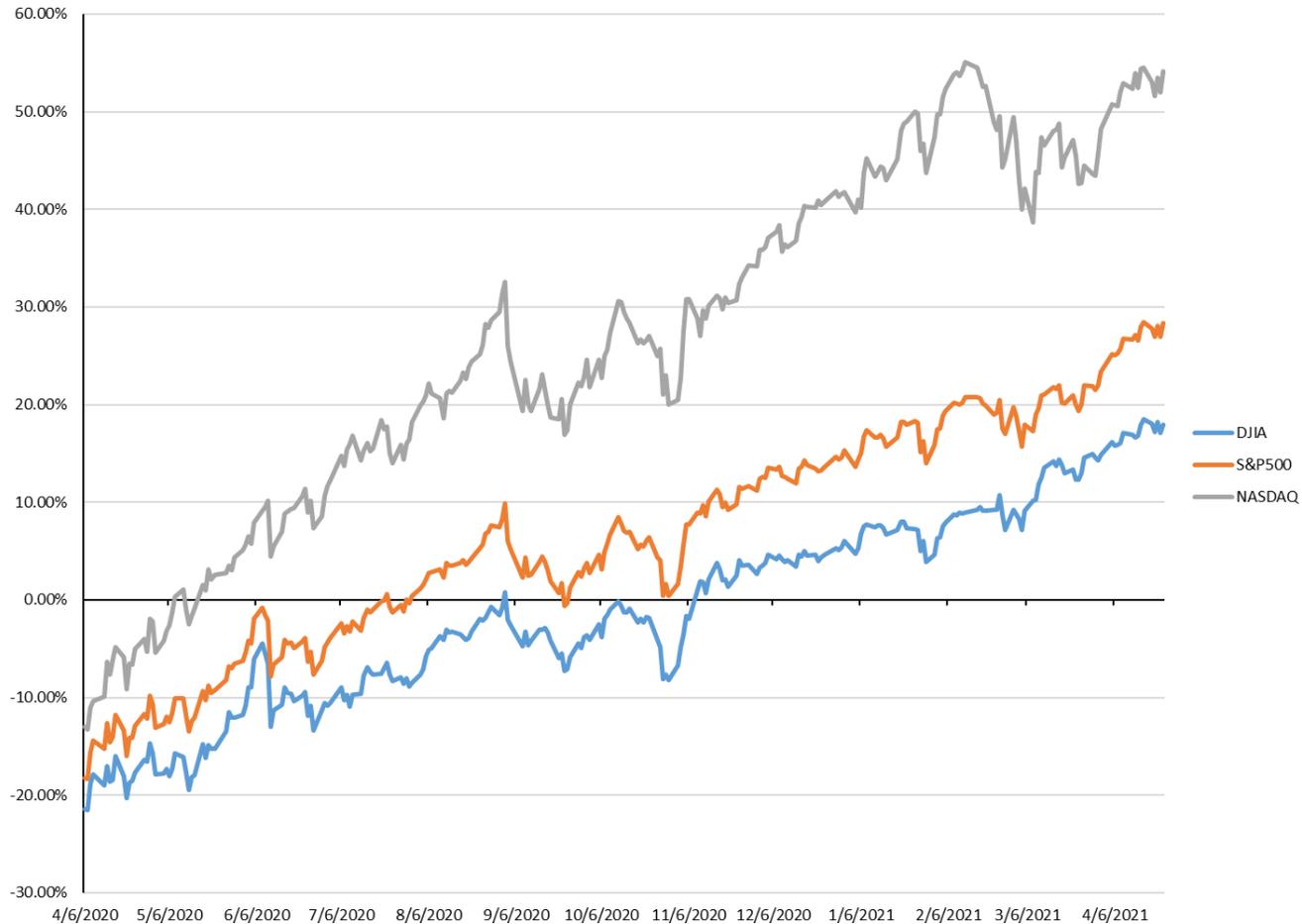
The Market...How It Started

Performance of major US stock indices from January 1, 2020 to April 3, 2020



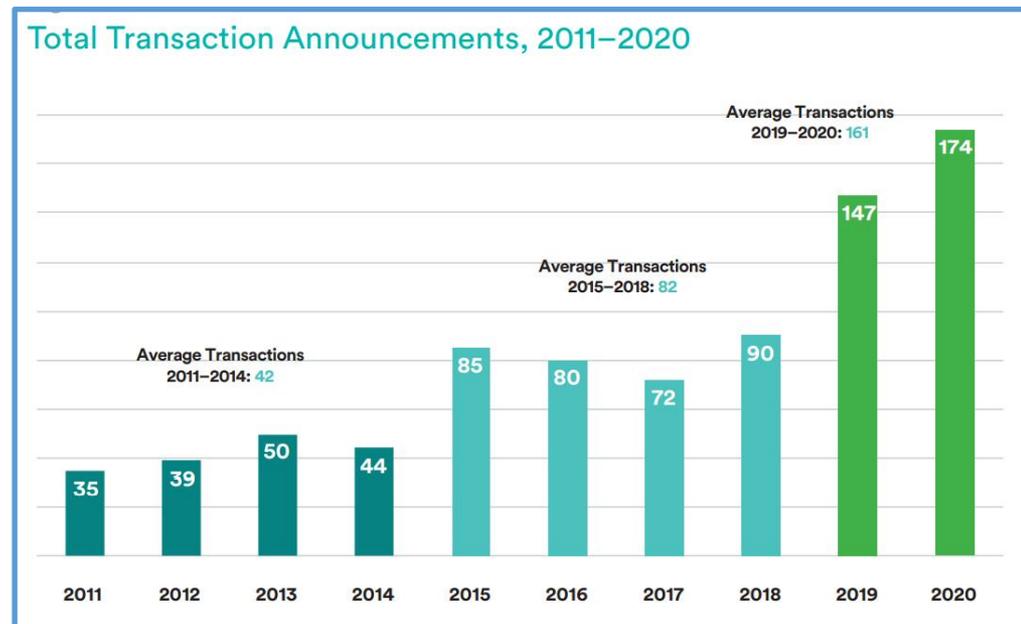
The Market...How It's Going

Performance of major US stock indices since April 3, 2020



Mergers and Acquisitions in 2020

- Expectations for 2020 were that activity would be less than 2019 – uncertainty due to the US and China sparring over trade plus a US Presidential Election
- Key takeaways
- 2020 was challenging due to COVID, deal suppression started in March
- Deals that were in process may have continued but more “at risk” for the seller
- 2020 ended up having increased deals of 18% but not as large of an increase as seen in 2019 of 83% (Source Ameritrade)



Middle Market M&A Activity

- Middle market M&A activity increased dramatically in Q4 of 2020
- Exceeding number M&A transactions pre-pandemic
- Valuations have seen some rebounding from the Q2, Q3 lows

Representative U.S. Middle Market Transaction Values					Total Enterprise Value / EBITDA		
Transaction Size (\$MM)	2003-2015	2016	2017	2018	2019	2020	All 2003 - 2020
Aggregate	6.2x	6.7x	7.2x	7.2x	7.1x	7.1x	6.5x
\$10 - \$25	5.6x	5.8x	6.3x	5.9x	6.2x	6.0x	5.7x
\$25 - \$50	6.2x	6.4x	6.6x	6.9x	6.9x	6.9x	6.4x
\$50 - \$100	6.8x	7.2x	8.2x	8.8x	7.5x	8.1x	7.3x
\$100 - \$250	7.4x	8.8x	9.1x	8.7x	9.4x	8.6x	8.2x
# of Deals	2,361	241	267	289	308	297	3,765

Source: GF Data ®

M&A Survey | March 2021

Source: Wilcox Investment Bankers

So What?

- Standard of value is fair market value
- Hypothetical willing buyer
- Hypothetical willing seller
- Neither under any compulsion to buy or sell
- With relevant knowledge of all the facts



What the Markets Tell Us.....

- Market's are one way we can get a feel of investors' outlook
- Caution – general outlook and sentiment – you need to look to the specifics of the market and industry of the business you are valuing to see what is actually happening
- But unlike Q2 and Q3 of 2020, when low to no M&A activity was happening, businesses are selling again
- What I hear from my partners, however, is that more “skin in the game” is being required by the seller. Meaning the multiple might be the same but more of it is contingent on the company performing in the future. Compensate for the additional RISK

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Valuation Date Dilemma

If I Had a Nickel.....

How are you treating COVID? One-time only event that you normalize? What about...what about...what about.....



What Valuation Date to Use?

- What valuation date to use?
 - 12/31/2019? 12/31/2020? Some other date?
 - What do you do about COVID based on the date you picked?
- **Legal issues** for the court/counsel to consider:
 - Historically we have used an early date as a convenience – for example, June trial date, therefore used a 12/31 valuation date.
 - My understanding of this is different than a defacto argument
 - Argument is that the 12/31 valuation is similar enough that it can be used for the June 30 trial date
 - If that is the case, you need to understand what valuation expert's standards say about **Subsequent Events**.

Subsequent Events

- Business valuations do not **typically** account for events occurring after the valuation date.
 - What was “known or knowable” as of the valuation date
- Should COVID-19 be considered then, for a 12/31/19 valuation?
What about what we know today for a 12/31/2020 valuation?
What about 6 months from now and a 12/31/2020 valuation?
 - In general, courts prefer to see real world events incorporated
 - Are you doing the client a disservice by not accounting for COVID-19?
- Valuation Standard
 - Known or knowable standard
 - **HOWEVER, there is more to that standard!**

Subsequent Events

- Jim Hitchner, CPA/ABV/CFF, ASA and Karen A. Warner, MA
- Timeline of COVID-19

VPS Valuation Products and Services

NOTE: The Monday or next-day index prices are used for announcements made on weekends or holidays.

Index highs/lows are from 12/31/19 to 4/1/20.

COVID-19 TIMELINE

EVENT

DATE

Wuhan, China. Dozens treated for pneumonia; authorities say no evidence of person-to-person spread.¹

Tuesday
12/31/19

Chinese authorities identify a novel coronavirus; reports of 59 cases.²

Thursday
1/9/20

DOW JONES INDEX PRICE	change in price from 12/31/19	S&P 500 INDEX PRICE	change in price from 12/31/19	RUSSELL 2000 INDEX PRICE	change in price from 12/31/19
28,538		3,231		1,668	
28,957	↑1.5%	3,275	↑1.4%	1,665	↓-0.2

Subsequent Events

China's state media reports first death, a 61-year-old man who visited the Huanan Seafood Market in Wuhan.³

Saturday
1/11/20

28,907

↑1.3%

3,288

↑1.8%

1,670

↑0.1%

First coronavirus case emerges outside China; case reported in Thailand.⁴

Monday
1/13/20

28,907

↑1.3%

3,288

↑1.8%

1,670

↑0.1%

RUSSELL 2000 HIGH

Thursday
1/16/20

29,297

↑2.7%

3,317

↑2.7%

1,705

↑2.2%

Other countries (Japan, South Korea, Thailand) confirm cases, according to World Health Organization (WHO) first situation report.⁵

Monday
1/20/20

29,196

↑2.3%

3,321

↑2.8%

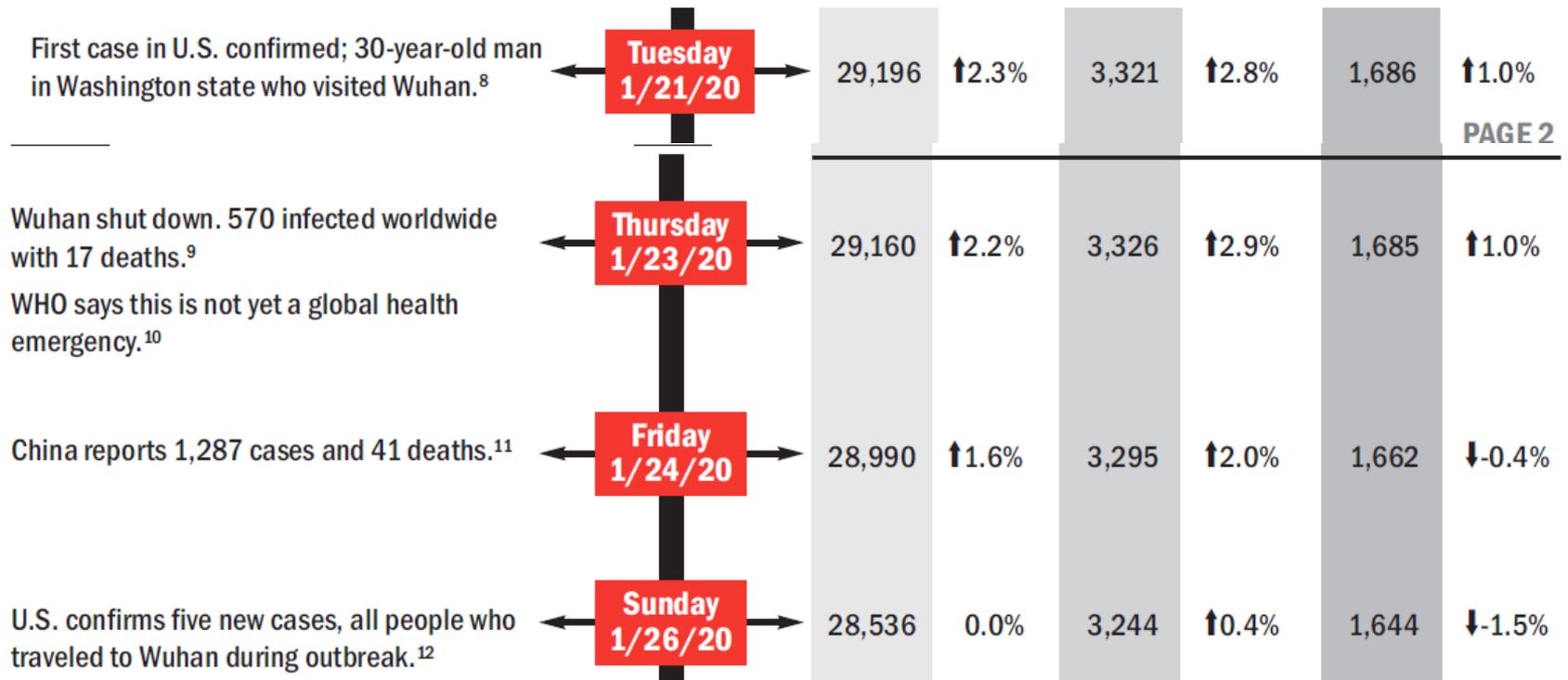
1,686

↑1.0%

China confirms human-to-human transmission, indicating possibility of rapid spread.⁶

Dr. Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases, says National Institute of Health is working on a vaccine.⁷

Subsequent Events



Subsequent Events

U.S. expands screening of international travelers; says risk to Americans is low. Health and Human Services Sec. Alex Azar says “Americans should not worry for their own safety.”¹³

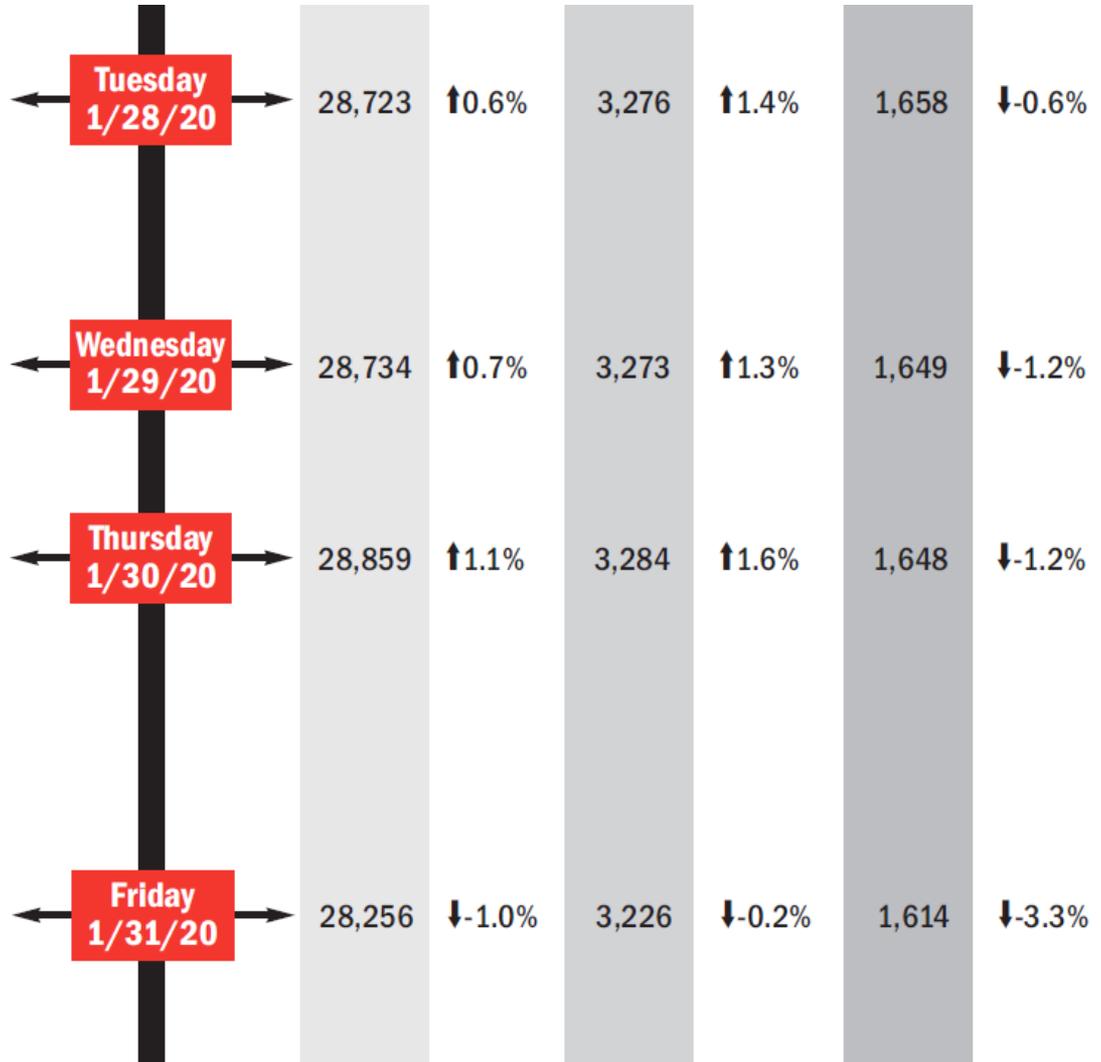
White House announces new task force to keep Americans informed about health and travel information regarding the virus.¹⁴

WHO declares global emergency; “a public health emergency of global concern.”¹⁵

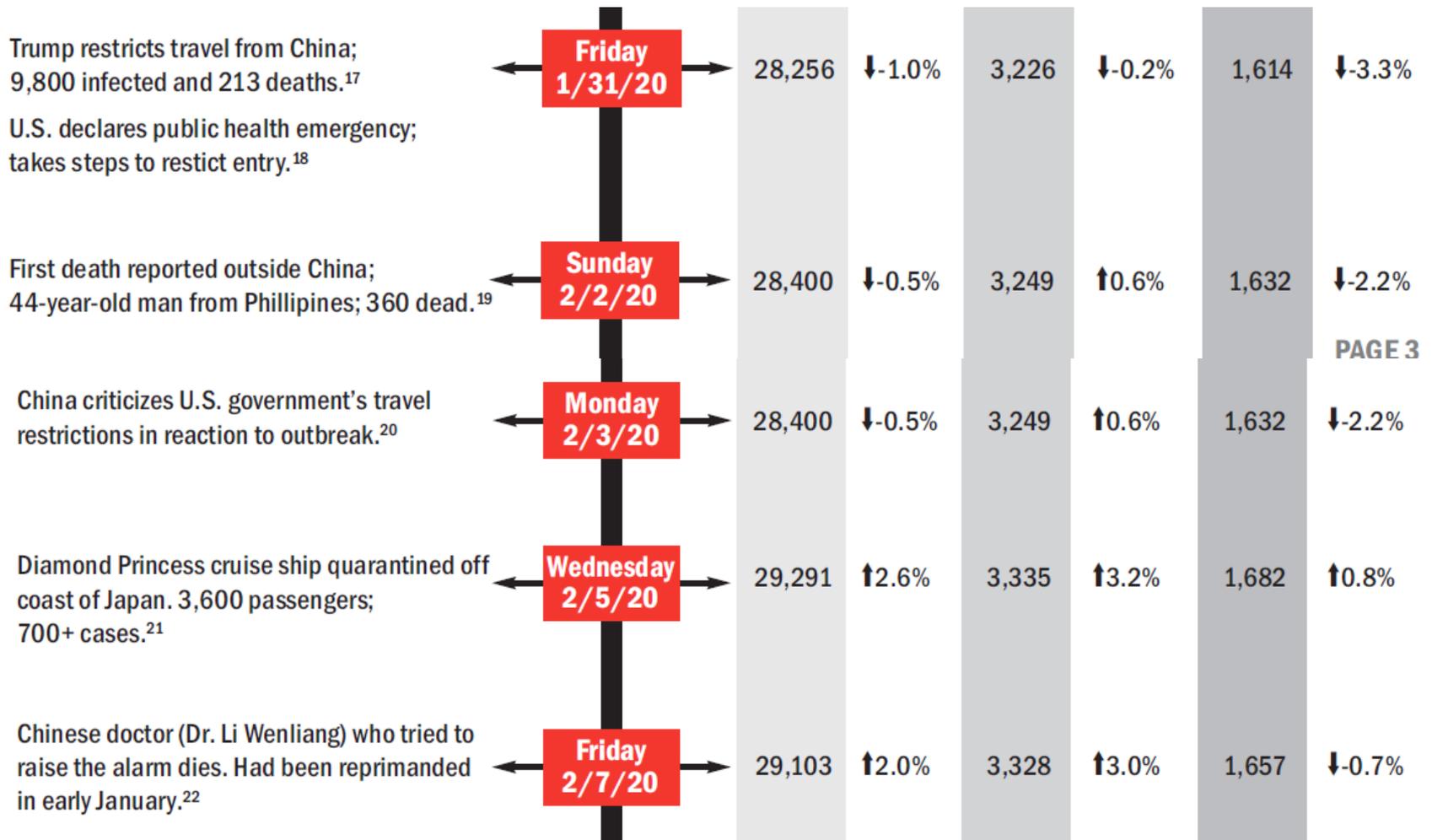
Trump says, “We think we have it very well under control.” Describes U.S. cases as “very little problem.” Says those affected “recuperating successfully.”¹⁶

Trump restricts travel from China; 9,800 infected and 213 deaths.¹⁷

U.S. declares public health emergency; takes steps to restrict entry.¹⁸



Subsequent Events



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Subsequent Events

- AICPA's Standards on Valuation Services (SSVS No 1 VS Sec100.43)
- "The valuation date is as of the specific date..."
 - Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date.
 - Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or condition.
 - **In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure in a separate section of the report in order to keep users informed.**

3 Commonly Accepted Methods



Income Approach

- The Income Approach determines the value of a business based on its ability to generate future economic benefit for the owners.
- Measures the cash flow associated with the ownership of the asset.
- The value is based on the net present value of expected future income streams from the ownership of the asset.
- Two methods under this approach:
 - Capitalization of Cash Flows
 - Discounted Cash Flows

Market Approach



- The Market Approach establishes the business value by comparisons to historic sales involving similar businesses.
- Based on arms-length transactions of comparable assets.
- An asset is worth what other, similar assets are worth.

Cost or Asset Approach

- The *Cost or Asset Approach* determines the business value based on the value of its assets. The idea is to determine the business value based on the fair market value of its assets less its liabilities.
- Based on the cost to replace or re-create the asset.
- A purchaser of the asset can avoid these costs by purchasing the asset instead of re-creating it.

Valuation Method Selection and Factors to Consider

Which valuation method appears to be the most reasonable for valuing companies impacted by COVID-19?

- Income Approach - Discounted Cash Flow
 - Provides a long term and forward looking view
 - Issue is the predictability of the future – even more so than before
 - Have to ask how/if COVID has changed the manner in which the business operates
- If using the Market Approach
 - Historical may not be comparable (non-COVID-19 transactions) and therefore adjustments will be necessary.

Cash Burn Rate and Cash Balance Rate

- Cash balance and cash burn rate – how has this rate been impacted by COVID-19?
- What kind of runway does the company have?
 - Key for evaluating the risk rate
 - Important for evaluating the company's ability to continue
 - Companies will fail and go out of business as a result of COVID-19

Valuation Procedures

- Management interview
- Industry research
- Trend analysis
 - Expenses that increased during COVID
 - Expenses that decreased or ceased during COVID – How do you establish the correct spending levels going forward?
- Access to capital



Documentation

- Documentation and rationale for decisions that affect a valuation are more critical than usual.
 - Is the valuation only considering the short term?
 - Were multiple scenarios considered?
 - What risk factors were considered?
 - How did the company change or innovate during COVID? Is that here to stay?
 - How did the industry change or innovate? How does that impact the subject company?
 - What about the customer base?
 - How does a prolonged recovery impact the company?
 - What about sources of capital available?

Other Damages and Valuation Considerations

- Non-recurring expenses
 - PPE expenses
 - Work from home expenses
- Additional employee compensation
 - “Hazard” pay
 - Retention bonuses
- Risk factors
 - Disruptions to supply chains?
 - Changes in consumer demand?
 - Long-term effect of pandemic related “pivots” in business model?

A black and white photograph of the United States flag waving in the foreground, with the dome of the United States Capitol building visible in the background. The image is partially obscured by a green horizontal bar at the bottom.

Income Considerations

Why Establish Individual's Earnings?

- Commercial litigation
 - Wrongful termination or other employment disputes
 - Wrongful death
- Family Law
 - Establishing income for support purposes



Establishing Income in the Middle of a Pandemic

- Even in the best of times, establishing someone's income can be difficult
- 2020 and 2021 additional factors to consider:
 - Reduction in income due to being laid off, reduced hours or other reasons – could be temporary or permanent
 - Unemployment benefits – Higher and longer than usual due to the temporary measures taken at Federal and State levels
 - Self-employed/business owners – stimulus and other relief vs. decreased earnings

Unemployment

- Federal and state unemployment laws have been extended
- 2020 and 2021 supplement
- Reduced taxability of unemployment (First \$10,200 not taxable)
 - **NOTE** – Unknown at this point if the various family law software will update for this change. You may have to do this manually by putting some of the unemployment in as “non-taxable” and the remainder in as taxable.
- Question is if the job loss is temporary or permanent

Business Owners/Self-Employed

- Consideration of one-time “income” (PPP, ERC) and how it is considered for various calculations:
 - Lost earnings
 - Support in family law - Historic income approach or current income in setting temporary or permanent spousal/child support orders
- Many of those forms of assistance were also available to sub-contractors
- Determine how 2020 business expenses might be impacted and the need to obtain documents to determine those expenses in light of an income reduction.
 - Red flag – Despite stay at home, social distance, a business has the same or higher travel and M&E
- Revenues could have decreased, but expenses likely decreased as well. Temporary exclusion of expenses could impact the bottom-line. On the other hand, the needs for PPE could drive expenses up.
 - Requires some analysis and digging to determine what the right approach is

Variable Income

- What to do with bonuses, commissions, overtime or other variable income that was historically not as predictable and even more so now
- Gather documents to understand what happened in 2020 and trend for 2021
- Are there clear communications from the employer regarding overtime or no bonuses in 2020, etc....
- Family Law - Consider creative solutions on sharing future bonus or commission income vs calculating an amount of support on historical averages



Expenses and Standard of Living During a Pandemic

- Family Law – Sometimes use standard of living as a measurement or argument for support
- 2020 (and into 2021) may not be representative of the standard of living
 - Lack of travel
 - Lack of extra curricular activities for children
 - Less entertainment expenses (no movies, ballgames, concerts, etc.)
 - Increased expense around cleaning, food delivery or takeout
 - Suspended payments on student loan or other debt deferrals
- Likely (hopefully) temporary in nature
- Raises the question where standard of living is considered of how to present “normal” expenses for the party
- May be helpful to prepare two budgets:
 - “As is” COVID budget
 - “Normal” budget

Get Creative!

- How do we solve these problems?
- In family law cases, no one wants to return to court endlessly every time income changes
- Ideas:
 - Percentage based
 - Lump sum payment
 - Plan for modifications

Percentage Based

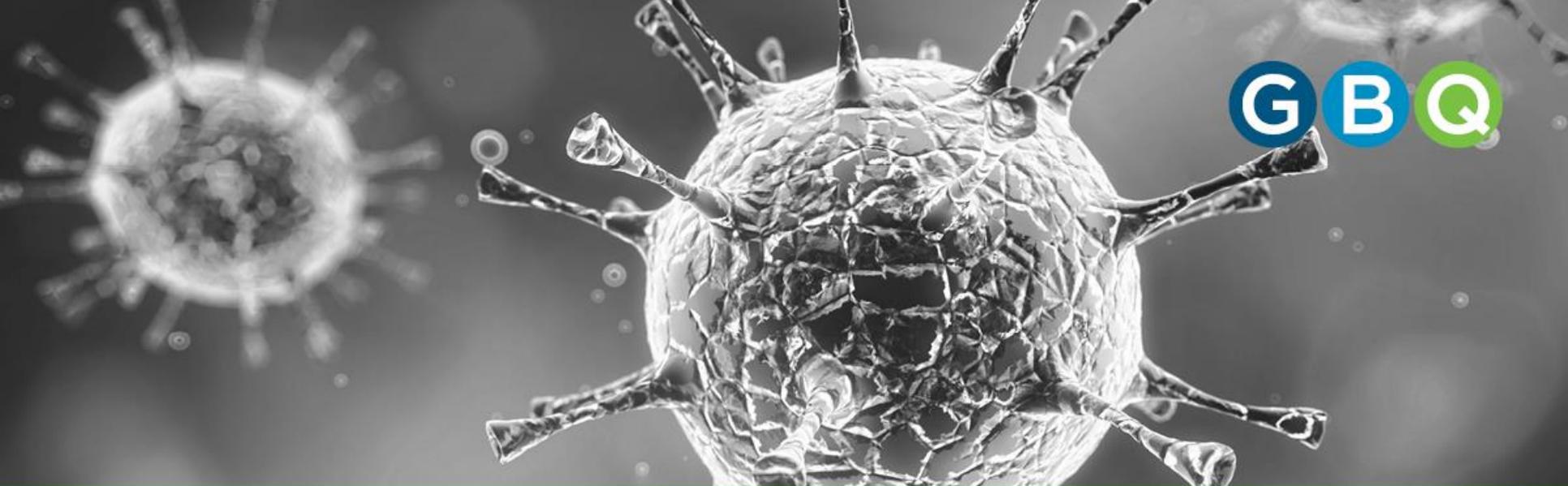
- How does this work?
 - Establish support based on a percentage of the payor's net income
 - Payor can provide the recipient with paystubs each period or monthly to confirm the amount paid.
 - True-up process at the end on taxes
 - This could be a temporary solution while things normalize, does not have to be permanent
- Pros
 - Parties ride the wave together. If income goes up, they both benefit. If it goes down, payor is protected.
- Cons
 - Most payors do not like the idea of having to share an "upside" from his/her hard work
 - Subject to manipulation which could land you back in court
 - Keeps the parties more entangled than a base amount

Lump Sum

- How does this work?
 - Determine a lump sum buyout for some/all of the support
 - Particularly helpful for someone with partial variable pay who wants to bet on his or herself
 - Determine a net present value of the component of support and then generally negotiating some “discount” for the buyout to the payor
- Pros
 - Can disentangle the parties
 - Payors who want to bet on themselves like the idea of enjoying all the upside
- Cons
 - Only works if there are adequate assets to go around
 - Cannot be done with child support

Plan for a Modification

- How does this work?
 - Support takes into account the special COVID circumstances
 - Make sure the order/agreement is clear about the circumstances and how that will be addressed
 - For example, consider someone who has a reduced salary but knows that it will go back to full salary at some unknown date in the future. Support could be paid at a lower rate until such date that the full salary resumes.
 - Exchange documentation in order to establish whatever the circumstance is and the change when it happens
- Pros
 - Allows for temporary circumstances to be address, the parties to move the divorce forward and not have to wait for that circumstance to resolve
- Cons
 - Subject to manipulation and having to return to court
 - Only likely works if there is transparency and trust

A detailed 3D rendering of a virus particle with a textured, spherical surface and several long, thin, protruding spikes. A second, smaller virus particle is visible in the background to the left.

Other Potential Financial Considerations

Relief



- Paycheck Protection Program Loans
- Economic Injury Disaster Loans
- Employee Retention Credit
- Other relief depending on the industry from state and industry resources (i.e. Restaurant Relief Fund in Ohio)

PPP Loans

- PPP First Draw (PPP1)
 - Early/mid 2020
 - Forgiveness is dependent on how the monies are spent and headcount
 - Forgiveness is not taxable
 - For accounting purposes, debt until forgiven by the SBA (currently the process is delayed)
- PPP Second Draw (PPP2)
 - Had to demonstrate a reduction in gross receipts
 - Based off of the same formula as PPP1
 - Same provisions for forgiveness and taxability
- Added it to our standard request to understand if a business received a PPP loan, how it is recorded on the books and records, if forgiveness has been applied for and if they are pursuing or have received a Second Draw loan.

EIDL & ERC

- Economic Injury Disaster Loan
 - SBA program
 - Debt, not forgivable
 - At favorable interest rates and terms
 - Personal guarantee requirement waived for loans less than \$200k for 1/31/20 through 2/31/20
- Employee Retention Credit
 - If certain criteria are met (i.e. shut down for a period of time or gross receipts declined by a certain %)
 - Employee tax credit that is refundable
 - *NEW* Previously those without a PPP loan could not receive the ERC. NOW, even with a PPP, you can get ERC.
 - Result is that many companies are receiving significant refundable tax credits in 2021 from 2020 payroll taxes
 - Credit extends through June 2021

So What?

- PPP loans and ERC are in essence “free money” (or as close as we will likely see)
- Purpose is to support the operations of a business and PPP has significant restrictions on the use of the funds
- What is the impact of COVID-19 related “aid” on the actual and projected financial results of the business?
- Consider the equitable outcome of the situation
- What if the ERC or PPP create a “windfall” to the business owner?
- Do you treat PPP as “real” debt?
 - Certainly some risk with SBA audits and lack of guidance



Questions



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