



The Expert

Perspectives on Litigation Services

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Trail of deception

Tracking down spouses' hidden assets and income

In many divorce cases, the relationships end in a cloud of distrust and ill will. But even when marriages ostensibly conclude amicably, you must work to ensure a fair and equitable resolution. Forensic accountants can help by uncovering assets and income that spouses may attempt to hide to minimize their liability for child support or alimony or to reduce the final settlement amount.

Mapping assets

To begin a search for hidden assets and income, a forensic accountant will request information and records relating to:

- The spouse's education and employment history,
- All banks, brokerage firms and other financial institutions where the spouse has held accounts,
- All sources of income, including pending litigation and insurance settlements, and
- Lifestyle and personal expense levels.

A CPA also will be interested in the individual's personal and business relationships — including the names of family members, friends and business associates. These relationships may indicate where income is going or assets are being stashed. All of this information allows the expert to construct a larger road map of potential hidden assets and income.



Turning over rocks

Once the basic information about the spouse is compiled, a forensic accountant generally uses one of several methods to ferret out assets:

Expenditure method. Also known as the source and application of funds method, this strategy is deployed by matching the spouse's total personal expenditures during a period of time — using evidence from checkbooks, bank statements and canceled checks — against the available sources of funds. These sources can include salary, loans, gifts, inheritances and cash on hand at the beginning of the period.

Net worth method. A CPA compares the spouse's net worth (assets less liabilities) at the beginning of a period with the ending net worth. Information about assets might be accessed through county assessor offices, bank and brokerage records, tax returns, and credit applications.

Bank deposits method. This method assumes that money is either spent or deposited. Thus, net deposits (deposits less transfers and re-deposits) are added to cash expenditures to calculate total receipts. Funds from known sources are then deducted to calculate the total funds from unknown sources.

Besides using these methods, a CPA might engage in a little detective work — examining statements from frequent flier accounts, phone services and credit cards for charges that are unusual in amount, type, frequency or location. It's possible these charges will lead to hidden assets or income sources.

Challenge of closely held businesses

If the suspect spouse owns a closely held business, he or she may try to use the company as a vehicle for masking assets and income. A spouse might, for example, use business funds to purchase personal assets such as cars and real estate or to cover



Tax returns: A wealth of information

Tax returns can reveal a wealth of evidence that a spouse is hiding assets or income. Itemized deductions listed on Schedule A, for example, may suggest that the spouse is living beyond his or her apparent means, in turn raising the possibility of hidden assets. It's important to investigate whether the deductions for property taxes, mortgage interest and charitable giving are proportionate to reported income.

Schedule B provides details on interest and dividends totaling more than \$1,500. The spouse should have disclosed all of the bank accounts and securities listed. If the amount on lines 8a and 9a of Form 1040 is \$1,500 or less, meaning the Schedule B detail isn't required, information on the underlying assets should be sought.

Schedule D reveals capital gains and losses. If capital transactions are recorded as having occurred, you can use discovery to follow up on the disposition of the proceeds.

personal expenses like cell phone bills, insurance premiums or club membership dues. All of these expenditures can reduce the business's net income and thereby reduce its value as a marital asset.

The business also could have unreported income. A forensic accountant, therefore, will scrutinize actual expenses, associated expected sales, accounts receivable and journal entry write-offs. And the expert will further examine the business's internal controls and the spouse's ability to override them, its markup structure, and the associated expected profitability. Finally, the

existence of related-party transactions is important because they can indicate attempts to divert income from the business.

Dig in every corner

You can ill afford not to dig in every financial corner — particularly in situations where a client had limited access to the couple's financial information during the marriage. Doing everything possible to uncover stashed income and assets ensures clients receive the settlement and support they're entitled to. ■

Discount-a-rama: Court addresses a flurry of discount issues

In a recent case over a taxpayer's gifts of more than \$34 million in partnership interests, *Temple v. U.S.*, the Eastern Texas District Court waded into a pool of issues related to appropriate discounts. Among other issues, the court addressed the applicability of the quantitative marketability discount model (QMDM), restricted stock studies and holding period requirements.

The gifts at issue

Arthur Temple made significant gifts of interests in four entities to his children and grandchildren. The entities included a family partnership, known as Ladera, which

held a ranch; a limited liability company that operated Boggy Slough, a winery in California; and two identical family partnerships that held publicly traded securities. All of the gifts were minority interests, except one gift of a majority interest in Boggy Slough.

When valuing the gifts for tax purposes, Temple applied a 40% discount to interests in Ladera and Boggy Slough. Following an audit, the IRS found that Temple had undervalued these gifts, and assessed additional tax and interest of \$3.54 million. The Temples paid the additional assessment but filed claims for a refund. At trial, the court focused on the applicable discounts, considering each entity separately.

Discounts for Ladera

Valuing the Ladera gifts, Temple's expert used a study that examined premiums paid for control of public companies to support a 25% lack-of-control discount. She relied on the QMDM — which considers the subject interest's future dividends, holding period and return requirements — to determine the marketability discount. Assuming a 10- to 15-year holding period and a 3% expected appreciation of property assets, she arrived at a 45% marketability discount. Her overall discount for the gifts was approximately 59%.

The court found the study of public companies inapplicable, because Ladera was a holding company. It also deemed the expert's assumptions under the QMDM too speculative, noting that the Ladera partnership agreement had no holding period requirement. Further, the 3% appreciation figure resulted from a conversation with someone in the real estate department of the expert's firm and wasn't based on similar Texas real estate holdings.

The court found the testimony of the IRS expert, who looked at average discounts for limited partnerships that held primarily real estate, more relevant. The court, therefore, applied a combined discount of 38%.

Discounts for Boggy Slough

Temple's daughter received a 76.6% membership in the Boggy Slough winery, and the IRS contested the related lack of control discount. Under the winery's operating agreement, 51% of the membership interests could dissolve the entity. The agreement, however, provided no mandatory manner of dissolution. The members holding at least 51% could sell the property in the event of liquidation and

dissolution, or could use distribution of property in kind. Because Boggy Slough constituted real property, any distribution of property would result in undivided interests to the members.

The court weighed the implications of receiving an undivided interest in the winery property. It observed that a key consideration for the dissolution of such an interest is the absolute lack of control any member holds, regardless of the size of the interest or part of that interest owned. Co-owners can, therefore, complicate the dissolution process greatly.

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The court concluded that a 60% discount was warranted for the *majority* interest. Its conclusion was notable, especially as the minority interest gifts in the winery received only a 38% discount.

Discounts for the family partnerships

To value the various interests in the family partnerships, the taxpayer and IRS experts both used closed-end funds to quantify the lack of control discount and restricted stock studies for the marketability discount. The court found the IRS expert's opinion more comprehensive because he hadn't excluded any funds when analyzing the control discount.

For the marketability discount, in addition to restricted stock studies, the IRS expert considered academic research, the costs of going public, secondary market transactions, asset liquidity, partnership interest transferability and whether distributions were made. The court opted for 3% to 10% discounts for lack of control and a 12.5% discount for lack of marketability.

Getting it right

Temple ultimately received a \$7 million refund from the IRS. The more far-reaching point, though, is that the court favored the discounts and testimony that were supported by the most data. ■



21st century discovery

FRCP amendments regarding electronic data demand expert assistance

This past April the U.S. Supreme Court approved several amendments to the Federal Rules of Civil Procedure that create a new category of materials subject to discovery, known as electronically stored information (ESI). Although the amendments don't actually define the term, they do address numerous ESI issues likely to arise during discovery. In light of these amendments, consider involving forensic experts from the very start.

Addressing early issues

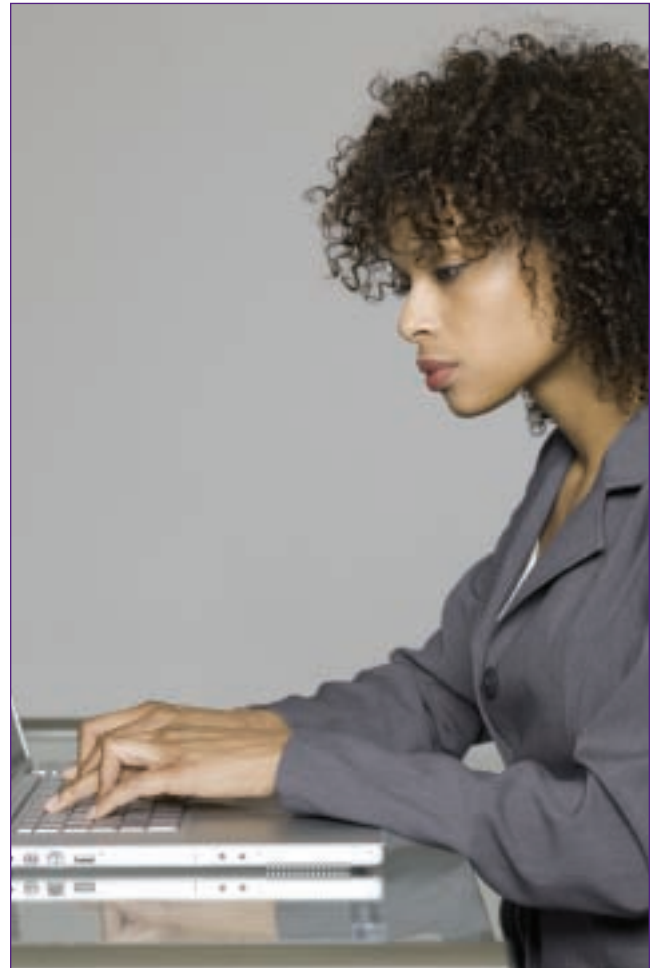
Various amendments address procedures early in a litigation. To begin with, amended Rule 16 establishes a process for the parties and court to address early issues pertaining to the disclosure and discovery of ESI. Similarly, Rule 26(f) is amended to direct parties to discuss discovery of ESI at the discovery-planning conference if such discovery is expected. This includes discussing the form and preservation of ESI, problems associated with reviewing ESI and the assertion of privilege after production.

Forensic experts can supply critical input on constructing the framework that will govern the discovery of ESI. In particular, the notes to Rule 26(f) urge attorneys to become familiar with ESI systems before the planning conference and caution against failing to address preservation issues early in the litigation. Forensic experts with experience in electronic data can assist with both of these concerns.

Producing ESI

The amendments also guide participants in the handling of ESI during discovery production. Rule 26(a) expressly recognizes ESI as a separate category of information subject to initial disclosure requirements. At the same time, the amendment deletes reference to “data compilations” — now regarded as a subset of both “documents” and “electronically stored information.”

Discerning if data qualifies as relevant — whether on the side producing the data or the side evaluating produced data — will often call for forensic expertise. The amendments don't provide clear rules for assessing whether produced data is responsive, but experts can strengthen a party's argument on the responsiveness question.



Experts also can weigh in on whether data is reasonably accessible. Rule 26(b) limits a party's obligation to produce ESI that is “not reasonably accessible because of undue burden or cost.” The producing party carries the burden of making the required showing. Even if that party carries its burden, the court can order discovery if the requesting party demonstrates good cause. Expert input can prove critical on such issues.

Other targets of discovery

Rule 34 authorizes a requesting party to specify the form of production and the responding party to object. Consulting with an expert in advance can ensure a party requests data in the most useful and workable format, saving subsequent time and money. If a request doesn't specify the form for producing ESI, the responding party must produce the information

in a form or forms in which it is ordinarily maintained or ones that are reasonably usable. A responding party need not produce the same ESI in more than one form.

The amendments also acknowledge that many businesses routinely delete electronic data — without intending to destroy evidence — as part of their normal operations. Rule 37 offers a safe harbor that protects a party from sanctions for failure to produce ESI as long as the party took “reasonable steps to preserve” ESI when it knew or should have known the information was discoverable. Expert testimony can aid a judge in determining whether reasonable steps were taken in light of the party’s specific

circumstances. The safe harbor also extends protection if the party’s failure occurred because information was lost during “routine, good-faith operation” of its ESI system.

Protect yourself

Discovery involving ESI can be thorny for any attorney, creating multiple opportunities to inadvertently fall short of obligations. To protect against costly sanctions — from fines to adverse jury instructions to default judgments — if you don’t fulfill the amendments’ electronic discovery requirements, enlist the support of a forensic expert during the discovery process. ■

Speculation not enough to determine damages

Reliable expert testimony is essential to prove damages claims in commercial litigation. A recent Florida appellate court case, *Susan Fixel, Inc. v. Rosenthal & Rosenthal*, illustrates dramatically how an expert’s mistakes can knock the legs out from under a claim.

Path to court

Fixel, which sold apparel, entered a manufacturing agreement with C&L Textiles. In doing so, Fixel relied on representations by Rosenthal & Rosenthal, with which Fixel had a business relationship, regarding C&L’s

solid financial condition. C&L eventually terminated the agreement, and Fixel ceased operations several months later. Fixel subsequently sued Rosenthal for, among other things, breach of fiduciary duty and negligent misrepresentation.

In court, Fixel’s expert based his damages calculation on future revenue and cash flow projections prepared by a principal of Fixel. The projections could not be supported independently for several reasons:

- They assumed Fixel would receive \$3 million from investors that was never received,
- Fixel was a startup, had never turned a profit, and carried costs that increased over time, and
- No comparable companies existed.

Fixel, however, asserted the speculative nature of the projections was irrelevant, because it sought not lost profits, but the market value of the destroyed business.

Court weighs in

The court disagreed, disallowing the testimony of Fixel’s damages expert and holding that the evidence failed to establish a viable damages claim. It found the use of purely speculative forecasts to determine the business’s market value just as inappropriate as it would be to determine lost profits.

The court also affirmed the exclusion of the damages expert because he relied on the incorrect date when determining market value. Instead of the date of the loss, he used a date almost a year earlier. The court ruled that this made his opinion “not relevant” and granted a directed verdict.



Communicating statistical evidence to jurors

Statistical evidence frequently plays a critical role in the courtroom, in cases ranging from antitrust and fraud to employee discrimination, and on both liability and damages. Yet, when not presented right, this type of evidence can cause jurors' eyes to glaze over with boredom, lack of comprehension or skepticism. It's essential, therefore, to engage an expert witness who understands how to use jurors' pre-existing tendencies to successfully relay statistical evidence to them.

Pre-existing hurdles

Statistics can be difficult to present, and not merely because many people are suspicious of numbers. Advertising, politicians and the media create skepticism about statistics in general. Often, jurors feel more comfortable relying on their own instincts or experiences to assess the likelihood of an event. Jurors tend to believe the popular interpretation of the principle known as Occam's Razor — that the best explanation for an occurrence is the simplest explanation — despite statistical evidence to the contrary.



The dynamics of a courtroom can pose obstacles, as well. Jurors typically place greater credence in evidence that supports their beliefs about the appropriate outcome, while discounting evidence that contradicts those beliefs. They also usually give more credit to studies and related

statistics that have been formulated independently of the case at hand, opposed to those conducted only for litigation purposes. And when experts present conflicting statistical evidence, jurors are likely to disregard both. In general, jurors hesitate to render decisions on liability based solely on statistical evidence.

Best practices

Qualified experts take several steps to overcome these obstacles. First, they ensure information is being communicated clearly — translating their field's numerical vocabulary into everyday English. They also simplify and condense multiple layers of statistical details into comprehensible bottom

lines — synthesizing, for example, reams of income and profit statements for dozens of product lines into a single, comprehensive summary.

Jurors have other needs as well. Perhaps foremost, they want to go home with peace of mind and a clean conscience regarding their final verdict. That generally means they prefer not to deny the claim of an injured plaintiff in the absence of another cause. Depending on which side they serve, experts use the statistics to support or eliminate alternative causation.

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Effective experts also act as advocates for statistics — building up the reliability of statistics in general, showing jurors how they can and do depend on statistics to help them with everyday decision-making. They accomplish this by providing examples of statistics and numbers commonly used in the jurors' worlds, such as sports statistics or weather predictions.

From there, experts build up the reliability of the party's statistics, illustrating how large or small a figure is in real life using points of reference to which jurors can easily relate. They then wield the same criteria used to fortify their own statistics to undermine the opposing party's statistics by showing how the latter fall short of meeting those criteria for reliability.

Making statistics talk

When selecting experts to testify on statistical evidence, look for more than impressive resumés. While good credentials are certainly important, effective court presentation requires someone whom jurors perceive as boasting real-world experience, rather than just theoretical knowledge, and who offers a proven ability to overcome hurdles to communicate with them. ■