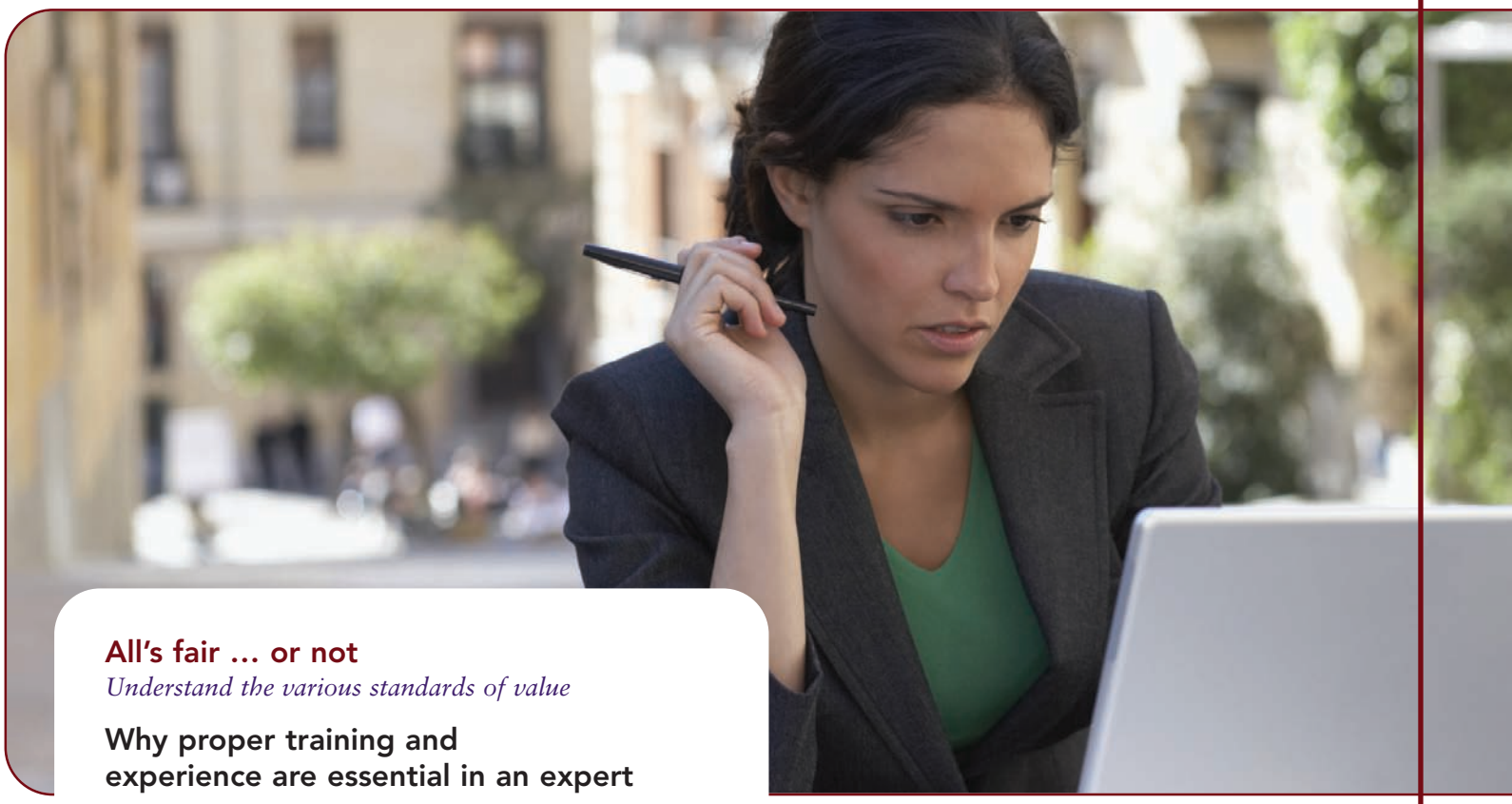
Advocate's EDGE



All's fair ... or not
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July/August 2008

McGOVERN & GREENE LLP

CPA's & Forensic Accountants

All's fair … or not

Understand the various standards of value

The need for business valuations arises in myriad types of litigation, but valuation is seldom as simple as it might seem. The final appraisal estimate is influenced by a variety of factors, including the standard of value. Attorneys who understand the various value standards and their implications are better prepared to understand and use valuation reports.

FAIR MARKET VALUE

The most widely recognized standard of value is likely fair market value (FMV). The IRS defines FMV as the price at which the property would change hands between hypothetical buyers and sellers who have reasonable knowledge of the relevant facts and are under no compulsion to enter into the transaction. The standard is often used for valuing business interests for estate and gift tax purposes.

Willing buyers and sellers are hypothetical — not particular parties — and dealing at arm's length. Thus, a particular buyer's or seller's individual motivations or characteristics don't enter the calculation. Further, FMV reflects the price at which the transaction would occur under the conditions that existed as of the valuation date. Unforeseeable future events that may subsequently affect value are ignored.

In addition, FMV represents the highest and best use that the property could be put to on the valuation date, taking into account special uses realistically available. Whether the owner has actually adopted that use for the property is irrelevant.

FAIR VALUE

The fair value (FV) standard is defined by the Financial Accounting Standards Board as the price it would take, in an orderly transaction between market participants, to sell an asset or transfer its liability in the market where the reporting entity would transact for the asset or liability. FV is usually applied for financial reporting purposes.

FV is also used in shareholder or divorce litigation but is generally defined by state law in such cases. In many states, FV for litigation involving dissenting shareholders is considered to be the pro rata share of a controlling level of value. Thus, for a company worth $200 million on a control-level basis (as opposed to a minority-level basis) with 200 million outstanding shares, the FV for each share would be $1.

INVESTMENT VALUE

Investment value, also known as "strategic value," represents the value of an asset to an individual. For real estate purposes, it's typically defined as the value of an investment to a particular investor or class of investors based on their investment requirements. Valuation is reached by discounting an anticipated income stream.

Investment value for an asset can vary from its FMV for several reasons, including:

- Different estimates of future income,
- Different perceptions of risk,
- Differences in income status, and
- Synergies with other operations owned or controlled by the investor.

In shareholder litigation, investment value carries a different meaning. There, investment value is based on earning power, but the appropriate discount or capitalization rate is typically a consensus rate — not a rate specific to any investor.

INTRINSIC VALUE

The intrinsic value standard, also known as fundamental value, represents the price that is justified for the interest when an asset's primary value factors are considered. Relevant factors include the value of the company's physical assets, expected future interest and dividends payable, expected future earnings and expected future growth rate. This standard is usually employed when valuing an equity share to get at its so-called "real worth."

Unlike investment value, which weighs a specific investor's characteristics, intrinsic value assesses the *investment's* perceived characteristics. Value might diverge from the current market price if other investors perceive the asset's characteristics differently.

WHICH STANDARD TO USE?

How do valuation experts decide which standard to apply when performing a business valuation? The appropriate standard typically is determined by state or federal statute; case law; administrative law; company documents, such as buy-sell agreements or articles of incorporation; prior transactions; or court orders.

Of course, professional judgment also factors into the decision. For this reason, it's always a good idea to hire valuators with experience appraising the types of assets involved in your cases.

EXPERTS ALSO CONSIDER PREMISES

The standard of value isn't the only factor that can affect value. Premises of value — or assumptions about the status of the business to be valued — can also dramatically sway an asset's final value.

Several premises are common when valuing a business, including:

- Going concern, which represents the business as a going concern with a collection of income-producing assets,
- Assemblage of assets, or the value of a collection of income-producing assets not currently producing income,
- Orderly disposition, which is the amount that can be generated through individual sales of the business's assets in their appropriate secondary markets, and
- Forced liquidation, or the amount that can be generated through the individual sales of the business's assets with less than normal exposure to their appropriate secondary markets because of the forced nature of the sales.

If the premise of value isn't dictated by controlling documents or otherwise, a valuator will determine which one to apply based on the highest and best use of the business.

SETTING THE STANDARD

The standard of value can make a significant difference in the final value of an asset. To ensure the proper standard is applied for your particular legal matter, discuss this issue with your valuator before work commences.

Why proper training and experience are essential in an expert

In estate tax disputes, it's critical to hire a qualified, informed appraiser. One recent case, *Estate of Thompson v. Commissioner*, demonstrates why.

ALASKAN ERROR

Josephine Thompson died in 1998 owning almost 21% of the shares in Thomas Publishing, the New York-based publisher of the Thomas Register. This closely held business was solely paper-based until the 1990s, when it began adapting to the digital marketplace.

In the six years preceding Thompson's death, the company's operating income was constant at around $25 million. In the years after her death, it dropped and eventually turned to losses. The estate reported a fair market value of $1.75 million for the decedent's interest. The IRS countered with a value of $32 million.

For its valuation, the estate hired an Alaska attorney who was assisted by a local CPA. Neither had significant valuation experience. The attorney, however, had represented to the estate that he could secure a more favorable result for them in Alaska than would be available from the IRS office in New York.

Reliance on an appraiser doesn't necessarily demonstrate reasonable cause and good faith.

The Tax Court found fault with both parties' valuations. It described the estate experts' reports and testimony as "only marginally credible" and the experts themselves as "barely qualified to value a highly successful and well-established New York City–based company with annual income in the millions of dollars." The court ultimately valued the decedent's interest at $13.5 million.

THE PENALTY ISSUE

Both parties appealed. In its appeal, the IRS argued that the Tax Court should have imposed an accuracy-related underpayment penalty on the estate. In the words of the appellate court, the Tax Court had declined to impose a penalty "principally on the grounds that the Commissioner's estimate [of value] was so high in the other direction and that the valuation issues were fairly debatable."

Under the penalty provision of the Internal Revenue Code then in effect, if the claimed value of an estate was not more than 25% of the amount determined to be correct, the taxpayer had to pay a penalty of 40% of the underpayment. Here the estate's proposed value of $1.75 million was less than 15% of the Tax Court's determination.

The penalty was mandatory unless it was shown that "there was a reasonable cause for such [underpayment] and that the taxpayer acted in good faith with respect to such." The Tax Court invoked this exception when declining to impose the penalty.

REASONABLE RELIANCE

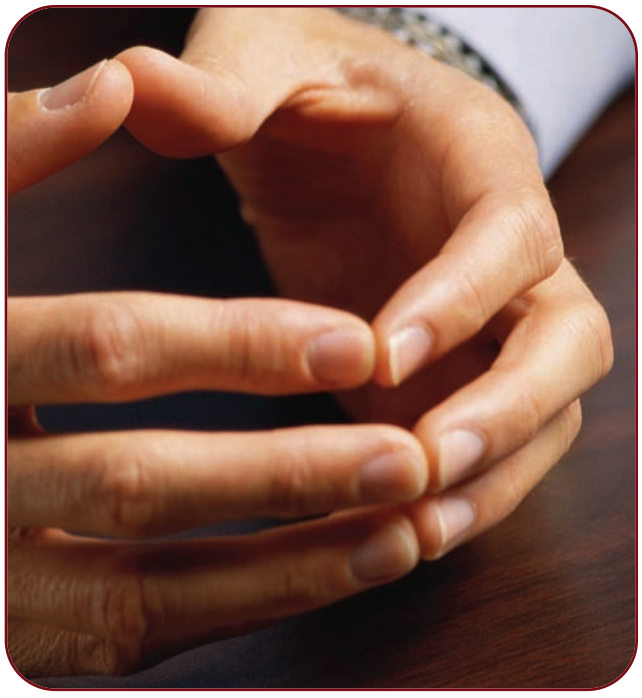
As the Second Circuit explained, the existence of reasonable cause is determined on a case-by-case basis: "Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability."

Reliance on an appraiser, however, doesn't necessarily demonstrate reasonable cause and good faith. Such reliance will only suffice if, under all of the circumstances, the reliance was reasonable, and the taxpayer acted in good faith. Notably, reliance might not meet those two standards if the taxpayer knew, or reasonably should have known, the expert lacked knowledge in the relevant aspects of tax law.

The Tax Court made no finding assessing the estate's reliance on its experts, though it found the experts lacked experience with technology and Internet-based companies and were "too inexperienced, accommodating, and biased in favor of the estate." Further, the Tax Court regarded the attorney's role as the estate's administrator for the anticipated audit of the estate tax return as "somewhat in tension with his role as a purported independent valuation expert." The appellate court concluded that a determination as to good faith was required and remanded the case to the Tax Court.

AVOID COSTLY MISTAKES

The *Thompson* case serves as a reminder that attorneys and their clients can't afford to cut corners when selecting experts. Choosing experts based on criteria other than their experience and expertise with the specific matter can be a costly mistake.



Up close and impersonal

Expert interviewers get face-to-face with financial fraud

The key to uncovering or confirming financial fraud often lies in one-on-one interviews. Skilled interviewers trained in fraud detection can spot fraud warning signs, detect deception and pin down suspicions by talking with suspects and their co-workers.

STANDARDS PROVIDE GUIDANCE

The specific information an expert asks employees depends, in part, on the circumstances and individuals involved. But experts generally rely on various financial and accounting standards to frame their questions.

For example, the American Institute of Certified Public Accountants' Statement on Auditing Standards No. 99 (SAS 99), *Consideration of Fraud in a Financial Statement Audit*, is targeted at auditors, but it also provides guidance that's useful outside the audit context. According to SAS 99, expert interviewers should ask members of management direct questions about their:

- Knowledge of any fraud or suspected fraud,
- Awareness of any allegations of fraud or suspected fraud,
- Understanding of the fraud risks to the company, including any specific risks the company has identified, and
- Implementation of programs and controls to mitigate specific fraud risks or to otherwise help prevent, deter and detect fraud.

A qualified expert will be familiar with additional standards and guidance that might apply to the circumstances at hand, including some related to Generally Accepted Auditing Standards, Generally Accepted Accounting Principles and the Sarbanes-Oxley Act.

TARGETING INTERVIEW SUBJECTS

SAS 99 suggests that a fraud interviewer speak not only with a company's management and audit committee, but also with anyone who can provide information helpful in identifying risks of financial fraud. Thus, interviewees might include employees at all levels who are involved in initiating, recording or processing complex or unusual transactions, as well as operating personnel not directly involved in the financial reporting process.

Rank-and-file workers can provide a different — and valuable — perspective from those who direct or oversee the financial reporting process. Their responses might corroborate management's responses or indicate that management is wrongly overriding internal controls.

ALL AREA ACCESS

To be as effective as possible, your fraud expert will need access to all relevant background information — including information about the interviewee's history, responsibilities and access to financial data. From there, the expert prepares the critical questions and corresponding evidentiary materials. The actual interview usually follows a three-stage structure:

1. Opening. The first stage comprises introductions and rapport-building. The interviewer explains the purpose

of the interview and may ask some questions to which the answers are already known, so he or she can observe the subject's demeanor and degree of candor.

2. Discussion. The interviewer moves from open-ended questions to more specific ones. He or she attempts to clarify any ambiguities but encourages the interviewee to do most of the talking. The interviewer also may use silence as a tool, as interviewees frequently fall prey to the urge to fill conversation gaps. The employee may disclose information unintentionally, provide clues or suggest an unplanned, but fertile, line of questioning.

3. Closing. Here the interviewer confirms the information elicited. He or she also solicits suggestions about other individuals to interview and areas to explore.

ONE CHANCE?

Fraud interviewers conduct every conversation under the assumption that the interviewee has valuable information and may attempt to mislead. Therefore, they must dig deep and closely scrutinize their subjects. You and your client may only get one chance for an initial employee interview, so make sure it's effective.

Daubert study highlights expert witness vulnerabilities

Since the U.S. Supreme Court's 1999 decision in *Kumho Tire v. Carmichael* extended the *Daubert* criteria for admissibility of expert scientific testimony, federal and state courts have heard more challenges to financial expert testimony. A PricewaterhouseCoopers (PWC) study of post-*Kumho* challenges to financial experts from 2000 through 2006 identifies trends that you may be able to leverage when submitting expert testimony.

JURISDICTIONAL DIFFERENCES

PWC examined almost 3,000 *Daubert* challenges in published opinions of federal and state courts. These included approximately 519 challenges of financial expert witnesses. The number of *Daubert* challenges to financial experts rose every year from 2001 and, of the financial experts challenged from 2000 through 2006, 30% were completely excluded and 18% partially excluded.

Almost 60% of the challenges to financial experts were heard in the Second, Third, Fifth, Sixth and Seventh Circuit Courts of Appeals. In the relevant period, 20% of the challenges to financial experts occurred in the Second Circuit. At the state level, Louisiana, Texas, Mississippi, Delaware and Massachusetts saw the most challenges — representing nearly 60% of the state-court challenges.

Rates of success varied by jurisdiction. In the Ninth Circuit, 68% of challenged financial expert testimony was excluded in whole or in part. The First Circuit, on the other hand, excluded only 24% of challenged financial expert testimony.

DIFFERENT EXPERTS, DIFFERENT RESULTS

According to the study, the party that the financial expert represents appears to influence the frequency of challenges. Plaintiffs' experts are challenged more often than defense experts — in fact, 70% of the challenges targeted plaintiffs' experts.

Once challenged, though, expert testimony was excluded on an almost equal basis, with 48% of challenged plaintiff testimony and 47% of challenged defense testimony either completely or partially

Lack of reliability was the top reason for the exclusion of financial experts, followed by lack of relevance and lack of qualifications.

excluded. The outcomes varied greatly from year to year, however.

The financial expert's field also seemed a factor. Challenges to economists, accountants and statisticians made up 50% of all challenges to financial experts, likely because they are the most frequently engaged financial expert witnesses. But all three were more likely to survive than other types of experts, including appraisers, analysts and academics.

Challenges to financial experts arose most often in breach of contract or fiduciary duty cases, with success rates of 41%. In fraud cases, by contrast, 54% of challenged financial experts were excluded.

REASONS FOR EXCLUSION

Lack of reliability was consistently the top reason for the exclusion of financial experts, followed by lack of relevance and lack of qualifications. Financial expert testimony is often excluded because it fails to satisfy multiple *Daubert* criteria — commonly due to a lack of both relevance and reliability.

The study observed that methodological flaws created by the misuse of accepted financial and economic methods were frequently the reason for exclusion. It cited several methods that courts have found flawed under *Daubert* standards of reliability, including:

Use of an untested proportional trading model (PTM). Used in securities trading cases, a PTM takes data on outstanding shares and trading volume to estimate the number and price of shares exchanged during the damages period. For example, a federal court in Illinois rejected a PTM because it had never been tested against reality or accepted by professional economists.

Failure to consider discounted cash flow (DCF) analysis. Courts have ruled that, when valuing a business, relying solely on the comparable-companies method without using the DCF method as a "check" rendered the value unreliable. The Southern District Court of New York, though, noted that a DCF analysis is less necessary as a check where the initial analysis is more trustworthy.

Enhancing a reasonable royalty rate by a multiplier. The plaintiff in a patent infringement case might be entitled to more than damages based on a royalty rate. But a California federal court found that the use of a multiplier to enhance the reasonable royalty calculation was "simply untethered by legal or factual support."

Use of the straight-line ramp-up method. This method plots the known value of a stock at two points in time, draws a line between the two and then assumes the stock's value changed at a consistent rate in the intervening period. The Utah court of appeals ruled the method was not an "accepted method of business valuation."

GETTING TESTIMONY ADMITTED

To increase the odds of admission, it's important to hire a financial expert whose academic and professional experience matches the issues involved in the case. Also consider the difference between damages and liability experts. A liability expert may not be qualified to testify on damages, so you may need to hire two experts.

In any case, require your expert to independently perform the work that forms the basis of his or her opinion. It may cost more, but a court could exclude the testimony of an expert who didn't personally conduct the underlying work.

Finally, retain an expert who can address any methodological limitations up front and justify his or her opinion despite the limits. Don't give a court grounds to exclude for lack of reliability.

AVOID EXCLUSION

Every expert is subject to scrutiny by the court, but attorneys can increase the likelihood of success by taking care when enlisting the help of financial experts. While some courts are more likely than others to exclude these experts, your selection could make the difference in the outcome.