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VALOREM PRINCIPIA

The Principles of Value

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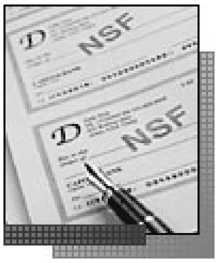

Buying Bargains on the Brink of Bankruptcy

by: J. Scott Bovitz, Esq. and Tracy Washburn

An entrepreneur, Chip Cheate, walks into a restaurant for the most important business meeting of his life. His once profitable company now lies on the brink of bankruptcy. Laden with debt, Chip fears losing everything he has worked for to his creditors. But alas, enter Joe Quickendeal, an up-and-coming entrepreneur ready to seize any opportunity that comes his way. Chip offers to sell Joe his company's assets at a price significantly less than their fair market value, claiming that he is tired of being locked up in such a venture and wants to retire. Joe, blinded by the bargain, ignores the warning signs and eagerly signs a check. Chip hands over the title to his business and flees to Cancun, stopping only at the local courthouse to file for bankruptcy.

What Joe doesn't realize is that, by not acquiring the proper professionals to assist him in conducting thorough due diligence before the transaction was completed, he entered into a situation involving a fraudulent transfer, which put him right in the middle of Chip's bankruptcy. Joe's inability to see the warning signs becomes apparent when Joe receives a letter from Chip's former creditors demanding the return of the assets he purchased from Chip. The Bankruptcy Court, relying on an independent valuation appraiser, determined that Chip sold his business' assets to Joe at below fair market value. The court concludes that this transaction was aimed at defrauding creditors, and that Chip and Joe were guilty of "Fraudulent Conveyance." Because the deal was illegal, it must be reversed. However, Chip has no means of paying Joe back for the business, so Joe now finds himself both without the deal as well as the funds that he invested into the transaction in the first place.

> "When buying a major asset, especially at a bargain price, it is imperative that the acquirer perform due diligence to ensure the transaction is not intended to defraud creditors..."

This story illustrates two important considerations affecting business owners and creditors: (1) when buying a major asset, especially at a bargain price, it is imperative that the acquirer perform due diligence to ensure the transaction is not intended to defraud creditors; and (2) when bankruptcy occurs, a creditor can analyze past asset sales and recover additional assets from an acquirer that participated in a fraudulent conveyance.

In the section that follows, we will discuss the ways qualified business appraisers can help business owners and creditors avoid the pitfalls of fraudulent conveyance. First, we will briefly outline the salient issues regarding the law as it relates to bankruptcy and fraudulent conveyance. Second, we will describe ways in which business appraisers can ensure that acquirers do not unknowingly become party to a fraudulent conveyance. Finally, we will show how appraisers can help creditors detect fraudulent conveyance and the diverted assets.

Valuation Issues in the Recovery of Fraudulent Transfers

Millions of individuals file chapter 7 to erase their debts. The "cost" for this is that the bankruptcy trustee will sell non-exempt (i.e. unprotected) assets for the benefit of the discharged creditors.

To insulate assets from a future bankruptcy trustee or aggressive creditors, a debtor will sometimes sell valuable assets at nominal prices or transfer property to friends or relatives for no consideration.

When an individual or business files for bankruptcy, it is necessary for the creditors and service professionals involved in the case to conduct proper due diligence and to liquidate all of the assets to those who have claims against the bankrupt entity. The trustee can sometimes collect additional sums for creditors by pursuing Uniform Fraudulent Transfer Act ("UFTA") claims against the transferees. If the bankruptcy trustee can establish that the person or business filing bankruptcy sold a key asset at a price that was significantly below fair market value with the actual intent to hinder, delay or defraud creditors, then the bankruptcy trustee can recover the asset from the recipient.

CAUTION! Legal Terms Straight Ahead

Under California Civil Code § 3439.04, "***A transfer made*** or obligation incurred by a ***debtor is fraudulent as to a creditor***, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, ***if the debtor made the transfer*** or incurred the obligation as follows: (a) ***With actual intent to hinder, delay, or defraud any creditor*** of the debtor." (Emphasis added)

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The trustee will rarely have witnesses who can testify about the debtor's actual intent. Thus, the court will usually be forced to make reasonable inference from the objective facts, such as:

- Were the assets transferred to an insider?
- What was the stated purpose of the transfer?
- Did the debtor disclose or conceal the transfer?
- Did the debtor transfer substantially all of his assets?

Under California Civil Code § 3439.04, there is an alternative and more common legal test. To wit: *"A transfer made or obligation incurred by a debtor is fraudulent as to a creditor...if the debtor made the transfer* or incurred the obligation as follows:

(b) for the transfer or obligation, and the debtor:

(1) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(2) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due." (Emphasis added)

The determination of "reasonably equivalent value" involves difficult questions of forensic valuation. Expert witness testimony is standard.

Hire the Right Experts

It is imperative to obtain professionals who are knowledgeable in bankruptcy and fraudulent matters to conduct the proper due diligence, file the correct forms and derive conclusions that will withstand third party scrutiny. Key qualifications to look for when selecting a valuation expert to appraise the asset(s) transferred in the fraudulent situation include whether the expert:

- Is qualified as expert in the particular field of endeavor;
- Is familiar with valuation issues of the type of property being assessed;
- Has knowledge of goodwill and intangible asset valuations;
- Has extensive experience in providing credible trial testimony; and
- Is an independent provider of valuations.

All service professionals involved in the case should be scrutinized on the same level to ensure well-qualified representation through the duration of the case.

The Bottom Line

As with any situation involving finances and multiple entities, efficiency and attention to detail is key in protecting persons or businesses from being involved in a fraudulent transfer. Bankruptcy and fraud are indeed scary concepts, but resolving fraudulent transfer issues doesn't have to be.

J. Scott Bovitz, Esq., of Bovitz & Spitzer, is a full-time Bankruptcy and part-time Internet attorney in Los Angeles. Mr. Bovitz is a Certified Specialist in personal and small business bankruptcy law with the State Bar of California Board of Legal Specialization, is board certified in Business Bankruptcy Law through the American Board of Certification, and has an AV rating in the Martindale-Hubbell Law Directory. He can be reached at 213/346-8300, or via email at bovitz@bovitz-spitzer.com.

> "You can't build a reputation on what you are going to do."
>
> Henry Ford

SP&H's Dynamic Duo

The world of finance is filled with a diverse mix of people. Here at SP&H, we have an accounting team that puts a bit of spice into their work, while getting the job done in a timely and efficient manner. Melissa Dunn, SP&H's Office Manager, and Miko Cunningham, our Accounting Associate, make up the dynamic duo. Together, they ensure that our office is running smoothly, our accounts are managed, and our financial system is organized. Melissa and Miko recently commented about life at SP&H:

•*Valorem Principia*: To start off, could you tell us a little bit about what your daily duties include?

Melissa: As Office Manager, a typical day for me includes working on payroll, overseeing building and equipment maintenance, managing our four SP&H offices, making sure the computers are running properly, and dealing with vendors and clients on a wide variety of issues.

Miko: Well, today I am posting checks, which is a part of the accounts receivable process for the firm. A little bit later, I will start compiling some financial reports.

•*VP*: What are your most and least favorite things about your job?

Melissa: I like all of what I do!

Miko: My least favorite thing is posting all of the checks. I HATE that so much...all those copies and stacks and folders that have to be created for each check that comes in! My favorite thing is when I have to chart the financials for the year. It is really fun to see the firm's revenues versus expenditures, where we've saved, where we have overspent.


Melissa Dunn and Miko Cunningham

•*VP*: Do you have any strategies to break the monotony of number crunching?

Miko: The awesome 80's radio station, baby!

•*VP*: What is your favorite memory here at SP&H?

Melissa: Probably the first company picnic that I attended. It was at the beach, there was tremendous camaraderie and togetherness, and everyone was laid back. It was nice.

Miko: When some of the staff members put on Broadway shows after-hours. Definitely my favorite memories!

•*VP*: Melissa, you started at SP&H over six years ago. How would you sum up your experience in three words or less?

Melissa: Extremely rewarding!

•*VP*: Do you have any special interests or hobbies?

Melissa: Family is my number one interest. I also enjoy counted cross-stitching. I love anything to do with animals.

Miko: I don't have time for any special interests of my own, as I am raising an 11 year-old boy. Jahal's habits are my habits. I am the mom for his basketball team, which takes up a lot of my energy. The life of a parent!

Melissa Dunn and Miko Cunningham can be reached at 310/571-3400, or at mdunn@sphvalue.com for Melissa, or mikoc@sphvalue.com for Miko.

Finding the "Pearl" in Your Hotel

By Thomas Pastore, ASA, CFA
and Fahm Saeteurn

Hotel appraisals are often needed during critical times, such as when buying or selling a hotel, gifting your hotel as part of an estate plan, or resolving valuation concerns during marital or partnership dissolutions. Because a significant investment is on the line, hiring the right appraiser to accurately assess your hotel's worth is crucial.

An interesting analogy can be drawn between hotels and oysters. Like an oyster, a hotel consists of several parts. The rock that the oyster lies on is analogous to the hotel's underlying land. The shell of an oyster is similar to the building of the hotel. Together, the land and building are the hotel's "commercial property." Finally, an oyster usually has no value without its pearl. Likewise, the combination of land and building in and of itself does not make a hotel. The value of the hotel is in the hotel's business, like the pearl to the oyster.

When valuing hotels, all three parts—the land, the building, and the business—need to be addressed. The land and building are usually appraised by real estate appraisers who utilize appraisal methods that are better suited for commercial properties. The business of the hotel needs to be valued by business valuation professionals, who are trained to appraise companies using approaches and methods that cater to the complexities and nuances of business operations.

How Hotels Differ From Commercial Properties

A hotel with a going concern business should not be considered a commercial property. Significant differences exist between hotels and commercial properties that prevent them from being comparable. Hotels are actually more similar to service and retail businesses, such as restaurants and retail stores.

Hotels have short-term occupants who usually stay for a few nights or weeks, while commercial property tenants reside for months or years. Hotel guests do not have the same rights as commercial property tenants. Guests of hotels also cause hotel revenues to be much more volatile than commercial property revenues. In addition, hotel revenues come from a variety of sources, including laundry, catering, restaurant, bar, and miscellaneous room service. Hotel revenues are further supplemented by renting out facilities for conferences and banquets. These extra services provided by hotels are similar to other operating businesses, such as dry cleaners, restaurants, and parking lot operations. Commercial property expenses usually consist of maintenance, real property taxes, insurance, property management, and security costs. A hotel's additional operating costs include management salaries, advertising and marketing, wages for room cleaning, and other service costs.

Valuing a hotel's commercial property and business usually requires both a real estate appraiser and a business valuation professional.

Three Approaches to Determine a Hotel's Value

The Cost Approach

Under the cost approach, the value of a hotel is calculated by aggregating the hotel's development costs as if it were to be constructed anew and then deducting depreciation and obsolescence based on the hotel's current condition. This results in a hotel value based solely on its tangible assets (the land and building) and ignores the hotel's intangible assets, such as management skills, profits from efficient operations, and brand recognition. Thus, the cost approach fails to recognize the value of a hotel's operations and the economics surrounding the hotel market.

The Market Approach

Under the market approach, a real estate appraiser analyzes sales of comparable, nearby properties to estimate the value of the hotel's commercial property. A business valuation professional analyzes sales of comparable hotel businesses. While the approach yields satisfactory results when used to value commercial properties, it is unreliable for appraising hotels when sufficient sales of similar hotels are not available. Oftentimes, hotel transactions data include only the value of the commercial property and not the business. Thus, the market approach may be less effective for valuing hotel businesses.

The Income Approach

Under the income approach, a property or business' expected future benefit or income stream is divided by a capitalization rate, or an investor's desired rate of return. While both real estate appraisers and business valuation professionals utilize the income approach to estimate future benefits and risks associated with owning properties or businesses, valuing a business is more complex than valuing a commercial property.

Choosing a trained, knowledgeable, and experienced business valuation professional to accurately assess your hotel's business value is very important. An appraiser not trained in business valuations, or one without significant experience or knowledge, may incorrectly value your hotel. Incorrect values can result in sellers leaving millions of dollars on the table, taxpayers subject to substantial penalties and interest charges, and buyers getting a below market rate of return on their investment. Make sure you select a business valuation professional with the proper training and knowledge to accurately value your hotel's "pearl."

Spotlight on Indigo Grill

Dining Spotlight...

In each edition of Valorem Principia, SP&H features a different dining hotspot in California, providing highlights, reviews, and insights to our clients and friends across the state. If there is a restaurant, venue, or event that you feel should be showcased in future editions, please contact Tracy Washburn at 310/571-3400, or twashburn@sphvalue.com.

The streets of San Diego's Little Italy are crowded with stores, eateries and meeting places adorned with Italian names and themes. The rustic, indigenous character of the Pacific Northwest meets Mexico theme of Indigo Grill seems a bit out of place, yet unquestioningly welcome among locals and tourists alike.

Walking through the main entrance, you are filled with the sense of being on the movie set of Indiana Jones. A resin cypress tree looms over the entryway and glowing wooden tables paired with chairs masked in cheetah and leopard motifs complete the 'native fusion' effect.

The menu is divided not by appetizers and entrees, but by 'Beginnings' and 'Sunset Offerings'.

The "Vera Cruz Tamales" ($11), listed in the 'Beginnings' section, are made fresh daily with fresh-roasted corn and are served with broken Mexican shrimp in a sauce of honey-roasted whole garlic, lemon, white wine and butter. Perhaps the most striking dish on the menu is the "Whole Scarlet Snapper" ($23), which joins your dinner party in its entirety. It is displayed on an elongated, ornate plate surrounded by avocado leaf, citrus broth, and is accompanied by an oven-fired vegetable skewer.

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Those with a heartier appetite will enjoy the “Mojo Bone-in Rib Eye” ($26), which is stuffed with honey-roasted garlic and acorn squash with bourbon-walnut butter. Vegetarian dishes are also available, such as the “Good Things Growing” ($18) plate, which features the restaurant’s famous Indian corn pudding, whole acorn squash with bourbon-pecan butter and carmaelized plaintains.

And now for dessert. The “Native American Bread Pudding” ($6.50) is filled with plump dates, figs, dried cranberries and apples, and is served with a light caramel sauce and blueberry wojabi jam. Another choice selection is the “Lemon Poppyseed Shortcake” ($10), which is served straight from the oven, topped with fresh strawberries, and paired with a scoop of strawberry sorbet and chantilly ice cream.

Indigo Grill is a remarkable creation by famed chef Deborah Scott, who transforms your dining experience into a fantastic escape by offering unique flavors and a creative mix of style and design. Whether attending a business lunch, a birthday party for twenty, or just craving an exotic drink, Indigo Grill is the place to be.

Indigo Grill
1536 India Street in San Diego’s Little Italy
619/234-6802

Hours: Mon-Fri 11:30am-2pm, Dinner Nightly after 5pm

Cost: Appetizers, $6.50-13, Entrees, $17-28, Sides, $4, Desserts, $6-10; Street Parking.

Thomas Pastore, Tracy Washburn, and Nevin Sanli at the 2004 California Redevelopment Association (CRA) Annual Conference in Monterey, CA, March 10-12.

NEWSFLASH

May 7th - Sacramento, California
Investment Society of California State-Sacramento
Forrest Vickery was a panelist at this event.

May 14th -16nd - Yosemite, California
California Bankruptcy Forum
SP&H was an exhibitor at this event.

May 15th - Los Angeles, California
L.A. County Bar Association Family Law Symposium
SP&H was an exhibitor.

June 8nd - Los Angeles, California
Los Angeles Venture Association Breakfast Seminar Series
Nevin Sanli and Tracy Washburn were panelists.

September 13th -14nd - San Francisco, California
M&A Advisory Conference
SP&H will be sponsoring, Nevin Sanli will be a speaker.

September 28th - San Diego, California
ACG San Diego Breakfast Seminar: Buy, Build & Sell
Nevin Sanli and Tracy Washburn will be a panelists.

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