

— Advocate's EDGE —



Discounting future losses for lost profits

Financial statement analysis

Don't value a business without it

Home run

LLCs enjoy a Tax Court victory

Only words?

*Forensic document examinations
consider content and context*

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Discounting future losses for lost profits

In many business litigation cases, financial experts must project damages for losses that the plaintiff will incur in the future because of the injury involved. Discounted future losses represent the amount of compensation needed now to replace that future lost income. If you've engaged an expert to calculate damages, it's important to understand that losses in a litigation context are different from the lost income that comes up in business valuation situations.

LOST PROFITS VS. BUSINESS VALUATION

Lost profits calculations and business valuations generally arise under different circumstances. The former considers the finite period of time — the term of a contract, the useful life of a product or the amount of time required for the plaintiff to reasonably mitigate losses — that will pass before a business can recover from the injury. The undiscounted lost profits represent the difference between the lost net revenue and the expenses saved (or, variable expenses) for that period.

RECOGNIZING RELEVANT RISKS

Discount (or interest) rates are used to compute “discount factors.” The projected loss for each applicable period is multiplied by the discount factor to determine the discounted loss, or present value.

Discount rates must accurately reflect the *expected* risks the particular business would face in the absence of the injury. Relevant risks might include:

- ▶ Market, such as barriers to entry, market size, strength of the competition and evolving buyer preferences,
- ▶ Financial, such as illiquidity and excessive debt,
- ▶ Management, such as the depth of management talent and dependence on key employees,
- ▶ Product, such as a dependence on key suppliers, obsolescence and limited production capacity, and
- ▶ Business environment, such as general economic conditions and government regulation.

According to a reference guide on damages appearing in the Federal Judicial Center's *Reference Manual on Scientific Evidence*, an “ordinary interest rate” (also known as a nominal interest rate) should be used to discount future losses projected in escalated terms adjusted for inflation. To discount future losses projected in constant dollars, a “real interest rate,” which deducts the assumed rate of future inflation from the ordinary interest rate, should be applied. In general, “[d]iscount calculations should use a reasonable interest rate drawn from current data at the time of trial,” such as a bond market rate.

A MENU OF METHODS

Depending on the subject of their calculations, damages experts may use one of several methods to arrive at the discount rate:

Safe rate. Also called the risk-free rate, the safe rate is the starting point for determining an appropriate discount rate. It can be derived from a Treasury Bond or Treasury Bill rate.

Build-up. The build-up method considers several factors to assess expected inherent risk in



Business valuation is required when a company is unable to recover. An expert must determine the value of the lost profits for the business's entire expected lifespan “but for” the injury. Its value is calculated using a capitalization rate that considers additional ongoing risk factors related to the projected life of the business. Such a rate will likely be significantly higher than the discount rate used to calculate lost profits — particularly for closely held businesses.

excess of the safe rate. An expert might start with the Treasury rate and “build” from there, using stock market benchmarks as well as risks inherent to the subject company. Also, the Capital Asset Pricing Model (named by the aforementioned reference guide) may be used “to calculate [a] risk-adjusted discount rate” by considering such factors as “the historical average risk premium for the stock market.”

Rate of return (ROR). Using this method, experts crunch numbers on relevant industry standards to obtain the average ROR. They then use the ROR as the discount rate.

Capitalization factor. As defined in the reference guide, a capitalization factor is the “ratio of the value of a future stream of income to the current amount of the stream,” typically derived from the market values of comparable businesses. To calculate the discounted value, an expert multiplies the current annual loss in operating profit by the capitalization factor.

Note that there’s some debate about whether, in determining the discount rate, an expert should consider the possibility that prejudgment interest will be added to the final verdict. And, if prejudgment interest is considered, should the discounting go back to the time of the injury or only to the date of the trial? Variance between state statutory schemes addressing prejudgment interest will affect the ultimate resolution of these issues.

APPLYING VARYING DISCOUNT RATES

Some experts contend that, when projecting damage losses, the discount rate need not be constant. If changes in the market that could affect the business’s risks are expected, it may be appropriate to apply different rates to account for the potential increased risk. For example, a store that enjoyed strong sales of CDs several years ago has probably experienced a huge hit in sales since iPods took off.

Further, T-bills carry different rates depending on their maturity dates. If the discount rate being applied is equivalent to the ROR on investments made for the relevant period of time, the discount rate could be considered overstated. Rather, a different discount rate should be applied to each year in the forecast.

Some experts even argue that each year should be broken down into payment frequencies that correspond to those under which the business would otherwise have earned profits. Instead of determining a lump sum at the end of each year, they advocate calculating each individual payment on a monthly or weekly basis.

GET A FAIR AWARD

Attorneys must be on guard against future loss calculations that aren’t discounted. If an opposing expert offers such a calculation to no objection, future objections are waived and damages aren’t appealable. That kind of mistake can undermine the odds of a fair damages award. ▀

Financial statement analysis

Don’t value a business without it

Business valuation may be required in a variety of legal contexts, and an accurate appraisal is essential for all of them. Valuation experts, however, can have a hard time calculating accurate numbers if they aren’t permitted to analyze the subject company’s financial statements. You can make the process easier for them by doing what you can to facilitate access to these documents.

STARTING WITH A GOOD SET OF DATA

Merely accepting a company’s financial statements at face value can lead to seriously undervaluing or, more likely, overvaluing the business. Closely held businesses that aren’t legally required to have their financial statements audited are at particular risk for skewed results because their financial statements may never have been subjected to Generally Accepted Auditing Standards (GAAS). Valuers, however,

typically insist that companies comply with Generally Accepted Accounting Principles (GAAP), at a minimum.

Private businesses can pose another problem as well. Many fail to prepare formal financial statements, forcing the valuation expert to rely on income tax return data. This data may not comply with GAAP and, because it typically is calculated on the cash basis of accounting, the expert must convert it to the accrual basis to get a more accurate financial picture.

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What's more, a closely held company's financial data may be shaped to favor the owner's interests. For example, an owner might take an artificially large salary to reap tax benefits or, conversely, a small salary to enhance the company's earnings. Similarly, financial statements can reflect tax minimization strategies that produce misstatements related to assets, revenues and expenses, such as the improper expensing of fixed assets that should be capitalized.

So that earnings may be analyzed accurately, valuation experts typically review a company's financial statements going back several years. They then make normalizing adjustments, removing nonrecurring items (such as gains on the sale of a fixed asset) and adjusting expenses that a potential buyer wouldn't likely incur (such as an owner's golf club membership).

Valuation experts often testify in court about their conclusions and methods. An expert who hasn't analyzed the financial statements risks challenges to his or her credibility — or even impeachment.

LOOKING FOR SUSPICIOUS TRENDS

Experts begin valuing a business by reviewing its financial statements for unusual or suspicious trends and relationships. If anything turns up, the expert performs more intensive forensic accounting work, possibly including analysis of specific transactions, journal entries, work papers and the supporting documenting evidence. Note that this forensic examination goes well beyond a standard audit conducted

under GAAS as well as standards of valuation. If the expert uncovers transactions that may themselves be deemed criminal activities, he or she may consider disengaging from the valuation.

The expert will apply several different types of analysis, such as:

- ▶ Vertical, which allows the expert to compare data from a single year to uncover unusual patterns that may require adjustments,
- ▶ Horizontal, which serves the same goal but allows the expert to compare current data with data from previous years, and
- ▶ Financial ratio, which calculates ratios from current year data and compares those with previous years' ratios for the subject company, comparable companies and the relevant industry.

To successfully apply financial ratio analysis, the valuation expert should have experience in the particular industry. And the expert must know GAAP and be able to recognize noncompliance with it. Noncompliance, in fact, is a large red flag and should prompt the expert to scour the statements with a more critical eye, including reviewing disclosures and footnotes.

ARRIVING AT AN ACCURATE VALUATION

Experts must closely analyze financial statement data to reach a true, unbiased understanding of a company's financial situation. Without the aid of a thorough expert, attorneys risk presenting a case that under- or overvalues a business. ▶



Home run

FLLCs enjoy a Tax Court victory

Family limited partnerships (FLPs) and family limited liability companies (FLLCs) typically receive close scrutiny by the IRS because they're owned by related individuals — and perceived as possibly engaging in non-arm's-length transactions. In recent years, some taxpayers who've retained a degree of control over or access to FLP or FLLC assets have found themselves on the losing end in cases questioning the legitimacy of these vehicles. As a result, the FLP or FLLC assets have been included in the taxable gross estate of the individual who established the entity.

But, in *Estate of Mirowski v. Commissioner*, the U.S. Tax Court allowed FLLC assets to be excluded from a decedent's gross estate. The decision suggests what can tip the scales in a taxpayer's favor in such cases.

TEAM-BUILDING EXERCISE

When Anna Mirowski's husband died, she inherited various patents for which he had entered an exclusive licensing agreement, his interests under the agreement and most of his remaining assets.

Mirowski subsequently formed individual irrevocable trusts for her three daughters. Each of the daughters was named as co-trustee on all of the trusts. As the court explained, "She did so specifically because she wanted her daughters to work together and have a close working relationship."

Mirowski gifted some of her interests in the license agreement to the trusts. Eventually, she held a 51% interest in the royalties under the agreement, with each trust holding a 7.26% interest and the co-inventor of the patented invention retaining a 27% interest.

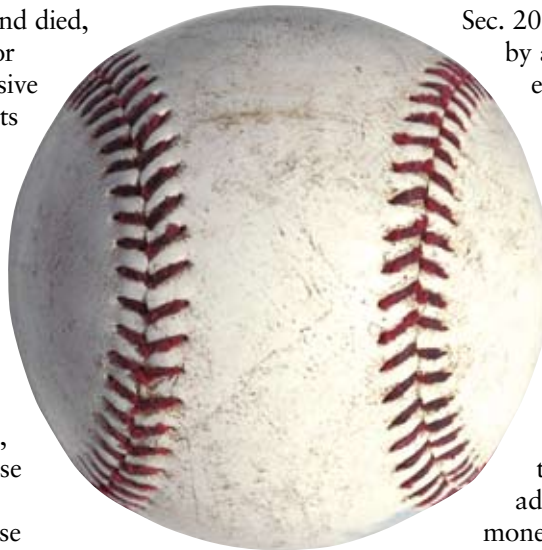
As time passed, Mirowski continued her efforts to foster a close working relationship between her daughters. In that vein, she decided to create an FLLC and planned to discuss the decision during a family meeting scheduled for August 2001. But before the meeting took place,

Mirowski underwent foot surgery, and she didn't attend the meeting.

Mirowski did, however, execute the final FLLC documents, which were filed on Aug. 30, 2001. Between Sept. 1 and Sept. 7, she transferred more than \$60 million in assets, including her 51% interest in the license agreement, to the FLLC. On Sept. 7, Mirowski gave each daughter's trust a 16% interest in the FLLC, retaining a 52% interest for herself. Days later, Mirowski died unexpectedly.

THE UMPIRE STEPS IN

The IRS claimed that the FLLC assets should have been included in Mirowski's taxable gross estate under Internal Revenue Code Section 2036(a). It sought a tax deficiency of \$14.2 million.



Sec. 2036(a) directs that property transferred by a decedent be included in the gross estate if the decedent retains "the possession or enjoyment of, or the right to the income from, the property" or "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." The provision, however, is subject to the "bona fide sale exception," which says that transferred property is excluded from the gross estate if the transfer was a bona fide sale for adequate and full consideration in money or money's worth.

The Tax Court held that Mirowski's transfer of assets to the FLLC was excludable under the exception and noted that Mirowski had three legitimate and significant nontax purposes for forming, and transferring certain assets to, the FLLC:

1. To jointly manage the family's assets by Mirowski's daughters and, eventually, her grandchildren,
2. To maintain the bulk of the family's assets in a single pool to allow for investment opportunities that wouldn't otherwise be available, and

3. To provide for each of her daughters and, eventually, each of her grandchildren on an equal basis.

The court also held that at all relevant times — both before and after Mirowski’s death — the FLLC functioned as a valid investment operation and managed business matters related to the patents and the license agreement.

NO IMPLIED AGREEMENT

The court decided that, even though the gifts of the 16% interests didn’t qualify as bona fide sales, they shouldn’t be included in the gross estate under Sec. 2036(a). It found no implied agreement that Mirowski would retain the possession or enjoyment of, or the right to income from, those interests.

Mirowski had retained substantial personal assets, including more than \$3 million in cash and cash

equivalents. Her personal assets were kept separate from the FLLC assets, and neither she nor her daughters expected that she would use FLLC assets to pay any unexpected financial obligations she incurred. Further, the FLLC’s operating agreement required annual distributions and didn’t authorize Mirowski to distribute capital proceeds or allocate profits or losses from capital transactions.

Also significant, the court held that Mirowski didn’t hold any right to designate the individuals who possess or enjoy the 16% interests or the income from those interests.

LET *MIROWSKI* GUIDE YOUR GAME

Like most cases under Sec. 2036(a), the opinion in *Mirowski* is fact-specific. You can nonetheless infer valuable guidance on forming and operating FLPs and family FLLCs in ways that will help your clients withstand IRS scrutiny. ▀

Only words?

Forensic document examinations consider content and context

Fraud investigations almost inevitably require documentary evidence to be examined — and it’s not a job for amateurs. Professional forensic document examiners review not only the content of documents. They also consider physical and latent evidence, such as handwriting, alterations and faded or decomposed material.

SCIENTIFIC PROCEDURES

Typically, forensic experts follow questioned document examination (QDE) procedures to answer questions about a disputed document using scientific processes and methods. According to ASTM International (formerly known as the American Society for Testing and Materials), an expert examines, compares and analyzes documents to:

- ▀ Establish genuineness or nongenuineness, expose forgery, or reveal alterations, additions or deletions,
- ▀ Identify or eliminate individuals as the source of handwriting,

- ▀ Identify or eliminate the sources of printing or other impressions, marks, or relative evidence, and
- ▀ Write reports or give testimony, and aid the users of the examiner’s services in understanding the examiner’s findings.

The expert applies both technology and subjective interpretation, based on training and experience, to accomplish these objectives.

SETTING HIGH STANDARDS

Typically, a forensic expert examines the questioned document and compares it with known documents referred to as “standards.” The similarities and differences between the standard and questioned documents form the basis for the expert’s conclusions.

Standards generally fall into one of two categories:

1. **Requested.** The individual is instructed to write the exact words desired. These standards, however, are vulnerable to distortions by the individual.

2. Nonrequested. These standards are writings executed in the normal course of events, without knowledge of their future use for QDE. Although they're not subject to willful distortions, nonrequested standards may not contain the exact words or phrases an expert is seeking.

Ideally, an expert can compare like documents or shared components, such as cursive to cursive or particular phrases used in both. If the same words or phrases don't appear in both, the expert likely will require a greater volume of standards and more analysis to reach conclusions. If the expert can reach a conclusion, he or she will provide it on a scale — usually ranging from “positively identified” to “eliminated.”

TECHNOLOGICAL ASSISTS

Experts use different types of technology to detect changes to documents and to retrieve or recover evidence. An electrostatic detection apparatus, for example, detects invisible indentations on questioned documents based on microscopic damage on their surface. Such a discovery could indicate that a notation on a document was added at a different time than claimed. In some cases, this technology is used to determine the age of the document.

An expert also might use a spectral comparator. Video spectral comparators enable examiners to analyze inks and watermarks, visualize hidden security features and uncover alterations and obliterations on a document. The main purpose of a Raman spectral comparator is to compare ink samples to determine if they match based on shared spectral characteristics.

An electrostatic detection apparatus detects invisible indentations on questioned documents based on microscopic damage on their surface.

INTEGRITY IS EVERYTHING

You and your client need forensic experts whose opinions will stand up in court. When seeking a document examiner, look for someone with a degree in criminal justice or a hard science. And make sure the



individual has experience with QDE and its associated technologies, testifying in court, and, preferably, training from law enforcement.

Certifications alone aren't enough. Some are honestly earned, but others are received in exchange for a fee. Also avoid experts who promise too much, such as being able to analyze personality based on handwriting.

Document experts aren't, of course, solely responsible for successful evidence testimony.

You can bolster your experts' testimony by maintaining document integrity. Don't fold, cut, staple or make notes on documentary evidence; do put any identifying marks on a document's package, rather than on the document; and, above all, preserve the chain of custody.

BEYOND THE NAKED EYE

Forensic document examiners can produce a wealth of evidence that a layperson could easily miss. Let them put their knowledge and the latest technology to work for the benefit of your case. ▀