



The Role of the Corporate Finance Expert in Debt-Equity Litigation: Lessons From *ScottishPower* (Part 1)

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Given enhanced political and societal focus on tax motivated structures, a good faith attempt to create a relationship between the borrowing and lending entities similar to that between unrelated third-party debtors and creditors may not be sufficient to avoid challenge by the IRS or state tax authorities.

Numerous articles have examined when and under what circumstances related party debt, (e.g. indebtedness issued by one member of a consolidated corporate group to another), may be considered valid debt for tax purposes. For example, Christensen¹ discussed the current state of debt-equity litigation and how courts have viewed the issue. Greenaway and Marion² reviewed the list of debt vs. equity factors considered in the seminal *Estate of Mixon*³ decision (the “Mixon

Factors”) using specific cases to demonstrate how courts have ruled on each issue. Many of these articles have discussed how intercompany debt should be structured, serviced, and retired so as to avoid contest by the IRS.

This two-part article takes a different approach than those that have come before it.⁴ It proposes, based on the authors’ experience consulting on debt-equity controversy matters, that given enhanced political and societal

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focus on tax motivated structures, a good faith attempt to create a relationship between the borrowing and lending entities similar to that between unrelated third-party debtors and creditors may not be sufficient to avoid challenge by the IRS or state tax authorities. Thus, particularly in high profile transactions or matters that fall under the purview of one or more IRS campaigns, taxpayers must be forward-looking. They must consider how the facts and circumstances of their particular situation and the work they do to document a transaction will appear to a fact finder. In short, taxpayers must prepare for court and hope that by doing so, they are able to avoid it.

It is generally accepted that the documentation of related party indebtedness conforms, as closely as possible, to the standards that would prevail among third-parties. This can be difficult, as the relationship between related party lenders and borrowers is typically different than the relationship between unrelated third-parties. Consider, for example, the process of authorizing the loan. A third-party would be unlikely to advance a multi-million dollar loan without explicit covenants, such as allowing the lender to inspect the audited books and records of the borrower on a periodic basis. However, in the case of related parties, the lender will likely have full access to all of the financial records of the borrower. This makes clauses regarding the lender's rights to inspect financial statements irrelevant from a practical standpoint. Moreover, most subsidiaries of consolidated groups are typically not subject to a stand-alone audit of their financial statements. Imposing the duty of obtaining such an audit on the borrower,

therefore, would cause it and the rest of the related group to bear needless costs. This is simply one example of how creditor/lender relationships will differ when they are between related entities rather than third-parties. There are many others. Consequently, courts have recognized that related party arrangements can be valid for tax purposes as long as they do not constitute a "patent distortion" of what would have been offered by a third-party.⁵ However, tax authorities may use these differences to challenge even those intercompany transactions on which substantial effort has been expended to ensure that they meet third-party standards and are economically reasonable.

What, then, should a company and its counsel do? This article partially

with oral arguments in 2011 and an opinion rendered in 2012. The Tax Court ruled in favor of the petitioner and determined that the intercompany loans in question were bona fide debt. As noted above, lessons learned from this case study are not limited to trial testimony. Approaching a transaction with the *ScottishPower* outcome in mind can help taxpayers document it in a way that will help it avoid or withstand challenge.

Summary of Financial Expert's Role in Debt-Equity Litigation

Many articles that have come before this one have focused their attention on the debt-equity issue by using a multi-factor



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answers that question by examining the role that financial experts play in documenting debt-equity related issues, and in litigation in particular. First, it provides an overview of the analyses generally performed by finance professionals to evaluate whether a related party arrangement is (from an economic perspective) debt for U.S. tax purposes. It then illustrates these objectives using the work the authors performed and trial testimony that was provided in the *NA General Partnership (ScottishPower)*⁶ case. *ScottishPower* is one of the most recent debt-equity issues tried to a verdict

framework. The most common of these is the one provided by the *Mixon Factors*, after the eponymous case, which laid out a list of 13 factors to weigh and consider when determining whether an intercompany transfer of funds is debt or equity. Other cases and sources use different sets of factors. Many of these factors are strictly legal in nature, but three touch on financial economics.

- Whether there was a source of payments to repay the intercompany obligations, which typically involves assessing a company's ability to pay its debt as they become due.
- Whether the fair market value (FMV) of the borrower's assets exceeds its debts, which is referred to as a company's "equity cushion."
- Whether a loan could have been obtained from outside institutions on substantially similar terms. This analysis, referred to as "capital adequacy," typically looks at an issuance's hypothetical credit quality as a key component of a third-party's willingness to lend.

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¹ Christensen, "The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion," *The University of Chicago Law Review* (2007), pp. 1309-1343.

² Greenaway, and Marion, "A Simpler Debt-Equity Test," *The Tax Lawyer* 61.1 (Fall 2012), pp. 73-112.

³ *Estate of Mixon*, 464 F.2d 394, 30 AFTR2d 72-5094, 403 (CA-5, 1972).

⁴ This article does not intend to provide guidance on the legal issues involved in a debt-equity tax controversy. It is rather written from the perspec-

tive of a financial expert, using the *ScottishPower* tax litigation as a case study. Furthermore, given that this article primarily focuses on the economics of the debt-equity issue it does not consider the recently finalized Section 385 regulations on debt-equity.

⁵ *ScottishPower*, Note 6, *infra*, p. 36 citing *Litton Bus. Sys. Inc.*, 61 TC 367, 379 (1973); *Nestle Holdings Inc.*, TCM 1995-441; cf. *Segel*, 89 TC 816, 832-834 (1987).

⁶ TCM 2012-172.

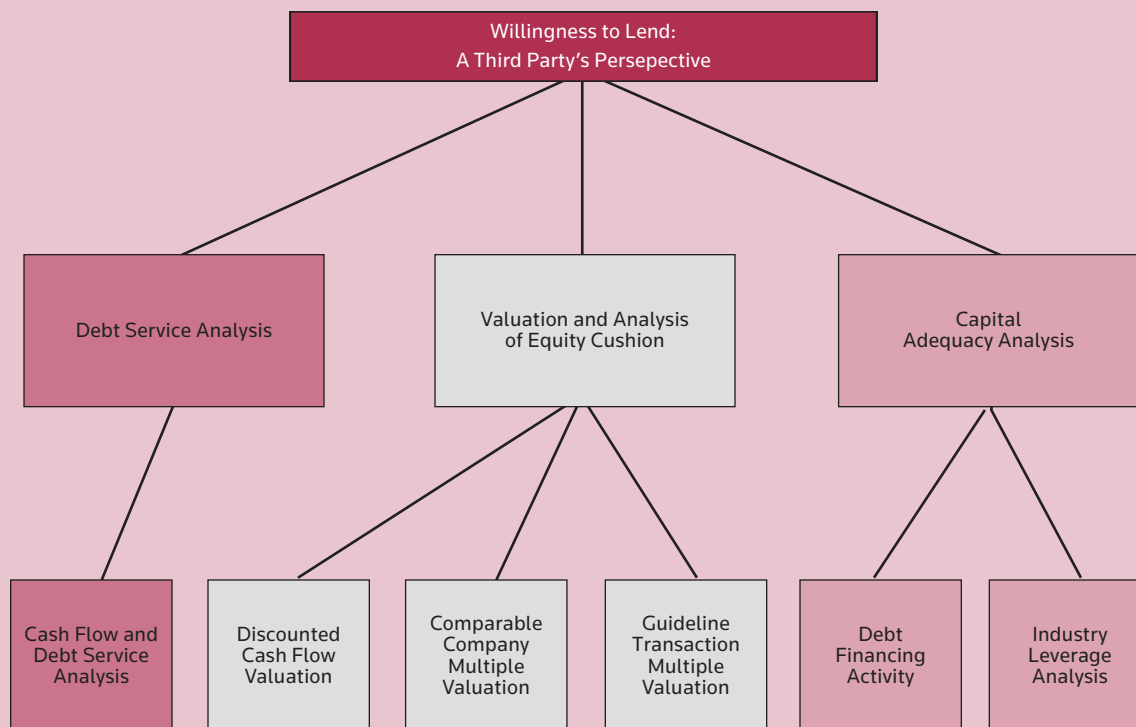
EXHIBIT 1**Corporate finance experts' analysis in *ScottishPower***

Exhibit 1 outlines the analyses performed by us as the corporate finance experts⁷ in *ScottishPower*. These analyses were conducted to determine whether a third-party would be willing to lend to the debtor on substantially similar terms. They also provided the foundation for petitioner's credit rating and investment banking experts who further assessed and opined on the credit rating and pricing of the loans at issue, and the ability of petitioner to have placed the debt issuances in the market.

The approach to corporate finance issues in *ScottishPower*, as shown in Exhibit 1, was an important part of the court's decision that the intercompany loan in question should be considered debt for tax purposes. Therefore, this outline provides taxpayers and their advisors with a useful template that can

serve as the foundation for a successful debt-equity defense during a transaction planning process or in subsequent tax controversy proceeding. Many advisors can perform credible credit rating estimates and survey market pricing, but those insights are typically most valuable when they are based on verified cash flow forecasts, value, and evidence of market acceptance of the borrower's approach to managing its capital structure. Note, however, that this template cannot be universally applied. Third-party lenders view different industries and companies in varying ways, and those views may shift over time. Moreover, data availability varies. Therefore, the work of a financial expert will vary on a case by case basis. Depending on the information available, and the appropriateness or applicability of its use, not

all of the analyses displayed in Exhibit 1 or discussed in this article will be conducted. Regardless of the analyses selected, financial experts must use only information that would have been known or knowable to a third-party lender at the time the related party loan was made.

Test of Reasonableness of Projections

Before performing any analysis, reasonable projections of the subject company's business performance typically must be obtained or developed. In determining whether financial projections are needed (most debt-equity documentation would benefit from forward-looking credit analyses), the financial expert must consider the re-

EXHIBIT 2

General framework for calculating DFCF

	EBITDA
-	Depreciation & Amortization
=	EBIT
-	Income Taxes
=	Net Income
+	Depreciation & Amortization
+ /	
-	Changes in Working Capital
-	Capital Expenditures
=	Debt Free Cash Flow (DFCF)

quirements of a third-party lender in that particular situation. In other words, there is no “one size fits all” answer that will work for all related-party arrangements. For example, while a lender might make small advances without projections, or advance substantial sums against high quality, easily saleable assets held by a borrower, most lenders providing large loans to operating businesses will perform a forward-looking analysis of that bor-

rower’s prospects. The starting point of that analysis is typically financial projections provided by management.

Analyses of an entity’s ability to pay its debts, capital adequacy, or value are forward-looking from the point in time being analyzed. Creditworthiness and market acceptance of debt issuances and a given interest rate are driven by credit rating agencies’ and investors’ expectations of future cash flows and business performance. Therefore, it is important that these projections represent the best judgment of management or knowledgeable market participants and incorporate all information available as of the issuance date of the intercompany loan. Projections that do not incorporate material information may require adjustment. However, projections that are not achieved

due to subsequent events that were not foreseeable as of the date of the analysis do not merit adjustment as long as the assumptions underpinning them were reasonable at the time.

If the projections are overly optimistic or aggressive, any analysis based on them is open to criticism as unreasonable and therefore unreliable. Conversely, if projections are defensible as reasonable or conservative, conclusions based on them will likely be accepted as reasonable by a judge or other finder of fact. Due to this, the financial expert may undertake substantial effort to test the reasonableness of the projections used in the analysis. Common tests of reasonableness that should be considered by a financial expert include, but are not limited to, the following:

- Comparison of historical results to projected performance.
- Comparison to projections developed by parties involved in the transaction.
- Comparison to projections developed by third-party market participants at the time of the transaction.

Furthermore, conditioned on information availability, the financial expert should look at the historical track record of the entity’s management team and its ability to meet or exceed forecasts.

Part two of this article describes, in detail, the extensive review of management’s contemporaneous projections undertaken by the financial expert in *ScottishPower* and why the findings helped establish the legitimacy of not only the expert’s report and testimony, but of the transaction. In certain circumstances, management’s projections may require modification. In a transactional context, this is best accomplished by management with input from the financial expert. However, a retrospective financial analysis may require that the financial expert make these modifications based on information which was known, knowable, and anticipated at the time.

Ability to Repay Debt

Having established reliable projections, the financial expert can then proceed

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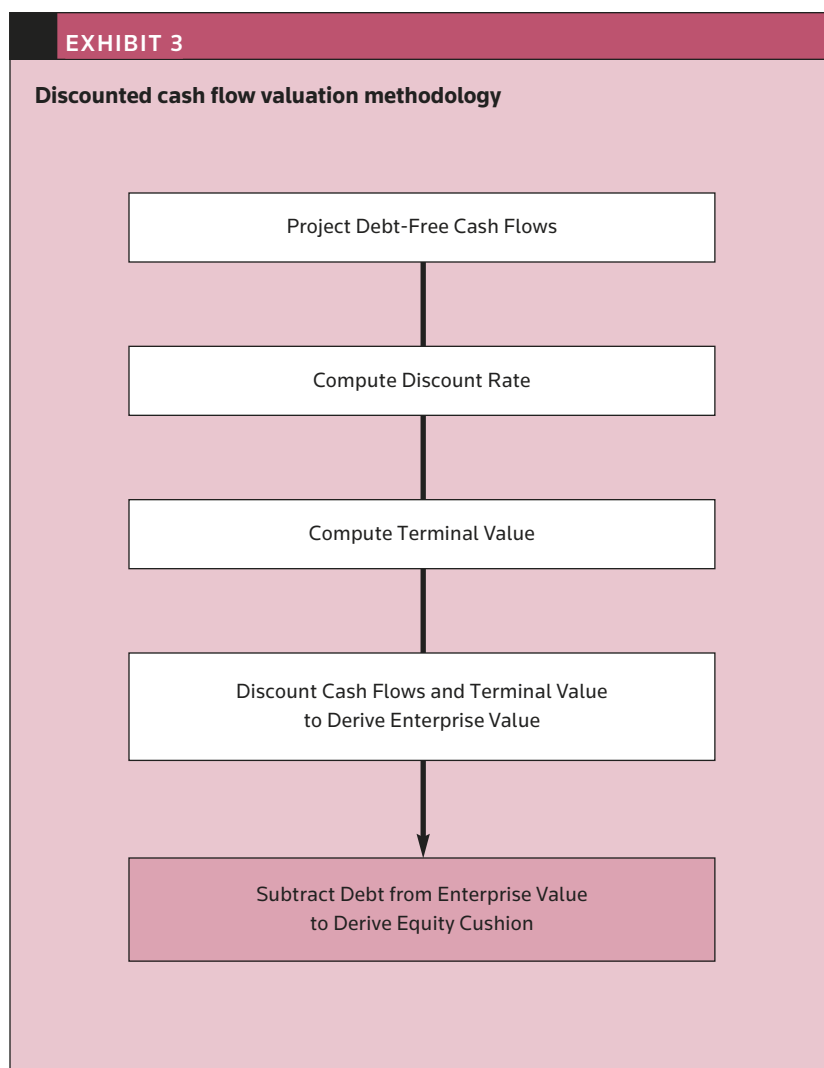
⁷ This article focuses on the role a financial expert plays in the debt-equity issue. However, other experts, such as a credit rating expert or an investment banking expert, play critical roles in any debt-equity controversy. The report of the financial expert, specifically in *ScottishPower*, only made sense in the context of the credit rating expert and investment banking expert report.

with the core economic analyses used to determine whether an intercompany obligation is debt or equity for tax purposes. The starting point is often an analysis of the subject company's ability to service interest in a timely manner and repay principal amounts as they become due.

Particularly with respect to principal repayments, and without digging too deeply into the court decisions, it is noted that there is a perceived divergence between case law and the reality of the financial markets. Various tax authorities have argued that repayment of a related party obligation must take place out of internally generated cash flows for it to be respected as debt for tax purposes. However, it is well understood in finance that companies pro-actively manage the proportions of debt and equity in their capital structure and regularly refinance a portion or all of their debts as they mature to maintain what they view as optimal proportions of debt and equity for reasons that include, but are not limited to, tax optimization. Debt ranks senior to equity in a company's capital structure—meaning that debt holders receive returns on their investment before benefits flow to equity holders. Given its priority claim, debt financing (even prior to considering tax benefits) is less expensive than equity financing. Due to this cost advantage, debt is an attractive source of financing to companies as long as it is reasonably expected to earn sufficient cash flow to support and service it. Consider, for example, the following from the financial literature:

There are many reasons why the use of debt may be desirable [to a firm] but we will concentrate on three. The first is that *the nominal cost of debt is less than the current cost of equity...*⁸

Reviews of various industries, such as that performed in *ScottishPower*, typically show companies increasing their debt burdens over time as the market value of their assets grows. To argue, therefore, that debt must be repaid by its maturity date out of cash flows generated by operations would apply a higher (unreasonable) standard



to intercompany debt than would be applied to debt between unrelated third-parties. All things being equal, however, demonstrating substantial capacity (if not intent) to repay a related party loan using cash generated by the borrower will generally make it easier to substantiate its treatment as debt for tax purposes.

To form an opinion on a company's ability to pay interest and principal on its debts as they become due, the financial expert typically begins by determining earnings and cash flow generated by its ongoing operations. One indication of a company's ability to make interest payments is the magnitude of its operating income, or Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) relative

to its cash interest expense. However, it is important to note that this is not sufficient to prove that a company has the ability to pay its interest. In order to demonstrate ability to pay interest, the financial expert generally needs to show that a prospective borrower generates enough cash to pay its interest expense, which, in turn, involves adjusting EBIT by adding back non-cash expenses and adjusting for changes in cash not reflected on the company's income statement.

To calculate cash flows available to make principal and interest payments on the subject company's debt, the financial expert generally calculates debt free cash flow, or DFCF, for the projection period. Exhibit 2 summarizes the general framework for calculating DFCF.

Additional DFCF may be generated by sales of assets, which will increase the figure computed in Exhibit 2 by the amount of after-tax proceeds received.

When analyzing a company's ability to accumulate cash to repay its debt on a prospective basis, the total cash available to pay maturing debt in each year is equal to the sum of the DFCF generated in that year plus the beginning cash balance. If DFCF plus cash on hand exceeds the debt principal repaid and any distributions made to shareholders, that excess cash may be carried forward to the following year. For modeling purposes, it is reasonable to assume that this cash carried forward earns additional returns. The most conservative representation of such returns is likely the yields on government securities but, depending on facts and circumstances, higher returns on excess cash may also be appropriate. For example, an asset management vehicle set up to manage a pool of corporate loans may assume reinvestment of cash flows in similar financial instruments.

Equity Cushion

The term "equity value," for tax purposes, is defined as the FMV of a company's assets less the value of its debts. Positive equity value indicates that a company has assets that can be monetized to meet debt obligations or carry the business through a difficult operating period. Generally, the larger a company's equity cushion, the greater the degree of assurance lenders and other investors enjoy. The value of a borrower's equity is relevant when determining whether a related party obligation should be characterized as debt for tax purposes

because lenders frequently look to this "equity cushion" to determine whether a company constitutes an acceptable credit risk.

If the value of the borrower is not readily available, a financial expert may perform a valuation to determine it. Even if indications of value do exist, a financial expert may perform a valuation to independently verify their reasonableness. Tax authorities may be expected to question valuations that are not contemporaneous, do not include all of the borrower's assets and liabilities, do not consider the borrower on a stand-alone basis, or contain biases or errors. An independent valuation can identify issues or preempt such challenges. Even if no valuation is performed, an understanding of funda-

cumulation approach has relevance primarily when valuing financial holding companies in which the value of the underlying assets is determinable (such as investment vehicles).

Discounted Cash

Flow Valuation Methodology

The income approach is most commonly represented by a discounted cash flow valuation (DCF). The DCF is a standard framework used by financial analysts for valuing a business. Generally, DCF and other cash flow based analyses are the preferred methods used by lenders to assess a company's ability to repay its debt¹⁰ and to estimate its equity cushion.¹¹ The DCF estimates a stream of cash flows into the future and then discounts the stream



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mental valuation methodologies is important when determining the reliance that can be placed on valuations provided to the financial expert.

The three primary accepted valuation approaches which may be used to value a company on a going concern basis are: (1) the income approach; (2) the market approach; and (3) the asset accumulation approach.⁹

The income approach establishes value by methods that capitalize future anticipated benefits, such as cash flow, by a discount or capitalization rate that reflects market rate of return expectations as well as the relative risk of the investment. The market approach compares an entity to similar businesses, business interests or securities that are for sale or have been sold. Generally, this is accomplished by analyzing comparable publicly traded companies, actual transactions of similar businesses sold, or prior arm's-length sales of the subject company's equity interests. The asset ac-

by a discount rate, or cost of capital, back to the valuation date. A terminal value, which accounts for any periods extending beyond the (detailed) projection period, is also included. Together, the stream of cash flows and terminal value derive a total enterprise value of the subject company. Debt is then subtracted from the enterprise value to determine the FMV of the company's equity. This process is depicted in Exhibit 3.

The discount rate used in a DCF is typically represented by the Weighted Average Cost of Capital (WACC). A company's WACC represents its cost of financing, and is calculated by multiplying its cost of equity by its percentage of capitalization that is equity, and adding to that product the after-tax cost of debt multiplied by the percentage of its capitalization that is debt. Exhibit 4 illustrates this process.

A company's cost of equity is the return necessary to compensate equity in-

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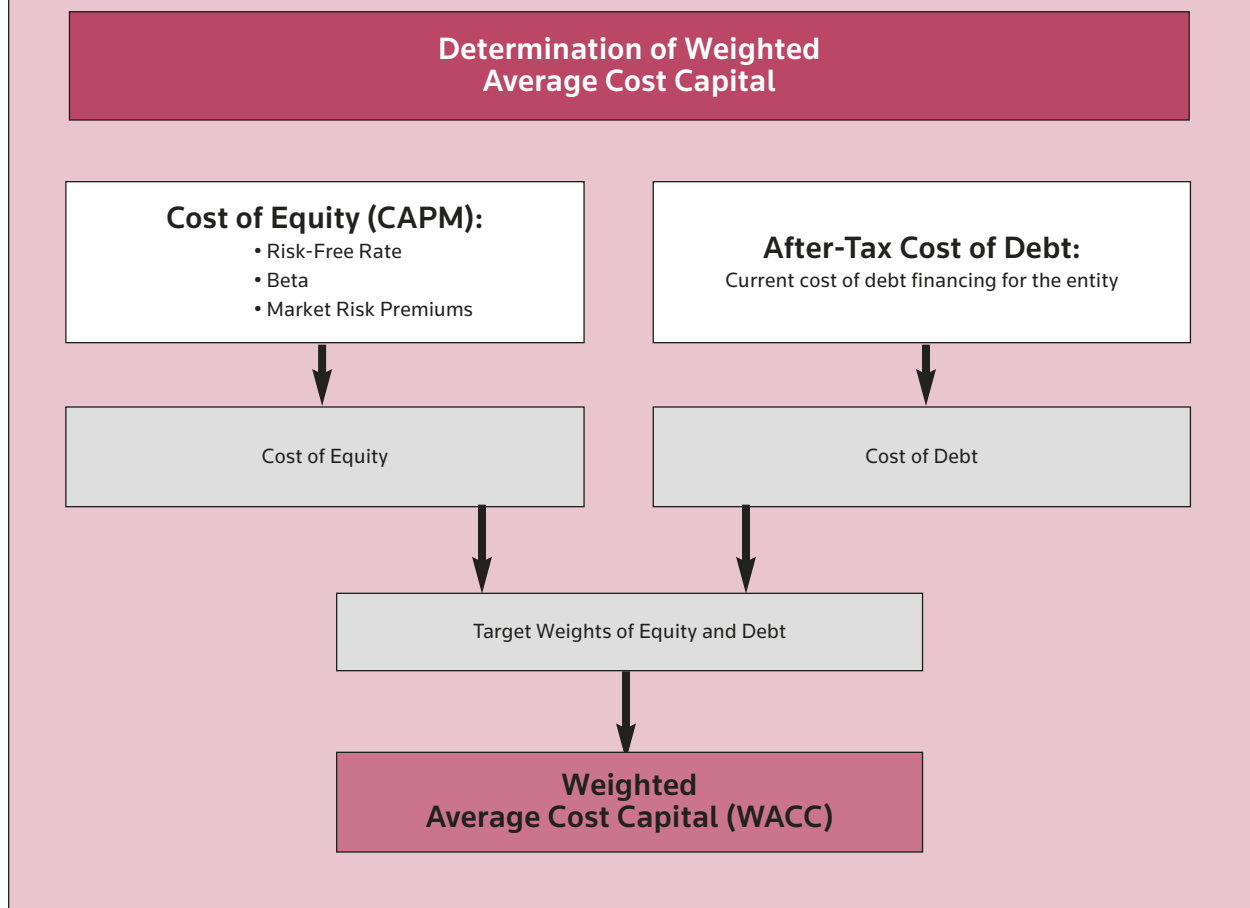
⁸ Bierman, *Private Equity: Transforming Public Stock to Create Value*, (John Wiley & Sons, 2003) pp. 47-48.

⁹ The term "going concern" refers to the value of a business that is anticipated to continue operating into the foreseeable future. It contrasts with the "liquidation" value of a business, which examines the value accruing to a business if its operations ceased and its assets were sold.

¹⁰ Rouse, Bell, and Graham, *Banker's Lending Techniques*, (Third Edition, Global Professional Publishing, 2011), p. 103.

¹¹ *Id.* at p. 123.

Weighted average cost of capital



investors for the risks associated with equity ownership. Generally, the Capital Asset Pricing Model (CAPM) is employed to determine the cost of equity. CAPM is commonly used by finance and valuation professionals. It attributes differences in returns of the universe of stocks comprising the “market” to their movements relative to that market. The formula to determine cost of equity (K_e) for a company using the CAPM is as follows: $K_e = R_f + \beta(R_m - R_f) + R_s$ where:

- R_f = is the risk free rate.
- β = is the Beta, or measure of systemic risk.
- $(R_m - R_f)$ = is the equity risk premium for the entire market.
- R_s = is the return in excess of the overall market, typically related to

firm size, or a specific risk borne by the company in question.

For the purposes of valuation, a company’s cost of debt is typically the subject company’s most current indication of the interest rate which it would need to pay, as of the date of the valuation, to obtain a loan from an unrelated, third-party lender. Depending on available data, this may be computed in a variety of ways. If available, the financial expert may calculate the yield-to-maturity on existing third-party debt as of the valuation date. If that is unavailable, the offer yield on recent debt issuances by the subject company can be observed. Use of, or interpolation from, industry benchmarks and market indexes, or recent debt issuance by comparable companies can also be

employed if specific company yield information is not available. In the absence of other data, cost of debt can be approximated by dividing interest expense by total debt. However, the issuance date of this debt and changes in the company’s financial condition since those issuances may affect the reliability of this method.

The DCF assumes that the subject company is a viable going concern entity and, therefore, its cash flows will not cease at the end of the projection period. To account for cash flows in the years beyond the projection period, the financial expert will typically use a terminal value. A common methodology used to estimate terminal value is known as the Gordon Growth Model, which takes the cash flows in the final

projected year, grows them by one year, and divides that cash flow figure by the cost of capital less the projected cash flow "terminal" growth rate. The result represents the present value of all the cash flows following the final projected year as of the end of that year. To estimate an appropriate terminal growth rate, financial experts will typically review long-term government growth rates or industry growth rates. Another method for estimating terminal value is to apply a valuation multiple to the company's financial metrics in its final projected year.

Next, the debt-free cash flows and the terminal value are discounted back to the valuation date, to derive the enterprise value of the subject company. Once the enterprise value is determined, the subject company's interest bearing debt is subtracted, and the value of cash and non-operating assets is added, to determine value available to equity holders.

Market-Approach Valuation Methodology

The market approach is another common valuation methodology that may be appropriate when analyzing equity cushion. The most commonly applied variations of this approach consist of the comparable company multiple valuation (CompCo), guideline transactions multiple valuation (CompM&A), and, if available, recent arm's-length transactions of the subject company's equity.

The CompCo approach is a standard method used by financial professionals to value a business. This approach determines a firm's value with reference to the values at which comparable public companies trade relative to their operating metrics, such as EBITDA. For example, research might show that public companies, which are similar to the subject company, are valued in the market at ten times their expected EBITDA. All other things equal, that multiple can be used to help assign a value, or range of values, to the subject company.

The first step in performing a comparable company multiple valuation is to determine a group of publicly traded peers that are comparable to the subject

company. In order to determine this group of peer companies, the financial expert will, generally, screen for companies which operate in similar industries, have size within a predetermined range, have comparable business operations, and operate in similar regions of the world. This list can be developed through discussions with management, reviewing industry analyst reports, and running targeted screens on financial databases such as S&P Capital IQ or Bloomberg.

The reliability of the CompCo approach is dependent on available data. Insufficient data, lack of publicly traded peer companies, and the uniqueness of the subject company's operations may prevent the application of this methodology.

reasonable knowledge of relevant facts by both parties.

"Thin" or Adequate Capitalization

Capital adequacy is a financial term that is highly dependent on the circumstances in which it is used. For example, in the banking industry, capital adequacy ratios are specifically defined. These ratios must be greater than a certain threshold for a bank to be considered adequately capitalized by its regulators. No equivalent bright-line rule exists for most companies. Adequate capital can be used when discussing whether a company's ability to pay its debts as they become due and this analysis is typically considered



The approach to corporate finance issues in *ScottishPower* was an important part of the court's decision that the intercompany loan in question should be considered debt for tax purposes.

The CompM&A approach is another standard process used by professionals valuing a wide range of businesses. This approach determines a firm's value based on selected multiples of similar businesses that have been acquired in recent transactions. Similar to the CompCo approach, the first step in the CompM&A approach is to compile a list of completed transactions in which the target company was comparable to the subject company.

Similar to the CompCo valuation approach, the application of the CompM&A is dependent on compiling a sufficient number of transactions that involve a target that is comparable to the subject company being valued.

The most reliable indication of value may be the price at which an interest in the borrower actually changed hands. This type of market-based valuation is often available in a transaction or leveraged buyout context. However, even in this context, the financial expert must consider whether the transaction was at arm's-length and whether there was

to be a key component of capital adequacy. Capital adequacy may also be analyzed by looking to market indications of what investors, at a particular point in time, consider to be appropriate leverage and risk/return characteristics, as well as considering qualitative factors underpinning a lending or investing decision.

The ratio analysis performed and credit rating opinions formed using methodologies published by major credit rating agencies, such as S&P and Moody's, are typically one component of a market-driven analysis of adequate capitalization. Additionally, market analysis on debt securities with characteristics similar to the related party issuance have been purchased by third-party investors are indicative that the borrower is adequately capitalized and would be able to issue the debt to an unrelated third-party.

Additional analyses, such as reviewing leveraged transactions taking place around the same time and in the same industry, the amount of debt raised from

leveraged transactions, the amount of debt raised and repaid by the peer companies of the subject company, and the leverage ratio of the subject company and its industry peers may also establish adequate capitalization from a market perspective.

In *ScottishPower*, these analyses were performed by separate credit rating, investment banking and corporate finance experts—with each expert focusing on different elements of market acceptance of the debt issued by the borrower. These experts were a former high-ranking executive in Standard & Poor's rating group, a senior investment banker with experience placing similar types of debt issuances, and (the authors' role) a finance professor with decades of experience providing corporate finance consulting to a wide range of industries, respectively.



The term “equity value,” for tax purposes, is defined as the FMV of a company’s assets less the value of its debts.

When preparing for litigation, or in the context of highly sensitive transactions, this separation of responsibilities ensures that each expert stays close to the subjects on which they will have the most credibility before a finder of fact. However, in situations which do not permit the hiring of three experts, a seasoned financial professional is typically capable

of performing analyses of capital adequacy and market acceptance using public market data and methodologies published by S&P and Moody's.

Conclusion

Part one of this two-part article proposes an outline that provides taxpayers and their advisors with a practical template that can serve as the foundation for a defensible debt-equity position during the transaction planning process or in subsequent tax controversy. This framework outlines the analyses performed by us as the corporate finance experts in *ScottishPower*. Part two of this article will take an in-depth look at *ScottishPower* by implementing the methodologies and analyses described in part one of this article. ■