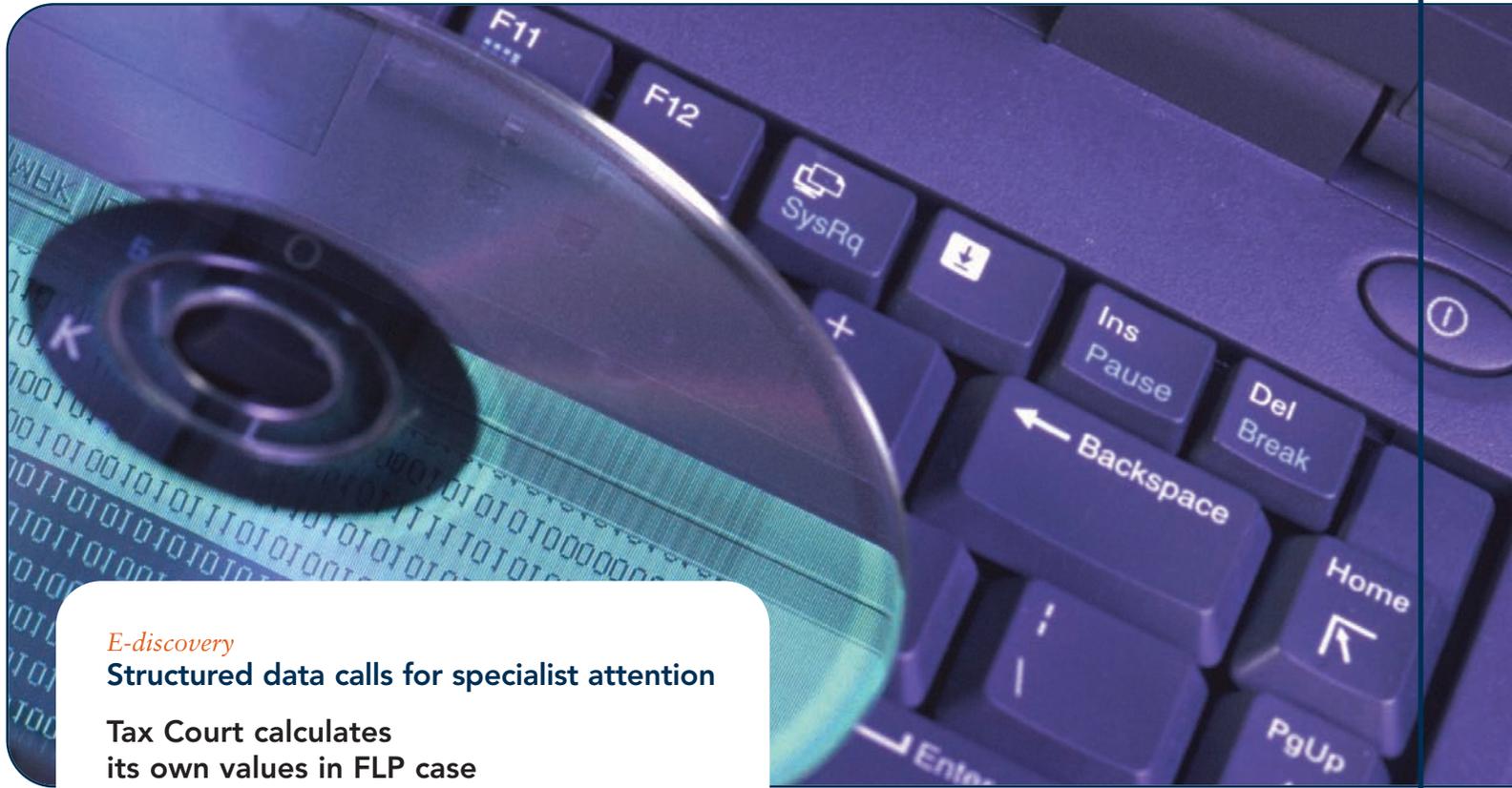


— Advocate's EDGE —



E-discovery

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Mission critical: Assembling an effective forensic accounting team

November/December 2008

E-discovery

Structured data calls for specialist attention

Since the 2006 amendments to the Federal Rules of Civil Procedure (FRCP) formalized electronic discovery, some attorneys have learned the hard way that e-discovery often means gathering and analyzing millions of bytes of information. Although much attention has been focused on discovery of “unstructured data” such as e-mail and documents, e-discovery also encompasses “structured data,” including certain financial and operational data. Proper retrieval and handling of this data differs from that associated with unstructured data sources and usually requires the assistance of a specialist.



UNDERSTANDING ESI

FRCP 26, 33 and 34 stipulate that electronic data is subject to discovery. FRCP 34 specifically states that a party may request another party to produce “any designated documents or electronically stored information — including writings, drawings, graphs, charts, photographs, sound recordings, images, and other data or data compilations — stored in any medium from which information can be obtained either directly or, if necessary, after translation by the responding party into a reasonably usable form.”

Understanding a business’s electronically stored information (ESI), both structured and unstructured, is a prerequisite to complying with the FRCP 26(f) requirement that parties discuss the discovery of ESI early in the process. Prior to the initial scheduling conference, the parties must discuss certain issues, including the form and preservation of ESI.

STRUCTURED VS. UNSTRUCTURED DATA

When attorneys hear the term ESI, they usually think of e-mail, word processing documents, instant message logs, PowerPoint® presentations and scanned documents. The unstructured data in these forms typically uses natural (as opposed to computer) language text, and may carry metadata.

But ESI also includes structured data, such as the data found in enterprise resource planning (ERP) and human resource systems. Structured data has a specific format assigned by, for example, SQL or Access databases, and frequently is tabular. Financial, operational and transactional data like that in payroll and point-of-sale systems are generally expressed as structured data.

The treatment of structured data varies from that of unstructured data for several reasons:

- ▶ Structured data is expressed in numbers, rather than words, so keyword searches are useless.
- ▶ Structured data includes fields, tables and databases with thousands or millions of records that can’t easily be reviewed.
- ▶ Different software companies may structure data differently.
- ▶ Structured data may hold no meaning outside of its system, so it can’t be reviewed on its own.
- ▶ The size of a structured data system can make complying with discovery efforts unduly burdensome or costly.
- ▶ Redacting meaningful information in structured data to comply with legal obligations can make it difficult or impossible to review related records from different data sources.

What's more, the Gramm-Leach-Bliley Act, Health Insurance Portability and Accountability Act and other government regulations restrict disclosure of certain consumer, employee and patient data.

THE NEED FOR EXPERTISE

Even if a company has its own IT specialists, the challenges of handling structured data call for the assistance of a qualified forensic expert. This expert can manage the production of the data by tracking it at the field, table and database levels, and extract and convert necessary tables and fields without compromising them. He or she will also have experience working with enterprise systems and database technologies — particularly those related to accounting and finance.

Additionally, forensic experts are familiar with the various search tools and techniques that can simplify and manage discovery of structured data. Selecting the appropriate tools early in the process can save your client time and money.

DON'T DELAY ON DISCOVERY DECISIONS

To narrow the focus of a search for structured data, extensive expert input is indispensable on the front end of e-discovery. Attorneys and their experts should prepare to justify their choices and explain why the results are reliable. ▸

AVOIDING INADVERTENT DISCLOSURE OF PRIVILEGED INFORMATION

The massive amount of data in electronically stored information (ESI) likely gives you nightmares about inadvertent disclosure. To minimize the risk, ask a forensic expert to search for specific documents that probably are privileged — including e-mails between in-house and outside counsel. An expert could, for example, look for the names and e-mail addresses of counsel.

This initial search doesn't preempt the need to actually review the returned documents to determine whether they are indeed privileged. And bear in mind that documents that aren't searchable by text, such as scanned documents, won't turn up in these searches. But they may prove both relevant and privileged and, therefore, will require individual review.

These measures don't constitute a guarantee. If disclosure does occur despite best efforts, Federal Rule of Civil Procedure 26(b)(5)(B) outlines the process for claiming that disclosed information is entitled to privilege or protection from disclosure as "trial-preparation material."

Tax Court calculates its own values in FLP case

In recent years, the U.S. Tax Court has heard its share of cases challenging the legitimacy of family limited partnerships (FLPs). In early 2008, however, it was presented with an FLP case in which the IRS merely challenged the taxpayer's valuation. The court in *Astleford v. Commissioner* ultimately decided to pick and choose from the opposing experts' conclusions to calculate its own values.

A FAMILY AFFAIR

In 1992, Jane Astleford and her husband created separate revocable trusts, with each transferring

various real estate interests to their respective trusts. The husband's interests included a 50% interest in a general partnership, Pine Bend Development Company, that owned 1,187 acres of farmland.

When the husband died in 1995, all of his real estate interests passed to a marital trust for Jane's benefit. In 1996, she formed the Astleford Family Limited Partnership (AFLP) to facilitate the continued ownership, development and management of the various real estate investments and partnership interests, as well as gifts she intended to make to her three adult children. She funded AFLP by transferring an interest

valued at about \$871,000. Each child received a 30% limited partnership interest, and Jane retained a 10% general partnership interest.

In 1997, Jane transferred the 50% interest in Pine Bend to AFLP, along with her ownership interests in several other real estate properties. The children made no contributions to AFLP capital in 1996 or 1997. During an audit of Jane's gift tax returns, the IRS disputed the values of the general partnership and AFLP interests.

FARMLAND FMV

The taxpayer's expert calculated an initial value for Pine Bend's farmland of \$3,100 per acre, for a total of \$3.68 million. The expert then applied an absorption discount based on his opinion that a sale of the entire 1,187 acres would flood the market, reducing the price at which the property could be sold. He assumed that the farmland would sell over the course of four years and appreciate at 7% each year. With the discount, he arrived at \$1,817 per share and a total of \$2.16 million.

Like the taxpayer expert, the IRS expert used a market data approach to value the property. He reviewed about 125 sales and settled on two as comparable. He valued the property at \$3,500 per acre or \$4.16 million total. The IRS expert believed the entire property could likely be sold in a single year and applied no absorption discount. Even if such a discount were appropriate, the IRS argued, the taxpayer expert's discount of 25% was excessive.

The court agreed with the taxpayer expert that a discount was appropriate but found his figure unreasonably high. It determined the appropriate rate to be 10%, citing: 1) the minimal risk involved in selling the land over four years, 2) the fact that most of it was already leased, and 3) the 9.2% return on equity earned by local farmers in 1997. The court put the FMV for the farmland at \$3.31 million.

PARTNERSHIP INTEREST OR ASSIGNEE INTEREST?

The IRS and the taxpayer disagreed on the proper treatment for gift tax valuation purposes of the interest in the Pine Bend general partnership that Jane transferred to AFLP. The taxpayer characterized it as an assignee interest and, thus, discounted it by 5% because, under Minnesota law, the holder of an assignee interest has interest only in profits and no influence on management.

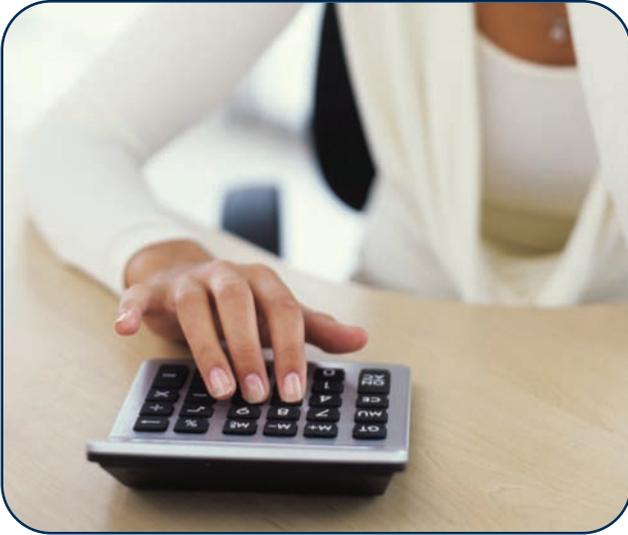
The IRS contended that the "substance over form" doctrine should apply — meaning the interest transferred should be treated as a general partnership interest. The court agreed with the IRS that, in substance, the interest should be treated as a general partnership interest.

As AFLP's sole general partner, Jane essentially maintained her same management position regarding the interest. Even after the transfer to AFLP, she controlled the management rights associated with the interest. Also, an AFLP partnership resolution treated the transfer as a transfer of all of Jane's rights and interests in Pine Bend.

ASSESSING APPROPRIATE DISCOUNTS

In calculating discounts for lack of control and lack of marketability, the taxpayer and IRS experts took distinctly different approaches. The taxpayer expert relied on comparability data from real estate limited partnerships (RELPs), while the IRS looked at data from sales of real estate investment trusts (REITs). The court declined to declare either type of data generally superior to the other.





The taxpayer expert applied a discount of 40% to the Pine Bend interest. The IRS, however, determined no discount was necessary because the interest was simply an AFLP asset, and a discount would be applied at the AFLP level. The court determined that discounts at both levels — the asset and the FLP — were appropriate. It proceeded to eliminate some of the taxpayer expert’s RELP comparables and

reached a combined discount for lack of control and marketability of 30%.

The court also determined that the taxpayer expert’s RELPs weren’t sufficiently comparable to AFLP and that the lack of control discount was, therefore, excessive. Rather than reviewing RELP data for more appropriate RELPs, the court used the IRS expert’s REIT data, “with adjustments to his methodology.” The adjusted discounts were 16.17% for 1996 and 17.47% for 1997, vs. the taxpayer expert’s discounts of 45% and 40%, respectively.

As to lack of marketability, the taxpayer expert estimated a 15% discount, and the IRS expert proposed 21.23%. The court saw “no reason not to use [the IRS’s] higher marketability discount” and applied a 22% discount.

YOUR EXPERT OR MINE?

As the decision noted, in deciding valuation issues, a court may largely accept one expert’s opinion over another’s. It also may be selective in determining which parts of an expert’s opinion it accepts. The Tax Court demonstrated that discretion here. ▀

No discounts allowed

Court applies standard to shareholder oppression case

Discounts for lack of control and marketability can dramatically reduce the value of an interest in a business. Such discounts generally aren’t applied when valuing interests in the context of a shareholder dissent case.

But, in *Edler v. Edler*, a Wisconsin court recently extended the principle to a shareholder oppression case. As a result, the court based the plaintiff’s award on the fair value of the corporation.

BROTHER AGAINST BROTHER

Edler & Sons Trucking & Excavating, Inc. grew out of a business started by the father of Steven (the defendant) and Richard (the plaintiff) Edler. Steven served as his father’s partner for many years, and Richard worked as a truck driver for the business. When the elder Edler retired in 1986, a corporation

was formed, with Steven owning 60% of the shares and Richard the remaining 40%. Steven was named president, and Richard became vice president. Steven ran the business, and Richard drove a truck and performed mechanical labor for it. Corporate formalities weren’t followed.

The trial court concluded that it would be inequitable to apply the lack of control and lack of marketability discounts the expert used in reaching FMV.

In early 2003, Steven eliminated Richard's salary and made him an hourly employee required to submit time cards; he also took away Richard's corporate check-writing privilege. Richard was away from the business in late 2003 because of cancer surgery and, when he tried to return in February 2004, Steven terminated him. Steven's wife eventually assumed the role of vice president.



Richard sought judicial dissolution of the corporation based on Steven's oppressive conduct in its operation. He alleged that the oppressive conduct breached a fiduciary duty Steven owed him. The trial court determined that Steven had breached his fiduciary duty by retaining certain income that should have gone to the corporation, and that corporate oppression occurred by virtue of the diminishment of Richard's participation. It required Steven to purchase Richard's 40% interest based on the fair value of the corporation, with a 6% liquidation discount applied.

VALUING THE CORPORATION

Steven and Richard had jointly retained an expert to determine the fair market value (FMV) of a 40% share of the corporation. The expert followed a net asset method and appraised the corporation as a going concern. Recognizing that the corporation wasn't expected to continue to operate indefinitely in a manner similar to past operations, the valuation accounted for this change.

The trial court adopted the expert's opinion as a starting point. But it concluded that it would be inequitable to apply the lack of control (or minority interest) and lack of marketability discounts the expert used in reaching FMV. His discounts totaled 30%.

Instead, the trial court relied on an earlier Wisconsin case that noted that a minority interest discount frustrates the equitable purpose of protecting a minority shareholder from a "squeeze out." The case was a shareholder dissent case, but the appellate court here found that "remedying shareholder oppression has the same objective of protecting a minority shareholder. The exclusion of Richard from the corporation created the same situation faced by a dissenter shareholder in a closely held corporation." In both situations, the shareholder not only lacks control over corporate decision making, but also would receive less than proportional value for the loss of that control if a minority interest discount were applied.

SERVING EQUITY

The court of appeals ruled that equity is served by allowing the "squeezed" shareholder to recover his proportional interest in the corporation as a going concern. The same rationale applied to the lack of marketability discount. "Moreover," the court wrote, "when the buy-out will serve to create liquidity where it may not have existed, the discount should not be applied."

The court also rejected Richard's argument that the 6% liquidation discount was improper. In his brief, he had conceded that it would be reasonable for the court, in fashioning a remedy in lieu of liquidation, to attempt to put the parties in the same position they would have been if the corporation were liquidated. The court held that Richard could not then complain that the liquidation discount was inequitable, as it had the effect of putting the parties in the same position as if liquidation had occurred.

DIFFERENT STANDARDS, DIFFERENT OUTCOMES

The *Edler* case illustrates how the standard of value applied can affect the final result. With a 30% discount, the FMV would have produced a more favorable outcome for the defendant. The case also indicates that shareholder oppression cases could be subject to a shareholder dissent valuation standard that favors shareholders. ■

Mission critical: Assembling an effective forensic accounting team

When launching a fraud investigation, one of the most critical tasks is building an effective forensic accounting team. Unfortunately, fraud teams often are assembled hastily and with little thought to their composition. But, as fraud schemes become more complicated and sophisticated, it's increasingly vital to focus on this first step.

MULTIDISCIPLINARY APPROACH

All fraud team members should be free of conflicts and bring qualifications that are relevant to the specific investigation. If, for example, your client suspects an employee of accepting kickbacks, the team should include accountants who have previously investigated such schemes — as opposed to experts who merely have a theoretical understanding of the matter. Similarly, if the scheme is particular to a certain industry, such as inventory theft in a pharmaceuticals manufacturing business, the team should include someone with experience in that sector.

At least one team member must be familiar with issues related to potential litigation, such as discovery and expert testimony. An investigation also usually

requires electronic evidence expertise, including knowledge of data mining, extraction and preservation. And because most investigations conclude with a final written report (intermediate reports may be drafted throughout), the team should include someone with report-writing skills.

At least one team member must be familiar with issues related to potential litigation, such as discovery and expert testimony.

SCREENING TEAM MEMBERS

An auditing background usually isn't sufficient to prepare someone to conduct fraud investigations. Although it provides a strong foundation, CPAs investigating a fraud incident also need specific forensic skills.

The American Institute of Certified Public Accountants (AICPA) Interpretation No. 101-3, *Performance of Nonattest Services*, makes clear that providing a client with specific forensic services is considered to impair a CPA's independence for audit and other attest service purposes. It may prove wise, then, to exclude a company's outside auditor from the investigation team.

CREDIBILITY MATTERS

The AICPA standard doesn't prohibit forensic services from an accounting professional who performs attest services for a client. But enlisting this expert for a fraud team could call into question his or her adherence to professional standards, which could, in turn, undermine the expert's credibility. Ideally, team members hold no such risk and are able, when necessary, to challenge your and your clients' perspectives. ■

