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# Fraud in the family business

**F**inancial statement auditors typically assess the risk of fraud as higher for family businesses than for nonfamily businesses. From a valuation perspective, this increased risk may translate into higher discount or capitalization rates (under the income approach) and downward adjustments to pricing multiples (under the market approach).

Likewise, from an operational perspective, this increased risk could mean that family businesses may be blindsided by fraud from within their ranks. Fortunately, there are some measures owners can take to lower their companies' fraud risks and increase their value.

## All in the family

Why are family businesses so vulnerable to fraud? The simple answer is trust. Family members often have trouble believing that a loved one would harm a company that benefits all of them. But one bad apple can single-handedly (or in collusion with others) destroy the enterprise the family has spent years building.

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Owners may be unwilling to admit that a family member would be capable of initiating or overlooking unethical or illegal activities. As a result, they tend to be remiss about fraud prevention and internal controls. In addition, emotional ties may make family business owners reluctant to punish wrongdoers.

When family business owners suspect fraud, attorneys can explain to perpetrators the illegality and possible consequences of their actions in an effort to stop them without further damaging the company.



But legal action may be the only option if family members are caught with their hands in the cookie jar — especially if prevention methods fail to curb wrongdoing. In worst cases, families may have to choose between maintaining ethical professional standards and saving a rogue loved one from scandal or punishment.

## Systematic approach

Family businesses need to follow a formal system of checks and balances to help prevent fraud. A comprehensive internal controls system for both family and nonfamily businesses includes:

- Physical restrictions on access to company assets,
- Written job descriptions,
- Mandatory vacation policies,
- Separation and duplication of sensitive duties,
- Regular reconciliation and analysis of key accounts,
- Fraud reporting mechanisms, and
- External audits by independent accountants or forensic accounting experts.

Like any business, a family enterprise needs to publicize its preventive measures through training courses and articles in the employee newsletter or on its intranet. This lets *all* employees — including those inside and outside the family circle — know

## Forensic accounting to the rescue

In an increasingly complicated, digitized world, forensic accountants have become valuable players in many types of litigation. These professionals are trained in both accounting and forensic investigation, and they're well versed in the needs of attorneys and their clients.

Situations where forensic accountants can add value include:

**Fraud investigations.** Forensic accountants know how to dig into data and conduct interviews to ferret out financial irregularities. They recognize the red flags of fraud and are trained in how to build a solid case (and mitigate losses) when such markers occur.

**Commercial litigation.** Forensic accountants can help resolve partner and shareholder disputes by analyzing compensation, providing valuations and evaluating finances. They also can compute damages for causes of actions, ranging from breach of contract and unfair competition to intellectual property infringement and product liability.

**Personal injury litigation.** Forensic accountants can calculate damages for lost wages, loss of consortium or household services, and emotional distress. Whether based on an accident, workplace injury or professional malpractice, these experts conduct the necessary fact-gathering and analysis.

**Divorce.** In straightforward marital dissolutions, forensic accountants prepare income and expense declarations, perform valuations and propose equitable asset divisions. In more contentious cases, they can uncover hidden assets.

If you suspect a forensic accountant can help your case, bring him or her on board as soon as possible. Your expert can streamline discovery, as well as save time and resources.

that internal controls are a priority and that serious consequences await perpetrators.

## COVID-19-related frauds

The process of implementing strong internal control systems is ongoing. Even after putting a policy in place and communicating it to employees, owners must continually monitor controls to ensure they remain adequate and effective.

The COVID-19 crisis has created *opportunities* for fraudulent activities. For example, it may be more difficult to enforce internal control policies when family members work remotely and engage in fewer in-person interactions. In addition, when normal business operations are interrupted — either positively or negatively — it may be difficult to analyze financial performance over time. Perpetrators may blame rising costs and other anomalies on the pandemic, when they actually result from inventory theft and other fraud schemes.

The pandemic has also created *motives* to commit fraud. Family members who have had their hours or pay reduced — or who have experienced COVID-19-related financial losses — may resort to “borrowing” from the family business to make ends meet or maintain their lifestyle. In some cases, pride may prevent them from asking a parent or sibling for assistance.

## Avoid blind trust

It's important for family business owners to recognize that they're not immune to fraud and financial misstatement scams. A forensic accounting expert can help family business owners implement a comprehensive internal control system to reduce fraud risks — or update an existing system to reflect pandemic-related challenges. Fraud experts also can investigate potential wrongdoing by dishonest family members. ■

# Plan for the future

## Balancing business succession and estate planning

A challenge presented by family businesses is that the older and younger generations may have conflicting objectives and financial needs. Here are some strategies to help resolve these conflicts, while minimizing taxes.

### Conflicts of interest

It's important to make a distinction between *ownership* and *management* succession. When a business is sold to a third party, ownership and management succession typically happen simultaneously. But in the family business context, there may be reasons to separate the two.

From an estate planning perspective, transferring *ownership* of assets to the younger generation as early as possible allows you to remove future appreciation from your estate, thereby minimizing estate taxes. Proactive estate planning may be especially relevant today, given favorable changes to the federal estate and gift tax regime under the Tax Cuts and Jobs Act (TCJA).

For 2021, the unified federal estate and gift tax exemption is \$11.7 million, or effectively \$23.4 million for married couples. That's generous by historical standards. In 2026, the exemption

is set to fall to about \$6 million, or \$12 million for married couples, after inflation adjustments — unless Congress changes the law sooner.

However, older generations may not be ready to hand over the reins of *managing* the business — or they may feel that their children aren't yet ready to take over. Another reason to separate ownership and management succession is to deal with family members who aren't involved in the business. Providing heirs outside the business with equity interests that don't confer control can be an effective way to share the wealth.

### Possible solutions

Several tools may allow owners to transfer family business interests without immediately giving up control, including:

- Trusts,
- Family limited partnerships (FLPs),
- Nonvoting stock, and
- Employee stock ownership plans (ESOPs).

Owners of smaller family businesses may perceive ESOPs as a complex tool, reserved primarily for large public companies. However, an ESOP can be an effective way to transfer stock to family members who work in the business and other employees, while allowing the owners to cash out some of their equity in the business. Owners can use this new-found liquidity to fund their retirements, diversify their portfolios or provide for family members who aren't involved in the business. If the ESOP is structured properly, the



owners can maintain control over the business for an extended period even if the ESOP acquires a majority of the company's stock.

### Divergent financial needs

Another challenge presented by family businesses is that the older and younger generations may have conflicting *financial* needs. Typically, a business owner may rely on the value of the business to fund his or her retirement. The owner's family members, on the other hand, might hope to acquire the business without a significant investment on their part.

Fortunately, several strategies are available to generate cash flow for the owner while minimizing the burden on the next generation. For example, an installment sale of the business to children or other family members can provide liquidity for owners, while easing the burden on children and grandchildren and improving the chances that the purchase can be funded by cash flows from the business. Plus, so long as the price and terms are comparable to arm's-length transactions between unrelated parties, the sale shouldn't trigger gift or estate taxes.

### Trust alternatives

Alternatively, owners may transfer business interests to a grantor retained annuity trust (GRAT) to obtain a variety of gift and estate tax benefits (provided they survive the trust term) while enjoying a fixed income stream for a period of years. At the end of the term, the business is transferred to the owners' beneficiaries. GRATs are typically designed to be gift-tax-free.

Similarly, a properly structured installment sale to an intentionally defective grantor trust (IDGT) allows an owner to sell the business on a tax-advantaged basis while enjoying an income stream and retaining control during the trust term. Once installment payments are complete, the business passes to the owner's beneficiaries free of gift taxes.

### A tailored approach

Each family business is different. Financial professionals with tax and valuation expertise can help identify appropriate strategies in light of your client's objectives and resources. ■

## Cryptocurrency and divorce: Getting your client's money's worth

**M**ore than a decade after Bitcoin launched, cryptocurrency has become mainstream and, therefore, relevant when it comes to property division in divorce. This form of currency can carry a high value, but it's also more easily hidden than traditional assets. Divorce attorneys need to get up to speed to help protect their clients' interests.

### Learn the basics

The term "cryptocurrency" generally refers to a form of digital (or virtual) currency. Beyond Bitcoin, there are thousands of other cryptocurrencies in

circulation. Cryptocurrency is used by millions of people in everyday transactions. A growing number of businesses — including Overstock.com, AT&T and online gaming company Zynga — now accept digital currency payments.

The value of a cryptocurrency comes in part from its scarcity. The supply of bitcoins, for example, is limited to 21 million "coins." Transfers occur instantly and are tracked in a transparent blockchain ledger. The ledger resides not with a central authority, such as a financial institution or governmental body, but across decentralized public



peer-to-peer computer networks. Transactions are conducted using private and public “keys” that users store in “digital wallets.”

The primary benefit of using cryptocurrency is privacy. But there’s a related downside: This aspect can make it harder to uncover cryptocurrency assets. Plus, cryptocurrency is highly liquid and hard to understand, and attorneys have no central authority to subpoena or target it with a court order.

### Recognize cryptocurrency clues

If you suspect that a spouse has undisclosed cryptocurrency assets, look for transaction confirmation emails that include the conversion rate, dollar amount, date and time. A confirmation email also might specify where the funds were withdrawn or deposited.

Transactions could show up, too, on bank or credit card statements. These statements can reveal payments to or deposits from cryptocurrency exchange companies, such as Coinbase. PayPal, Venmo and other mobile payment options should also be reviewed for transactions with cryptocurrency exchanges.

Federal tax returns are another avenue for discovering cryptocurrency interests. The IRS requires taxpayers to recognize gain or loss on the exchange of it for cash or other property (including exchanges for other

cryptocurrencies) — that is, whenever it’s used to purchase goods or services. Beginning in 2019, the IRS has included a check box on individual returns to indicate whether the taxpayer has received, sold, sent, exchanged or otherwise acquired any financial interest in any cryptocurrency.

Attorneys should consider including explicit references to cryptocurrencies when formulating their discovery requests and interrogatories.

Consider including explicit references to cryptocurrencies in discovery requests and interrogatories. Examples of items to request include:

- Forms 1099-K issued by cryptocurrency exchanges,
- A list of digital assets held, received, accepted, used, purchased or sold as of a certain date, and
- Computer hardware and software devices used (or previously used) in connection with digital assets.

If devices are turned over for examination, computer forensic experts can search for evidence of cryptocurrency transactions, such as keys, wallets and Internet history.



### Estimate value

Once cryptocurrency has been identified, it needs to be valued. The value of cryptocurrencies is influenced by different factors than traditional assets, so it can fluctuate wildly. If your divorce case involves cryptocurrency, make sure you hire a qualified appraiser who’s familiar with the ins and outs of digital assets to obtain a fair and accurate valuation. ■

## *Gavrilides Mgmt. Co. v. Michigan Insurance Co.*

# Court dismisses COVID-19 business interruption claim

**D**uring the COVID-19 pandemic, governmental authorities have ordered many nonessential businesses to shut down temporarily. Hundreds of companies have filed claims under their business interruption coverage — claims that insurers generally have denied. The ruling in one of the first such cases to go to court has given insurers confidence that their denials will stand. But that ruling might not be as far-reaching as they hope.

### Court opinion

The owner of two restaurants in Michigan filed a lawsuit after his insurer denied his \$650,000 claim. The owner alleged that the governor's stay-at-home order interfered with his use of the businesses. The insurer countered that business interruption coverage is triggered only by the loss of or damages to the physical property.

The Ingham County court found it clear from the policy language that only *direct* physical loss was covered. According to the judge, such loss requires something tangible that alters the physical integrity of property. The complaint alleged no such loss or damage. The judge acknowledged that government

acts can trigger business interruption coverage. But that coverage still requires physical loss or damage.

The court also found that, even if physical loss or damage existed, the policy's virus exclusion would apply. The exclusion stated that the insurer "will not pay for loss or damages caused by or resulting from any virus ... that induces or is capable of inducing physical distress, illness, or disease."

The court rejected the insured's argument that this exclusion was vague.

### Limited relevance

Although the court's ruling in this case was good news for the insurer, it remains to be seen how applicable it will be to other disputes. Courts in other states, for example, have previously found that business interruption coverage applied where the insured sustained a loss of use without any physical damage to property.

Moreover, policy language can vary greatly as to coverage of grants and exclusions. For instance, some policies expressly cover "communicable disease." In addition, the Michigan court wasn't required to consider whether the entry of COVID-19 upon the premises would satisfy the direct physical loss requirement because the complaint asserted that no one with the virus entered. It's possible a court could find the virus to be something tangible that harms the property's physical integrity.

### Stay tuned

Many other cases under similar circumstances have yet to go to court. Neither insurers nor insureds should read too much into this single ruling. But it may provide helpful guidance in similar situations. ■

