Advocate's EDGE

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Fraud experts "like" social media evidence — with good reason

The surging popularity of social networking media such as Facebook, Twitter and YouTube has opened up new avenues of exploration for fraud experts. These investigators can now tap into a wealth of potential evidence that was nearly impossible to find only a few years ago.

LOOKING FOR REASONS

What prompts people to post incriminating material online? One explanation is the mistaken belief that their information is private or will disappear when they remove it or deactivate their account. The reality is that these sites generate revenue by compiling and selling users' information to advertisers. So sites hold onto it — even after the user hits "delete."

Another explanation for indiscriminate online sharing is simple hubris. A 2008 memo by the U.S. Citizenship and Immigration Services encouraged its agents to take advantage of the "narcissistic tendencies in many people [that] fuels a need to have a large group of 'friends' linked to their pages." The memo notes that many people accept online friends they don't even know, providing an excellent opportunity for investigators to observe the daily life of suspected fraud perpetrators.

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TOO MUCH INFORMATION

Facebook alone now boasts more than 500 million active users, 50% of whom visit the site on any given day. According to the site, the average user produces 90 pieces of content each month. User profiles might include photos and videos, as well as lists of friends, interests and activities. In their "status updates," users post information about their day-to-day activities and thoughts.

An insurance fraud case provides one of the best examples of a social media posting coming back to haunt its author. A claimant sought a large payout for a disabling injury that supposedly prevented him from working. But his profile featured recent photos showing him engaged in sports and other physical activities that undermined the legitimacy of the claim.

Similarly, photos and personal updates can reveal information about extravagant purchases or vacations. Such postings might suggest an employee suspected of fraud is living above his or her means or is enjoying a recent windfall. Users might also post comments indicating discontent with their employers — providing the employee's motive for fraud — or about an incident that forms the basis for insurance fraud.

TREADING LIGHTLY

Some limitations do apply when it comes to obtaining evidence from social media, particularly from nonpublic profile pages. Last year, a New York City Bar Committee of Professional Ethics opinion stated that a lawyer may not attempt to gain access to a social networking website under false pretenses, either directly or through an agent, to obtain information for use in litigation. The opinion, however, does allow lawyers and their agents to use their real names and profiles to send a "friend request" to obtain information from an unrepresented person's profile without disclosing their reasons for the request.

The Philadelphia Bar Association has taken a similar position. It indicated in an opinion that retaining a third person, whose name a witness wouldn't recognize, to "friend" the witness to gain access to her profile without revealing the true purpose for the access would violate the rules of professional conduct.

But the New York State Bar has made a distinction between public and private information. A lawyer who represents a client in pending litigation — and who has access to the Facebook or MySpace network used by another party in the litigation — may access and review the social network pages of that party. As long as those pages are accessible to all members of the network, the lawyer can use the information.

A FEW CAVEATS

The legal community's position on obtaining and using social media evidence is still evolving. And it's important to note that such evidence isn't always conclusive; photos can be old and postings may be in jest. Further investigation by a fraud expert is necessary.

A DIFFERENT KIND OF SOCIAL NETWORK

Online communities aren't the only kind of social networks that can be used to root out fraud. In recent years, many fraud experts have used "social network analysis" (SNA) to detect sophisticated fraud schemes — particularly those in which perpetrators (such as banking or insurance fraud rings) act like legitimate customers.

SNA is a form of data mining that maps massive amounts of data. It enables investigators to examine relationships and communication flows among people, groups, organizations, computers, URLs and other connected entities. Experts can also use SNA to analyze behaviors that are red flags for occupational fraud. Moreover, SNA makes it easier for investigators to identify suspicious actions, such as transferring large amounts of data, working after hours or accessing data without authorization.

6 principles for better database management

As more and more organizations store information in searchable databases, disputes over the discovery of that data have become increasingly common in civil litigation. In response, the Sedona Conference — an influential think tank of leading jurists, lawyers, experts and consultants — has developed principles to simplify discovery of database information and clarify the obligations of both requesting and producing parties.

DEFINING "DATABASE"

According to the Sedona Conference Working Group Series, almost all databases share certain characteristics. They contain multiple pieces of discrete information, subdivided into data elements (or fields) or data records, stored in a common format and repository. The information stored in databases differs fundamentally from discrete unstructured data files (such as word processing documents), which tend to be static and self-contained.

Although they may refer to other files, unstructured files are standalone pieces of evidence. The user determines the information on the page and the formatting. In a database, individual data elements generally have no meaning on their own and may be calculated by a prescribed formula rather than by the user. Users also must adhere to strict rules on how information can be entered, stored and retrieved.

A responding party must use reasonable measures to validate ESI collected from databases.

DATABASE DISCOVERY PROCESS EVOLVES

Since the 2003 release of its principles for addressing electronic document production, the Sedona Conference has provided guidance on the preservation and production of all forms of electronically stored information (ESI), including databases. But the evolving nature of database discovery prompted the Sedona Conference to look beyond those principles to address issues that are unique to databases and their information.

For example, because of the frequently massive volume and structural complexity of database information, preserving, collecting and producing databases typically involves greater costs and burdens than those associated with producing unstructured information. Further, as the Sedona Conference notes, databases often are large collections of disparate information, and only a portion of a database is usually relevant to a legal dispute.

DATABASE PRINCIPLES

To define a reasonable scope of database discovery, both parties must understand several issues. These include the purpose for which the information is sought, components and respective relevance of the

data at issue, technology that stores and manipulates the data, and validation processes to ensure that the data produced is what is expected.

Then to inform and foster discussions between the parties of those issues, the Sedona Conference recommends the following six database principles:

1. Absent a specific showing of need or relevance, a requesting party is entitled only to database fields with relevant information, not the entire database where the information resides or the underlying database application.
2. Due to differences in the way that information is stored or programmed into a database, not all of the information may be equally accessible. Thus, a party's request for such information must be analyzed for relevance and proportionality.
3. Requesting and responding parties should use empirical information, like that generated from test queries and pilot projects, to determine the burden to produce information in databases and reach consensus on the scope of discovery.
4. A responding party must use reasonable measures to validate ESI collected from databases to ensure completeness and accuracy of the data acquisition.
5. Verifying information that has been correctly exported from a larger database or repository is a separate analysis from establishing the accuracy, authenticity or admissibility of the substantive information within the data.
6. The way in which a requesting party intends to use the database information is an important factor in determining an appropriate format for production.

The Sedona Conference plans to revisit these principles regularly to ensure they remain topical.

LAYING A FOUNDATION

In the meantime, the Sedona Conference expects its database principles to provide a foundation for attorneys and their experts. You should use them to devise effective solutions in this tricky area of the law.

Economic damages

The choice between lost profits and lost business value

Arriving at a damages award for a plaintiff's loss of economic benefits may involve calculating lost profits, lost business value and, in some cases, both. But the distinction between lost profits and lost value can be confusing. However, attorneys need to understand the difference so their clients don't accidentally "double dip" when calculating damages.

PROPER MEASURE OF DAMAGES

The availability of damages for lost profits or lost business value depends in part on applicable federal or state law. But most courts agree that, when a defendant's conduct destroys a business, the proper measure of damages is the business's fair market value on the date of loss.

In breach-of-contract cases, courts often limit damages to a plaintiff's lost profits during the contract term — even if the breach causes the plaintiff to go out of business. The rationale is that, if the defendant hadn't breached the contract, it could have terminated the relationship at the end of the term, and the plaintiff would have lost the defendant's business anyway. A plaintiff might counter, however, that if the defendant hadn't ended the

contract prematurely, it would have had time to develop new business to replace the loss.

In other cases, a plaintiff may be entitled to lost profits, lost business value or both (although this is rare). In "slow death" cases, for example, in which a defendant's conduct injures, and eventually kills, the plaintiff's business, both damage measures may come into play.

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AN OBVIOUS RELATIONSHIP?

Double dipping may occur when lost profits and lost business value damages relate to the same time period. The value of a business for a going concern is generally based on the future profits a hypothetical buyer can expect to earn. This is true regardless of the valuation method.

When the income valuation method is used, the relationship between profits and value is obvious. Under this approach, a valuator uses discounted cash flow or some other method to convert anticipated future earnings into a present value. Damage measurements for both lost profits and lost value focus on cash flow estimation and timing. They also take into account the risk associated with the probability of achieving a projected cash flow stream. But a business's earning capacity also must be considered when market- or asset-based valuation methods are used.

DIFFERENT ASSUMPTIONS, DIFFERENT RESULTS

Even when damages based on lost profits and lost business value overlap, the results of these two approaches won't necessarily be identical. In theory, when a defendant's conduct diminishes the value of a plaintiff's business, the difference between the "before" and "after" values may equal the present value of the plaintiff's lost profits on the valuation date. But this seldom happens in practice, because calculating lost profits and lost business value often involves different sets of assumptions, leading to different results.

For example, while a fair market value analysis looks at a business from the perspective of a hypothetical willing buyer, a lost profits calculation may involve consideration of the plaintiff's specific tax situation or other factors that cause it to earn more (or less) than a typical investor. A valuator may assess risk differently depending on whether damages are based on lost profits or lost value, which may affect the discount rate used to convert future profits to a present value. In addition, the valuator may reduce the business value for lack of marketability or liquidity — reductions that aren't applied in lost profits cases.

Another potential difference between lost profits and lost value is the role of hindsight. Business value generally is based on facts known or reasonably knowable on the valuation date, regardless of what has transpired between that time and the trial date. But it may be appropriate to consider subsequent events in determining the amount of lost profits.

MAKING THE CASE

Courts have ruled inconsistently on the types and amounts of damages that are allowed. To support your client's position, hire a financial expert who can help determine which type of damage measure is appropriate and persuasively make the case in court.

Calculation vs. valuation: A critical difference

Attorneys and their clients sometimes ask professional valuators to provide preliminary estimates — called "calculations" — rather than full-fledged business appraisals. While such requests might save money up front, a recent Iowa case, *In re Marriage of Hagar,* illustrates why calculations are no substitute for valuations.

DRY CLEANERS DIVORCE

Jodi and Michael Hagar married in July 1999. In December 1999, Jodi quit her job as a publishing sales representative and joined Michael at Goliath, Inc., where he had worked since 1996.

Goliath was established by Michael's parents to operate a dry cleaning business. In 1996, the parents formed Hagar, Inc. to purchase real estate and distribute income to themselves. Goliath remained the dry cleaning operating entity and leased its buildings and land from Hagar, Inc. In December 2000, the parents' CPA, Ron Helle, roughly estimated Goliath's value at about $500,000.

In January 2002, Michael entered into a purchase agreement and note to purchase Goliath for $300,000 from his parents' trust, which held all of the Goliath stock. Over the course of the marriage, Jodi and Michael reduced the note obligation to $160,000, creating $140,000 in equity.

When they divorced, the trial court found that Helle, who testified in court, estimated Goliath's value to be between $71,000 and $120,000. Neither party presented formal valuation testimony from a qualified valuation expert. In fact, Helle testified that his "computation" was *not* a valuation. Eventually the court determined that the business's value was $95,500.

COURT OF APPEALS DECIDES

On appeal, Michael claimed that the trial court had overvalued Goliath. He argued that Helle had provided an upper range of $71,000, and a lower range of *negative* $120,000. Jodi, on the other hand, asserted that the court had undervalued Goliath. She pointed out that the company had been "valued" at $500,000 in December 2000 and that half of the purchase price had been paid off.

The court of appeals agreed with both of them. It held that the $120,000 figure had been expressed as a negative number, as Michael contended. But it rejected Helle's calculations (which the CPA himself described as "thumb-nail") because he admittedly hadn't used "judgment" or recognized the family relationship between Goliath and its landlord.

The court found that Goliath and Hagar were, first and foremost, operated to benefit the family. For example, one unprofitable Goliath location wasn't closed as quickly as it could have been because the rent paid on it benefited Michael's parents. A qualified expert would have incorporated such factors in a thorough valuation.

REAL COST REVEALED

Goliath was ultimately valued at $140,000, about $70,000 more than the highest calculation provided by the CPA. Don't risk such a discrepancy in your own cases — get a thorough valuation.