



# The Expert

Perspectives on Litigation Services

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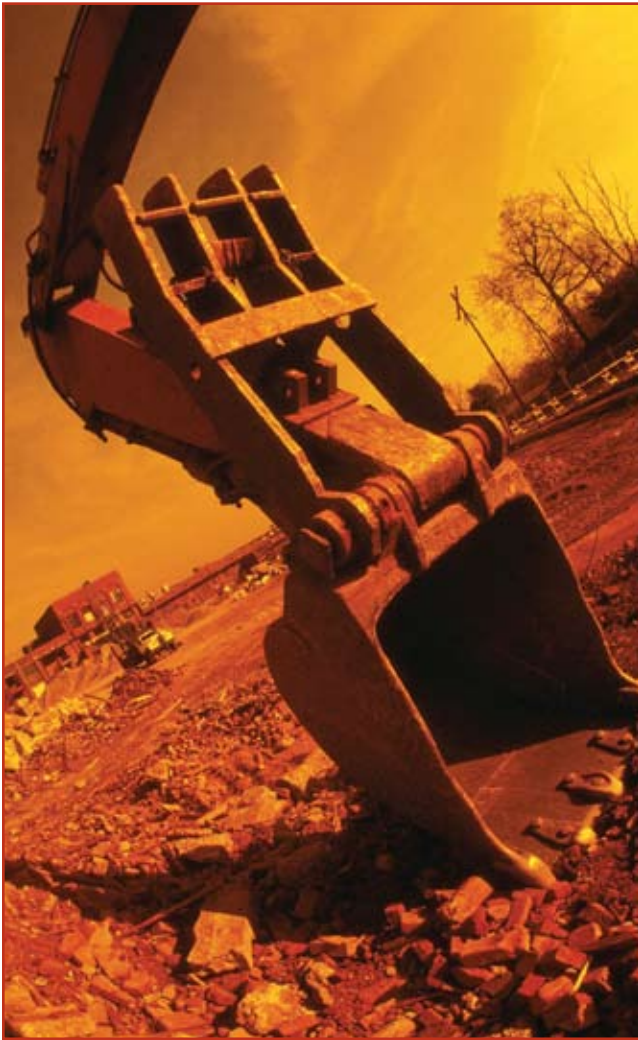


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# Information mining

## How experts dig through data to find fraud

From insurance scams to financial statement manipulation to fudged expense reimbursement reports, fraud victimizes businesses of every size and in every industry. Even when owners suspect fraud, however, they may not know how to gather the evidence to confirm it. Forensic accounting experts can help with data mining. By analyzing a company's own records, experts may be able to spot fraud before it causes significant financial losses.



### Shine a light

To mine data, specialists extract and analyze electronic data from databases to detect trends, patterns or inconsistencies. Data that might be mined include general ledger transactions; customer, vendor and employee records; access, telephone and computer network logs; and e-mail files.

In a fraud investigation, an expert generally looks for activity that diverges from behaviors typically associated with nonfraudulent transactions. Data mining, for example, could catch:

- Records with missing information,
- Vendor addresses that match suspicious addresses,
- Multiple vendors using the same address,
- Unusually high payments to vendors or other transactions outside the normal range,
- Payments for large amounts near the end of a quarter,
- Vendor invoices with consecutive numbers, suggesting the vendor has no other customers,
- Payments just under the amount requiring manager approval,
- Payments to terminated or nonexistent employees, and
- Transactions with future dates.

Though innocent explanations are always possible, any of these occurrences merit further investigation.

### Down the shaft

Forensic experts develop a set of business rules for identifying nonsuspicious data and validation procedures, such as verifying that a vendor's listed address actually exists. If data violate the rules or can't be validated, fraud may be to blame — particularly when multiple deviations are uncovered.

Experts then determine which data to mine, narrowing it according to the relevant time period and appropriate computer system. They must establish how the data will be gathered and prepared, interpreted, and monitored going forward.

### Hitting a wall

Several preliminary considerations will affect the scope and effectiveness of data mining. The availability of the

## Fraud investigation or audit?

Your clients may not understand the distinction between audits and fraud investigations, but the processes differ in several significant ways, including:

**Timing.** Audits are conducted on a recurring basis; investigations are generally triggered when a business has received an anonymous tip, auditors have found a discrepancy or suspicions are otherwise raised.

**Scope.** Auditors issue an opinion; investigators uncover and report facts that support or refute a suspicion. Investigators don't weigh in on a suspect's culpability or provide assurance that the company is free of fraud.

**Method.** Auditors examine financial information. Investigators dig deeper, considering a wide range of business documents, data and relationships. They also might conduct interviews with employees and third parties such as vendors.

**Approach.** Auditors render an opinion as to whether the financial statements fairly represent the company's financial position. Thus, the auditor has some flexibility, in the form of professional skepticism. By contrast, investigators are finders of fact who look only at the financial and nonfinancial facts surrounding a transaction.

necessary data — for example, the amount of lead time required to obtain access to it — will be a factor. Experts also must decide if the data requires extensive, potentially time-consuming preparation to convert it into a usable format. Other considerations include the integrity of the data source and the data; the software and hardware needed for analysis; and any limitations within the data that affect its usefulness.

*Experts must decide if the data requires extensive, potentially time-consuming preparation to convert it into a usable format.*

Data collection can prove difficult with complex or older data stored in a single database. A company's database might, for example, hold some tables compiling customer data and other tables with order information. An expert must link those tables together using common fields in each and then narrow the data to the fields with information of interest.

Working with multiple systems and data also can present challenges. Data field formats might not translate properly when imported; numbers, dates or ranges might import as text; or data may be split among multiple fields. The necessary data may not even be readily available in database form. When a specialist is dealing with expense reimbursement or other hard copy forms, for example,

it may be necessary to build a new database from the submitted forms.

### Be properly equipped

Forensic accountants with experience identifying specific fraud schemes can use data mining to spot telltale patterns. These experts also are invaluable in analyzing data to determine whether suspicions are founded and worth pursuing.

Finally, forensic accountants understand the implications of potential litigation and recognize the need to protect the company while conducting their investigations. They'll structure their notes appropriately to maintain the integrity of the data and preserve the chain of custody. ■



# Court excludes assets from gross estate in family LLC case

After dealing taxpayers a series of losses in cases involving family limited partnerships (FLPs) and limited liability companies (LLCs), the Tax Court has allowed the assets in a family LLC to be excluded from the decedent's gross estate. The opinion in *Estate of Mirowski v. Commissioner* provides valuable guidance on how your clients can effectively use these planning tools.

## The family that works together

Anna Mirowski's husband held various patents relating to the implantable cardioverter defibrillator (ICD) and had entered an exclusive licensing agreement. Upon his death in 1990, the patents, his interests under the license agreement and most of his remaining assets passed to Mirowski.

In 1992, she created irrevocable trusts for each of her three daughters. According to the court, she "named all three of her daughters as cotrustees of each of the daughters' trusts. She did so specifically because she wanted her daughters to work together and have a close working relationship." Mirowski funded the trusts with gifts of her interests in the license agreement, until she held a 51% interest in the royalties under the agreement and each trust had a 7.26% interest. Over time, the royalties received increased from thousands of dollars a year to millions of dollars a year.

*The transfer fell within the exception because Mirowski had legitimate and significant nontax purposes for forming the LLC and transferring certain assets to it.*

In 1999, Mirowski started thinking about other ways to encourage her daughters to work together. Ultimately, she decided to form an LLC, but delayed discussing it until a family meeting in August 2001. In the interim, Mirowski developed a foot ulcer, for which she underwent surgery.

Mirowski's health wasn't rapidly deteriorating, but she didn't attend the family meeting where the LLC was discussed. After the meeting, she executed the final LLC 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 LLC, in exchange for a 100% interest in the LLC. On Sept. 7, Mirowski gave each daughter's trust a 16% interest in the LLC.

Mirowski died unexpectedly on Sept. 11, 2001, holding a 52% interest in the LLC. Before her death, she had retained substantial personal assets, including more than \$3 million in cash and cash equivalents, and at no time were the LLC assets commingled with her own. Nor was there any express or unwritten agreement among Mirowski and her daughters that Mirowski would distribute LLC assets to pay any unexpected financial obligations she incurred.

## The bona fide sale exception

The IRS calculated a tax deficiency of \$14.2 million, asserting that the assets in the LLC were includible in Mirowski's gross estate under Internal Revenue Code Section 2036(a). Under Sec. 2036(a), property transferred by a decedent is nonetheless 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 Tax Court, however, held that the bona fide sale exception applied to the transfer of the \$60 million in assets

to the LLC. The exception excludes from the gross estate any property transferred by a decedent if the transfer was a bona fide sale for an adequate and full consideration in money or money's worth.

According to the court, the transfer fell within the exception because Mirowski had legitimate and significant nontax purposes for forming the LLC and transferring certain assets to it. These purposes were to:

- Manage jointly the family's assets by her daughters and eventually her grandchildren,
- Maintain the bulk of the family's assets in a single pool of assets to allow for investment opportunities that would not otherwise be available, and
- Provide for each of her daughters and eventually each of her grandchildren on an equal basis.

The court further found that at all relevant times, including after Mirowski's death, the LLC was "a valid functioning investment operation and has been managing business matters relating to the ICD patents and the ICD patents license agreement."

## No implied agreement

The gifts of the 16% LLC interests to the daughters' trusts weren't bona fide sales within the exception. But the court held that they also were excludable for Mirowski's estate because no implied agreement existed that Mirowski would retain the possession or enjoyment of, or the right to income from, the 16% interests that she gave the trusts. It noted that the LLC's operating agreement mandated annual distributions and didn't grant Mirowski authority to make distributions of capital proceeds or allocate profits or losses from capital transactions.

Similarly, the court found that Mirowski didn't retain — either alone or in conjunction with another — the right to designate the persons who possess or enjoy the 16% interests or the income from those interests.

## Mirowski as a roadmap

The Tax Court decision in *Mirowski* is, of course, fact-specific, but it can serve as a useful reference for attorneys involved in FLPs and family LLCs. In particular, the opinion includes an appendix with the LLC's operating agreement that can serve as a roadmap for future agreements. ■

## Methodology matters

### When an expert isn't expert enough

A Rhode Island court's decision to exclude expert testimony in a patent infringement case should remind attorneys that their experts' qualifications aren't the only potential issue. The decision in *Bowling v. Hasbro* suggests that experts also must base their opinions on reliable methodology.

### Roll of the dice

Michael Bowling, who holds a patent on a type of dice, alleged that Hasbro sold board games with dice that infringed his patent. Bowling retained an expert to determine the amount of damages caused by Hasbro's infringement.

The toy maker moved to exclude the testimony on the grounds that the expert's credentials and background were insufficient. It further argued that his opinion was unreliable because he'd failed to adequately apply the relevant methodology for calculating royalties, known as the *Georgia-Pacific* factors.

Bowling's expert held degrees in business and accounting; had worked as a CPA for more than 30 years; had testified on licensing matters at least six times; and had prepared approximately 12 expert reports on intellectual property, infringement and licensing issues for various courts. Hasbro, however, argued that he was unqualified because he lacked experience in the area of game-component licensing.

### Reliability rejected

The court disagreed with Hasbro. It held that the witness's "qualification as an expert does not depend on his experience in the toy industry, and he is otherwise amply qualified to testify as to reasonable royalty calculations."



The problem, the court said, derived not from his knowledge, skill and experience, but from the specific analysis he conducted in the case. The court didn't soft-pedal its criticism: "[His] report and testimony reveal that no rigorous analysis was performed here; rather the witness engaged in a superficial and result oriented application of the *Georgia-Pacific* methodology." It specifically faulted the analysis for its lack of sufficient reference to facts, data or any relevant information.

For example, the fifth *Georgia-Pacific* factor involves analysis of the commercial relationship between the parties. Without any explanation, the expert deemed the relationship as one of supplier (Bowling) and customer (Hasbro), tilting the royalty rate heavily in Bowling's favor.

He provided no examination of either Bowling's or Hasbro's other business relationships for these or similar products, no industry data for game components, and no discussion of the parties' relative market powers. As the court noted, the expert "provide[d] no facts to indicate why, despite Hasbro's ability to manufacture and supply the dice on its own, as it was doing, the parties would have negotiated as customer and supplier."

### Don't gamble with methodology

An expert's qualifications alone don't render his or her opinions admissible. As the court in *Bowling* so eloquently put it, "Mere reference to the [accepted methodology] cannot change the sow's ear of rank speculation into a silk purse of reliable expert opinion." ■

## Failure to obtain valuation undermines fraud claim

A recent fraud case involving a buy-sell agreement drives home the importance of obtaining an independent valuation. In *Lusins v. Cohen*, the plaintiff's failure to compel an independent valuation meant it couldn't ultimately claim justifiable reliance on the defendants' representations regarding a sale.

### A partnership divided

The case was brought by the executor of an estate that included interests in a number of business entities the decedent had owned with a partner. The partners had an agreement that, if one died, the other could purchase his piece for a price of at least \$500,000.

The executor retained an attorney to represent the estate in the sale. He consulted with the decedent's CPA, a close family friend; the partner; an attorney who had performed work for the entities; and a CPA who had performed work for some of the entities. Based on information those sources provided, the executor entered a settlement and sales agreement for \$500,000. The executor subsequently filed a fraud action against the partner and the attorney and CPA who had worked for the entities. (The decedent's own CPA had died.)

The estate's attorney testified that the decedent's CPA had determined the estate couldn't establish a value greater than \$500,000. The estate's executor had accepted the deal to avoid the expense of an independent valuation, provide the widow with an immediate source of income and ensure continued employment of the decedent's son by one of the entities.



### Justifiable reliance lacking

The appellate division of the New York Supreme Court noted that justifiable reliance — one of the essential elements of fraud — has been found lacking where a party had the means to discover the true nature of a transaction by exercising ordinary intelligence but failed to use those means. Because the executor could have compelled a valuation of the entities before accepting the \$500,000 purchase price, a claim of justifiable reliance could not stand. The fraud cause of action was, therefore, properly dismissed.

Don't let the upfront costs of a valuation deter your clients. In the long run, the expense is usually well worth it.

# Calculating losses for new or never-launched businesses

Lost profits are a common form of damages in business litigation, and most damages experts are comfortable calculating them. But establishing lost profits when the plaintiff is a new or never-launched company with little or no historical financial data can prove tricky — tricky, but not impossible.

## Dealing with a dearth of data

The problems when estimating damages for new or never-launched businesses stem primarily from a lack of data. To calculate lost profits, experts generally project the plaintiff business's lost revenues and adjust that amount by appropriate profit margins. They typically base revenue projections on data related to the company's own projections, its historical performance and its industry, as well as on larger economic trends and forecasts.



With a new business, an expert may face inadequate or nonexistent performance data and insufficient business data that can be correlated with trend information. How then can he or she project revenues and profit margins?

## Determining reasonable certainty

Fortunately, those calculating lost profits need only determine them to a reasonable certainty. Thus, an expert might be able to apply industry growth rate projections to individual company data to develop multiple revenue projections, varying the combinations of actual and projected data. If the results from the different projections fall within the same range, the

expert can proceed to use company-specific data to develop cost structures.

If company data is sparse, experts can determine market share and estimated penetration based on models and studies of new-product lifecycles. They can validate revenue projections with data from governmental agencies, trade associations and other sources that track expected demand, prices and cost structures.

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When determining profit margins for new businesses, experts again run into insufficient historical performance data or internal forecasts. In that situation, they may develop profit margins using internal data and reports, industry forecasts and other information sources.

## Court recognizes discounted damages

As with all calculations of this kind, experts apply a discount to projected lost profits. Courts recognize the need for such discounts on two bases:

1. The fact that a plaintiff can invest its award and earn an additional return on it — meaning that a plaintiff who receives an undiscounted amount of lost profits would stand to recover more than its actual damages, and
2. Projected lost profits necessarily carry an element of uncertainty. In the case of a new business, the discount must reflect the increased risk usually associated with young ventures and the possibly unrealistic — and unreliable — nature of the company's own projections.

## Going with experience

Calculating lost profits for embryonic companies with little historical data requires a different skill set than other damages calculations do. So be sure to work with an expert with experience in determining profits — and profit losses — in these situations. ■