Valuation & Litigation Briefing

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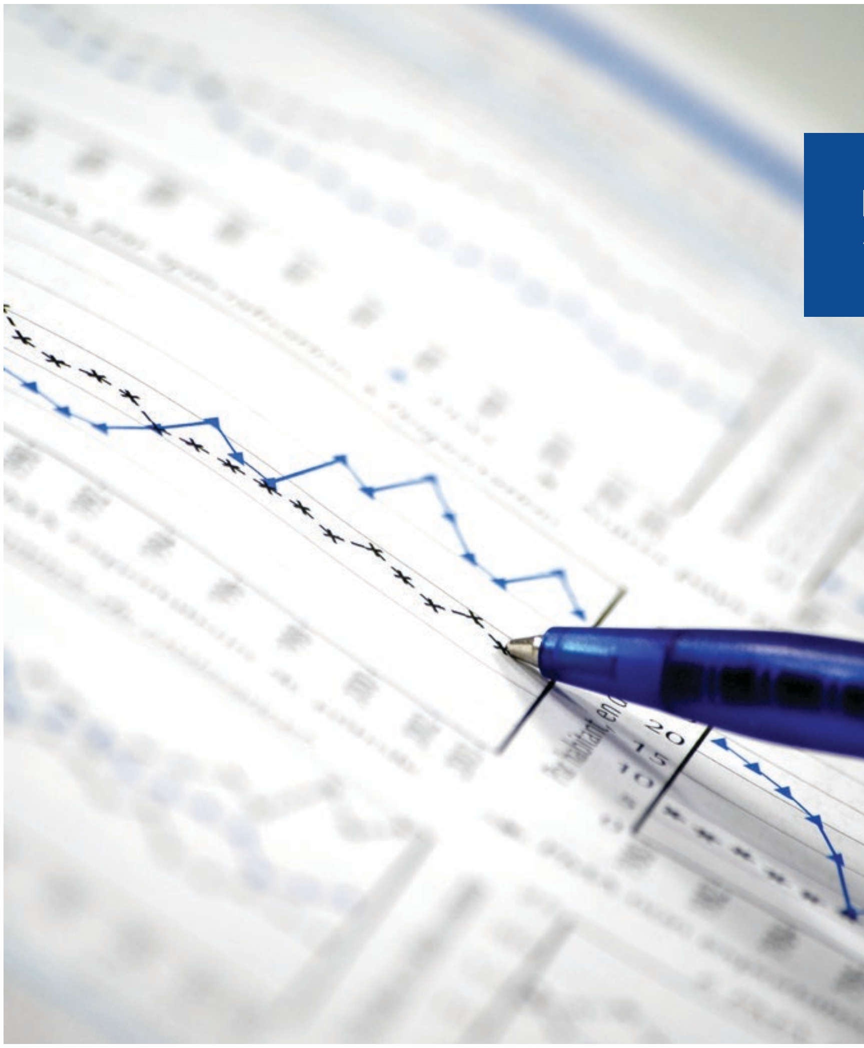

Proving lost profits with "reasonable certainty"

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Recovering lost profits generally requires a plaintiff to establish three elements: causation, foreseeability and reasonable certainty. The third element creates a challenge for damages experts. By definition, establishing lost profits involves proving something that, as a result of the defendant's misconduct, didn't occur.

What does it mean?

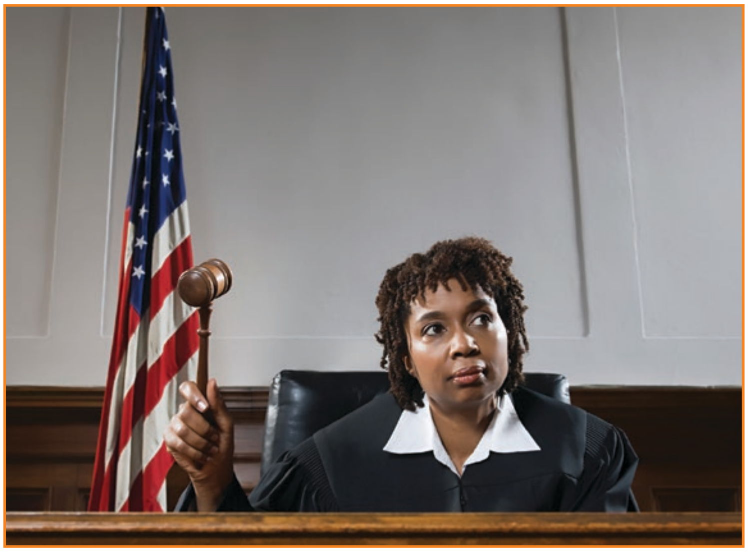
The meaning of "reasonable certainty" varies significantly. In some cases, plaintiffs must prove lost profits by a "fair preponderance of the evidence." In others, the standard might be "probable" or "more likely than not." Courts generally agree, though, that proving reasonable certainty doesn't require mathematical precision.

Some courts make a distinction between the *fact* of damages — that is, proof that the plaintiff would have enjoyed *some* level of profits but for the defendant's actions — and the *amount* of damages. They typically demand a greater degree of certainty that the plaintiff would have turned a profit and a lower degree of certainty regarding the amount of lost profits.

Is the business established?

It's generally easier to prove lost profits for an established business with an earnings track record. At one time, the "new business rule" prevented unestablished businesses from recovering lost profits on the ground that such damages were unduly speculative. Today, however, most courts have rejected the new business rule and allow unestablished businesses to recover lost profits as long as those profits can be proven with reasonable certainty. Part of the rationale for the modern rule is that it would be unfair to penalize a plaintiff for lacking a sufficient track record when it was the defendant's actions that prevented the plaintiff from establishing a track record.

However, keep in mind that, regardless of whether a business is established or unestablished, determining lost profits is a forward-looking exercise. An established business's earnings history provides important evidence of its future earnings potential. But a damages expert still must analyze a variety of factors — outside of the defendant's alleged wrongdoing — that might cause its future earnings to increase or decrease. Even a business that historically has been unprofitable can recover lost profits damages if its facts or circumstances signal a rosier future.



Damages experts consider several factors in determining lost profits, including management quality; management's experience with similar types of businesses; profits earned by comparable companies; industry, market and economic data; and, as discussed below, management's own business plans and financial projections.

Why is it critical to trust but verify?

For many courts, the best evidence of lost profits is management's own projections. Why? No one understands the company's operations better than people inside the company. When analyzing management's expectation of future performance, damages experts usually take a "trust but verify" approach. In other words, they understand that management is usually in the best position to gauge a company's financial prospects, but they also recognize that management's expectations are sometimes unrealistic. Forecasts and projections may be unreliable if they're, say, prepared in anticipation of litigation, in connection with a merger or acquisition, before going public, or under other circumstances in which management has an incentive to inflate its earnings potential.

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Even if management prepares a forecast or projection in the ordinary course of business, a damages expert will analyze the risks — including company-specific, industry and economic risks — that the plaintiff won't achieve its expected results. The expert can reflect these risks in lost profits calculations by reducing expected profits or by using a higher discount rate to determine the present value of those profits.

What's reasonable?

Damages experts need not prove lost profits with mathematical precision — the inherent uncertainty over any company's future performance makes such precision impossible. Nevertheless, they must present evidence and analyses that estimate lost profits with reasonable certainty. ■

Lost profits: A case in point

In *Inspectronic Corporation v. Gottlieb Skanska Inc.*, a New York appellate court addressed two of the three elements of a lost profits claim: foreseeability and reasonable certainty. The defendant had entered into a contract with New York City to perform repairs and renovations to the city's water reservoir system and had subcontracted diving and underwater services to the plaintiff. Nearly halfway through the project, the defendant terminated the subcontract and engaged another company to complete the work. The plaintiff sued for breach of contract.

The trial court ruled that the defendant had wrongfully terminated the contract and awarded the plaintiff more than $300,000 in lost profits. Damages were upheld on appeal.

Regarding lost profits on the unfinished "base work" items, the appellate court agreed that the proper measure of damages was the contract price, less payments made, less the cost of completion. There was no dispute over the contract price or payments made, and the court found that the plaintiff's own cost projections were generally reliable.

With respect to the change-order work, the appellate court found that lost profits were foreseeable because the parties anticipated dive-related change orders when they entered into the contract. And the amount of lost profits could be determined without speculation based on the actual amount paid to the successor subcontractor for change-order work.

Where's the money?

Ensuring fair outcomes in divorce cases

Unfortunately, divorce often becomes acrimonious, and that acrimony frequently centers on money. Allegations of hidden assets, or even fraud, can muddy the waters and heighten tension, making a fair resolution increasingly difficult. Especially when a private business interest is involved, valuation and forensic accounting expertise is key in helping spouses equitably divide their assets.

Looking behind the numbers

Valuators may have to watch out (and adjust) for spouses trying to dissipate their businesses' values. For instance, the moneyed spouse may attempt to hide business assets, delay revenue recognition or overstate expenses.

Of course, the nonmoneyed spouse has less experience and knowledge of the business, and such a charge may be baseless. But to determine whether the claim is justified or is completely without merit, valuation — and forensic accounting — expertise can be key.

A lower bottom line benefits a moneyed spouse in two ways. First, to the extent that a company's value is based on its earnings, reduced income lowers value. Therefore, low profits increase a moneyed spouse's share of the marital estate's remaining assets. Some moneyed spouses will even hide physical assets or use fraudulent accounting tactics to lower profits reported before their divorces.

This requires the valuation expert to look behind the numbers and use forensic accounting techniques to search for unreported income. One approach valuators use to uncover missing income is to search for hidden cash.

Finding missing cash

Business owners sometimes receive unreported income in the form of cash. To avoid detection, the business doesn't record the income in its books or deposit the cash in its bank account. But experts can use several forensic accounting techniques to indicate whether cash is missing and estimate how much the owner isn't reporting.

Under the bank deposits method, the expert reconstructs income by analyzing bank deposits, canceled checks and currency transactions. The expert also accounts for cash payments made from *undeposited* currency receipts as well as nonincome sources of cash — such as loans, gifts, inheritances or insurance proceeds.

Alternatively, when experts use the source and funds application method, they analyze the business owner's personal sources and uses of cash. This method is effective in addressing the question: Where did income and other funds come from, and what were they used for? If the owner is spending more than he or she is taking in, the excess represents unreported income.

The net worth method is based on the assumption that an unsubstantiated increase in a business owner's net worth is attributable to unreported income. Here, the valuator estimates net worth using documents such as bank and brokerage statements, real estate records, and loan or credit card applications.

Under the percentage mark-up method, the expert estimates net income by applying a benchmark profit percentage to sales or some other base amount. He or she starts with the amount of gain in net worth, subtracts reported income and adjusts this amount to reflect nondeductible expenditures — such as capital asset acquisitions — and nonincome sources of funds. This method is often used to corroborate results of other methods.

Reaching an accurate and fair result

The techniques described here are just a few examples of the many ways forensic accounting techniques can produce more accurate valuations. When searching for hidden cash, it's important for valuation experts and legal counsel to work together closely, because laws and legal precedents in divorce cases may differ from state to state. Such collaboration can help ensure that the numbers are accurate — and that the settlement is fair and holds up in court. ■

Reasonable compensation

IRS job aid offers guidance

The reasonableness of a business owner's compensation is an issue in many valuation and litigation contexts. For attorneys, business appraisers and financial experts faced with this question, the IRS publication *Reasonable Compensation: Job Aid for IRS Valuation Professionals* can be a useful resource.

Why it matters

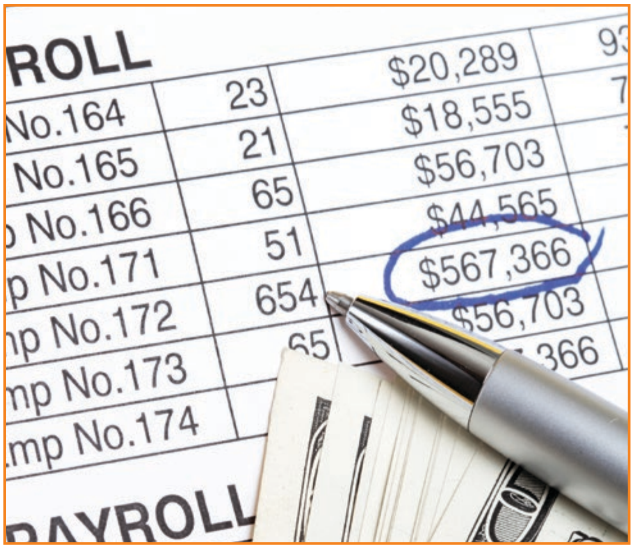
Reasonable compensation issues arise in a variety of situations. When valuing a controlling interest in a business, for example, valuators often "normalize" owner compensation. In other words, they adjust it (either up or down) to a reasonable level to provide a more accurate picture of the company's potential earnings in the hands of a hypothetical buyer.

It's also a frequent issue in tax-related litigation. For example, the IRS or a state tax authority might allege that:

- A family business owner overpays his or her children to disguise taxable gifts as deductible compensation,
- A C corporation overpays its owners to disguise nondeductible dividends as deductible compensation, or
- An S corporation or other pass-through entity underpays its owners (and makes up the difference with "distributions") to minimize payroll taxes.

The job aid emphasizes that reasonable compensation is a "factually intensive" issue that "must be determined based on all relevant facts and circumstances." Factors to consider include the employee's qualifications and role in the company, comparable salaries paid by similar companies for similar services, the company's character and condition, potential conflicts of interest in the employee's relationship with the company, and internal consistency in the company's compensation practices.

The IRS considers more than just an employee's weekly paycheck. It looks at his or her *entire* compensation package, including company vehicles, club memberships, discounted products and services,



educational reimbursements, below-market loans, employee stock plans and profit sharing arrangements, and other perks that may or may not show up on W-2 forms.

Three valuation approaches

The three general valuation approaches — market, income and cost — also apply to reasonable compensation. The market approach is most commonly used and involves comparing an employee's salary to those paid by similar companies for similar services. The job aid lists several sources for obtaining comparable salary data, including general surveys that are coded by industry, salary surveys published by trade groups or industry analysts, public company annual reports and proxy statements, and private company compensation reports such as those published by Dun & Bradstreet or The Risk Management Association.

The income approach is based on an independent investor test. It asks whether an independent investor would be satisfied with his or her return on investment after paying the compensation at issue. The job aid notes that this approach works only if the company's fair market value is available for each year the compensation is paid. This can be a challenge, especially for private companies.

On the other hand, the cost approach breaks down an employee's duties into its components — such as administration, finance, marketing, purchasing or engineering — and then uses salary surveys to assign a "cost" to each duty. This technique can be useful when an employee performs a wide range of tasks and works long hours — or when replacing the individual would require the company to hire multiple people. Challenges associated with using this approach include correctly allocating an employee's time and finding market salaries for comparable part-time positions.

Opposing arguments

The job aid discusses several arguments taxpayers may make to support the reasonableness of allegedly excessive compensation. For example, a taxpayer might argue that the excess is meant to make up for being undercompensated in previous years, performing multiple jobs or personally guaranteeing company debt.

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Key people may also command an above-average salary, especially if they've signed a noncompete or employment contract. To claim someone is a "key person," a link between the value of the business and the retention of the individual must be established. No one is irreplaceable over the long run, but it sometimes may be difficult for a company to recover from the loss of an exceptionally talented or charismatic leader.

Valuable tool

The job aid isn't binding on the IRS, and it has no precedential value. But it does offer valuable insight into the IRS approach toward determining reasonable compensation. You can find it on the IRS website or contact a valuation professional for more information.

Qualified settlement funds provide significant tax advantages

Lawyers for both plaintiffs and defendants should consider using qualified settlement funds (QSFs) to achieve smoother, more tax-efficient settlements. A QSF is a trust designed to hold settlement funds pending distribution to one or more plaintiffs. It allows defendants to take a current tax deduction for payments into the QSF, even though it may be months, or even years, before the plaintiffs and their counsel receive any taxable income.

Potential upsides

Congress originally authorized QSFs to facilitate class action settlements, but they can be used in many other types of litigation. They're particularly valuable in cases with multiple claimants or multiple defendants that involve complexities or disputes over cost and fee allocation or settlement fund distribution. Defendants can satisfy their liabilities, gain immediate tax benefits and remove themselves from the proceedings — leaving plaintiffs and the court to sort out the ultimate disposition of the funds.

From the plaintiffs' perspective, a QSF provides the time and flexibility to address various administrative matters and to decide whether to take a lump-sum payment or arrange a tax-advantaged structured settlement. Similarly, plaintiffs' lawyers can decide whether to take their contingent fees as a lump sum or stretch their taxable income over several years in a structured fee arrangement.

The basics

A QSF is relatively easy to set up and has three requirements — it must:

1. Be established and supervised by a court or government agency,
2. Be established to resolve or satisfy one or more legal claims, and
3. Meet state-law requirements for establishing a trust.

As a separate legal entity, a QSF is subject to tax on its income — but it's exempt from tax on contributions from defendants. Even though QSFs were designed with class actions in mind, tax code wording appears to permit their use in all types of litigation.

Some critics argue that QSFs aren't appropriate in cases involving single claimants, because single-claimant cases don't have the same settlement-fund-distribution complexities that multiple-claimant cases do. Proponents point out that, even when there's only one claimant, a QSF can serve a legitimate purpose. For example, it can facilitate a structured settlement in cases where defendants are uncooperative, or help sort out claims by insurers or other creditors.

Plan ahead

To take advantage of a QSF, make arrangements early in the litigation process. Once a settlement agreement has been signed and funds have been transferred, it may be too late. ■