



The Expert

Perspectives **L** on Litigation Services

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Summer 2008

New search-and-retrieval tools make it easier to target electronic data

Technological advances have made it cheaper and easier to store huge amounts of information electronically. As companies generate and store growing stockpiles of data, the search for relevant electronically stored information (ESI) during discovery becomes more and more daunting. Fortunately, the range of search-and-retrieval technologies has also expanded. So you'll never have to go back to the days when attorneys had to rifle through hundreds of boxes to find a single document.

ESI challenges

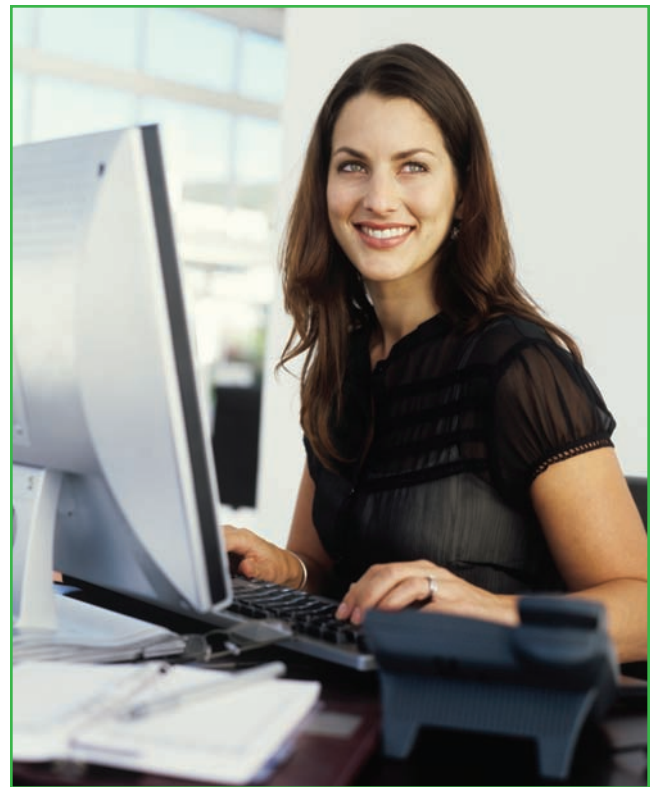
The search and retrieval of relevant ESI presents several challenges distinct from those that arise with hard copy evidence. For example, many employees today rely on laptops, PDAs, mobile phones and other portable devices. Relevant data could be found on any of these or other storage devices, as well as across multiple internal and external systems. It's possible that no single employee is even aware of every potential storage device being used by a company's workers.

Clustering groups documents with similar content, often by the number of words that overlap between each pair of documents.

What's more, much ESI is expressed in language, as opposed to numerical figures. The meanings of words can change or be ambiguous. They also can be adapted to particular circumstances, as when companies or industries develop their own lexicons. So relevant information can escape detection, as words that have one meaning to the search technology may have an entirely different meaning to those actually employing the words in the ESI.

Also, different search methods can produce different results. Tools and techniques apply various methods, and some of these are more effective than others in certain contexts.

Finally, though the most familiar search technique — keyword searching — is very effective for specific names and dates, it has notable deficiencies. Considering the abundance



of synonyms in the English language, a searcher essentially must guess which synonyms will locate the information of interest. If the search is too narrow, it could miss vital information, and if it's too broad, it might trigger a flood of "false positives." Typos or common misspellings also lead to overlooked ESI, and keyword technologies rarely provide rankings based on potential relevance.

Emerging tools

The gaps from keyword searches have inspired the introduction of alternative methods, including fuzzy logic (which captures variations on selected words), conceptual searching (which uses categories developed by linguists) and tools that rely on mathematical probabilities. The Sedona Conference, a nonprofit institute of judges, lawyers, experts, academics and others, has grouped the current search methods and techniques into three broad categories:

1. Keyword searches and Boolean operators. These encompass several methods, including keyword searches. This category also covers strings of keywords with Boolean operators such as "AND," "OR," "AND NOT," and "BUT NOT" to narrow results.

Getting a crack at the hard drive

Conducting a comprehensive search usually requires that you first obtain a court order for imaging, or duplicating, the hard drive of interest. Federal Rule of Civil Procedure (FRCP) 34(a) was amended in 2006 to allow litigants to request the opposing party to “produce and permit the party making the request ... to inspect, copy, test, or sample any ... electronically stored information.”

Access to a hard drive isn’t guaranteed, though. The Advisory Committee Notes to Rule 34 state that the addition of ESI to FRCP 34 wasn’t intended “to create a routine right of direct access to a party’s electronic information system, although some access might be justified in some circumstances.”

Under FRCP 26(b)(2), “[a] party need not provide discovery of electronically stored information from sources that the party identifies as not reasonably accessible because of undue burden or cost,” in the absence of good cause. Generally, courts have interpreted the rules to permit the imaging of a hard drive where a party has not satisfactorily met its document production obligations or upon a finding that a hard drive search would likely uncover deleted items.

2. Statistical techniques. These techniques analyze word counts — for example, the number of times a keyword appears in a document or appears near other keywords.

One example is clustering, which groups documents with similar content, often by the number of words that overlap between each pair of documents. Statistical techniques rest on the theory that a high number of common words indicates that separate documents cover the same topic.

3. Concept tools. Using various methods, these tools categorize an entire data set by searching for related words or terms. The tools help find documents that are conceptually related to the topic of interest based on commercially available data or information compiled specifically for the search. Such information is provided by attorneys or developed for the business function or industry at issue. A computer will then organize the documents according to predetermined

categories. Concept tools can be used to categorize a data set at one time or continually, as more data is added.

Planning your e-discovery

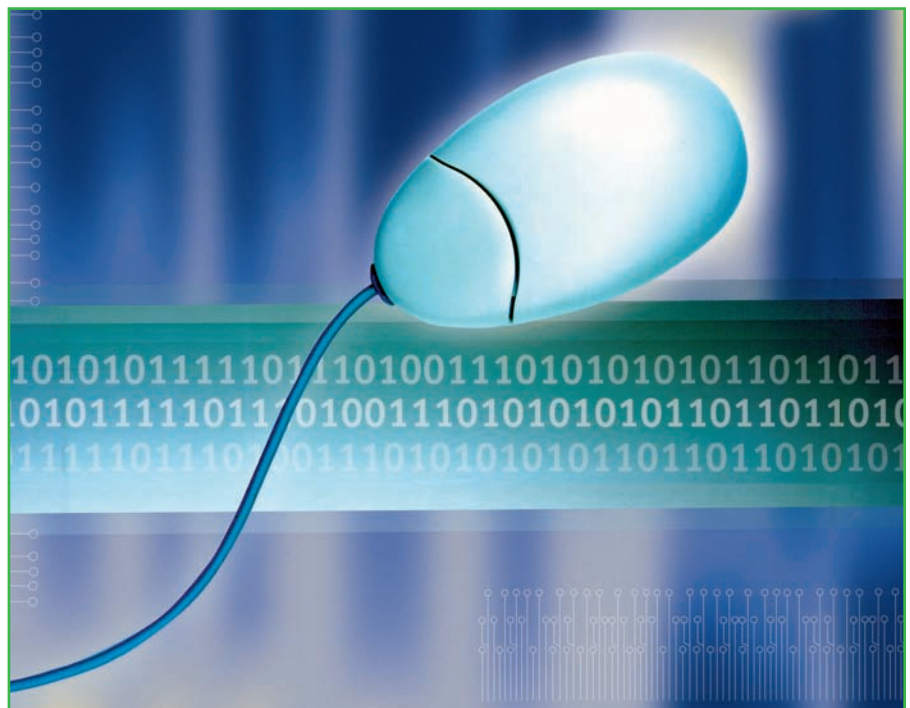
Not surprisingly, no single search-and-retrieval technology is superior for every scenario. Some technologies are better suited for certain situations, and some circumstances may call for the application of multiple tools. The appropriate method will depend largely on the particular legal context.

To make the most of the new technologies, you must first accept that manual searches are no longer reasonable in many, or even most, circumstances. Automated search tools should be considered early in the process to save the most time and expense.

At the same time, new techniques aren’t without their manual components. Extensive human input is required on the front end to narrow the focus of a search. Ideally, the opposing parties can collaborate in good faith on the selection of methods and even keywords. You and your experts should be prepared to justify your choices and explain why the results will be reliable.

A continuing evolution

The latest tools and techniques for finding relevant ESI are promising, but bear in mind that they will continue to evolve. In turn, the definitions of which actions are “reasonable” will change, potentially affecting the requests and responses that courts will approve. ■



Catching employee corruption before it corrupts a company's finances

Employee fraud isn't limited to misappropriation or manipulation of financial statements — corruption can cost employers, too. In its 2006 *Report to the Nation*, the Association of Certified Fraud Examiners (ACFE) revealed that the median loss suffered by surveyed companies from corruption schemes was \$538,000. But, if you know the signs of corruption, you can nip these schemes in the bud and minimize financial losses.

Undermining internal controls

ACFE defines corruption as “any scheme in which a person uses his or her influence in a business transaction to obtain an unauthorized benefit, contrary to that person's duty to his or her employer.” It typically involves collusion between an employee and an outside party to undermine a business's internal controls.

ACFE has noted a strong correlation between corruption and asset misappropriation schemes — with 75% of corruption schemes accompanied by misappropriation. Common corruption schemes include:

Conflicts of interest. The most popular type of corruption, conflicts of interest arise when an employee or executive has an undisclosed economic or personal interest in a transaction that could adversely affect the company. For example, an employee who owns an undisclosed interest in one of the company's suppliers and negotiates above-market prices for the supplier's goods has a clear conflict of interest.

An audit could uncover kickbacks, bribes or illegal gratuities disguised as consulting or finder's fees.

Bribery. This occurs when a person offers, gives, solicits or receives something of value in exchange for influencing an official act or business decision without the knowledge or consent of the business's principal. After accepting a kickback from a vendor, an employee might approve the vendor's inflated invoices.



Illegal gratuities. Similar to bribery, an illegal gratuity is when a person offers, gives, solicits or receives something of value for, or because of, an official act or business decision without the knowledge or consent of the principal. For example, an executive may negotiate an agreement with a contractor in exchange for an all-expenses-paid Caribbean vacation.

Extortion. When someone coerces another to enter a transaction or deliver property based on the wrongful use of actual or threatened force, fear, or duress, it's extortion. A classic example of this type of corruption scheme is when an employee refuses to use a particular vendor unless the vendor hires one of the employee's relatives.

Crime of opportunity

As with most employee fraud, corruption perpetrators usually see an opportunity and seize it. In the ACFE study, 28% of the perpetrators were members of upper management, who are in a position to bypass or override internal controls. Twenty-nine percent of the perpetrators worked in accounting or sales, where they had regular contact with vendors and clients.

The motive for these employees is often personal debt — at least initially. After perpetrators pay off their bills with ill-gotten gains, though, schemes frequently continue and many perpetrators begin to live beyond their apparent means. A lifestyle that seems disproportionate to an employee's salary is an important red flag that corruption is occurring.

There are, however, many other warning signs to tip off companies to the possibility of corruption. These include:

- Rising expenses for goods and services,
- Slow deliveries or other drop-offs in vendor performance,
- An increase in the dollar amount or number of purchases from a single vendor,
- Contracts that restrict competition, such as no-bid contracts,
- Unusually close relationships between a company's purchasing agent and its vendors, and
- Employees intervening to obtain preferential treatment for individual vendors, such as expedited payment.

Businesses should also monitor contract bidding patterns. If one vendor repeatedly wins contracts by narrowly outbidding the nearest competitor, or if the winning bid is often the last one submitted, it could indicate collusion between the vendor and an employee.

Unfortunately, corruption is unlikely to show up in an audit of the victim's books. So businesses should consider including contract provisions that grant them permission to audit their vendors' books related to the contract. An audit could uncover kickbacks, bribes or illegal gratuities disguised as consulting or finder's fees.

Finding the Achilles' heel

As corruption schemes go on, perpetrators tend to become lazy or sloppy, making detection more likely. In other words, every fraudster has an Achilles' heel. But with the potential cost so high, businesses can't afford to wait for slip-ups. Qualified fraud experts can help them spot internal control weaknesses and red flags early — before the financial and public relations consequences are dire. ■

How normalized earnings paint a true-to-life financial picture

You can't always trust that a business's financial statements will convey its true value. A company that seems to be scraping bottom may actually be supporting its owner's expensive lifestyle. To reach an accurate value, you need to work with a professional valuator to determine the business's normalized earnings. These earnings provide a more complete view of a company's financial position and facilitate easier comparison with other companies.

Making necessary adjustments

Valuators make adjustments after they study several critical areas. Most adjustments stem from the accounting method used in the financial statements. Under the cash basis method, for example, a company records revenue only as it's received and expenses only as they're paid. Thus, a company with high accounts receivable due could appear to have substandard revenue. And a business with significant debt may appear to be faring better than it is.

The income tax basis method, on the other hand, allows companies to defer some revenue, accelerate expenses (such





as depreciation) and ignore other expenses (such as vacation pay). Valuers often find it necessary to convert earnings calculations using this method to an accrual basis, recording income and expenses in the period in which they were generated.

Depreciating assets

Experts also adjust for depreciation and amortization. Fixed and intangible assets are depreciated based on their estimated useful lives and the method of allocating costs over those lives. But the useful lives and methods chosen may bear little resemblance to the actual economic lives and related reduced value of assets.

A company might, for example, routinely depreciate equipment over five years, but use some of that equipment for 10 years. The financial statements must be adjusted accordingly. Adjustments are also required when companies elect Section 179 treatment for equipment purchases under the Internal Revenue Code.

Other considerations

A variety of other adjustments can, depending on the company, be significant or relatively minor in the final calculation. These include:

Compensation and benefits. Some businesses hide costs in their compensation and benefits — particularly those for owners. Salary, wages and bonuses may not represent ordinary and necessary business expenses or prove reasonable relative to the work performed. When this is

the case, experts adjust numbers to reflect the value of the actual services rendered. They also scrutinize benefits — including retirement plans, club memberships, auto expenses, insurance, and travel and entertainment — for reasonableness and necessity.

Related-party transactions. Business transactions with parties related to a business's owners must be conducted at "arm's length." That is, if the business pays above- or below-market rental rates or prices for goods or services from related parties, experts make adjustments so that the goods and services represent fair market value. Sweetheart deals for favored customers also call for adjustments.

Inventory. The last-in, first-out (LIFO) method of accounting for inventory can understate inventory and deflate earnings.

Valuators generally convert inventory to the first-in, first-out (FIFO) basis for a more accurate balance sheet and cost of sales figure.

Salary, wages and bonuses may not represent ordinary and necessary business expenses or prove reasonable relative to the work performed.

Repairs and maintenance. Valuators review repair and maintenance costs to determine whether capitalization or expensing is the more appropriate treatment.

One-time entries. Recording income or expenses that are unlikely to recur can distort earnings. Valuators typically adjust for entries associated with developments that arise in the ordinary course of business, including litigation, government contracts or "acts of God."

Minimizing distortion

Valuators are capable of conducting the in-depth analysis needed to normalize assets and obtain a better picture of a business's value and position. Whether for divorce, sales, shareholder litigation or other purposes, adjustments can help produce an accurate and reliable documentation of a company's true earnings. ■

Allocating value to different types of stock

A privately held company's capital structure must be taken into account when calculating its value and the value of its stock. But this can be complicated because, increasingly, companies are financed with hybrid mixes of capital, including common stock and several classes of preferred stock.

The role of rights

Different equity classes offer different mixes of economic and control rights to their shareholders. Economic rights provide a shareholder with rights that remain effective regardless of the company's financial situation and preferences superior to lower classes of stock.

Preferences and protection include:

- Preferred dividends,
- Liquidation preferences,
- Mandatory redemption rights, and
- Conversion rights.

And control rights include voting rights and veto rights — providing shareholders with influence in major company decisions.

3 value allocation methods

The economic and control rights associated with a share class will greatly affect its value. The American Institute of Certified Public Accountants (AICPA) has recognized three methods for allocating value among different classes of equity:

1. Current value method (CVM). This method determines value by allocating the company's present value according to the rights and preferences of each equity class. CVM is easy to apply, but it doesn't take a forward-looking perspective on value. Instead, CVM assumes that the company is on the verge of liquidation and its enterprise value will be available for distribution to shareholders.

The AICPA suggests applying CVM only when a liquidation event is indeed imminent. It may also be used when a company is at such an early stage of development that no material progress has been made on its business plan and no reasonable basis exists for estimating future value.

2. Probability weighted expected return method (PWERM). Under this method, the company's value is estimated as of the date of various assumed future outcomes — including liquidation or an initial public offering. Each outcome is assigned a probability and value is allocated based on the preferences of the respective classes of equity.

PWERM assumes that shareholders maximize the value of their investments by, for example, converting their preferred stock to common stock, when appropriate. Each estimated outcome value is discounted to present value to reach a fair market value.

The AICPA deems PWERM appropriate for later-stage companies with the potential to go public or be acquired in the next few years. Although the method is forward-looking, it can prove difficult to apply because PWERM requires a significant level of subjectivity and a number of assumptions. It also can be hard to support the probability of different outcomes and value of the company under those outcomes.



3. Option-pricing method (OPM). Probably the most commonly used method for allocating value to stock, OPM regards the different classes as a group of call options on the company's value, which shareholders are capable of exercising. The shares' exercise prices represent each class's liquidation preferences and conversion rights.

Like PWERM, this method takes a forward-looking perspective on the differences between share classes. Unlike PWERM, it requires fewer assumptions. One OPM assumption, however, requires the valuator to account for volatility, which can be tricky to accurately estimate. OPM is generally best applied to mid- and later-stage companies with a wide range of potential future outcomes.

Which one?

The AICPA has noted that "no single ... value allocation method appears to be superior in all respects and in all circumstances over others." A professional valuator, therefore, will customize his or her approach to the specific facts, and the characteristics of the equity at issue, to ensure the most accurate appraisal.